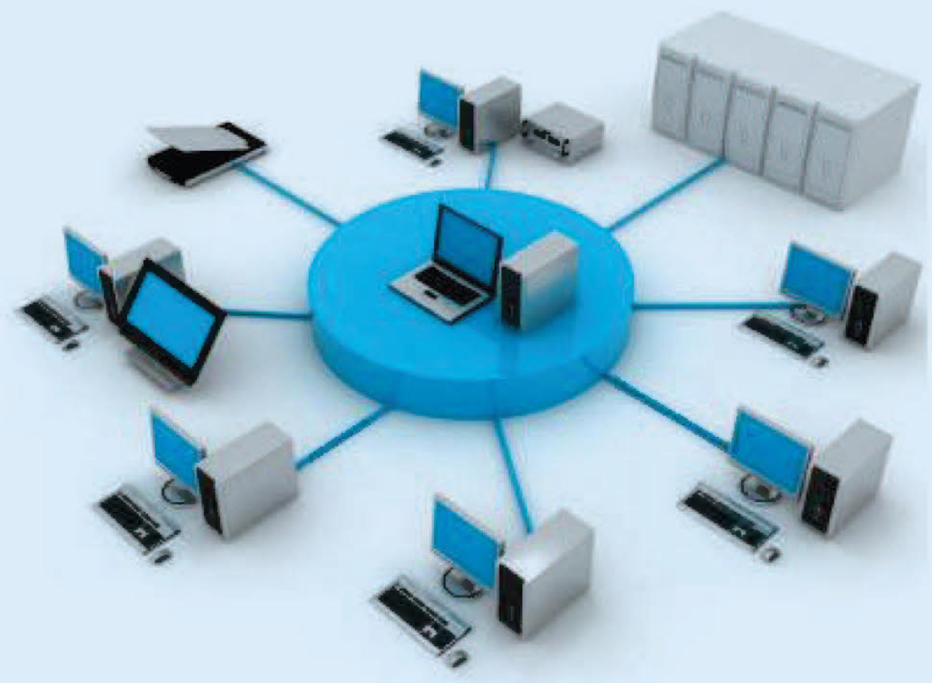

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Financial Management

Institute of Open and Distance Education

Faculty of Management

Financial Management

4BBA3

DR. C.V. RAMAN UNIVERSITY
Chhattisgarh, Bilaspur
A STATUTORY UNIVERSITY UNDER SECTION 2(F) OF THE UGC ACT

4BBA3

Financial Management

4BBA3, Financial Management

Edition: March 2024

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1 ABC of Accounting

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The Chapter Covers :

Learning Objectives:

After going through this chapter, you should be able to:

- Understand meaning, need and features of Accounting
- Explain Accounting Cycle
- Define objectives of Accounting
- Explain Accounting Information
- Elucidate advantages, limitations and branches of Accounting

NOTES

INTRODUCTION

A businessman carries out many transactions in his day-to-day activities. He may make a number of sales or purchases of a number of items during the year. All these transactions are needed to be recorded down lest the businessman may forget when a specific item was bought or sold. He may give out goods on credit to his customers and he may not remember all of them. Thus he must put down the transaction in a recorded form. That is why keeping of accounts in a business is important.

Accounting becomes mandatory when you run a business. It plays an important role in keeping your business organized especially financially and you become aware of each bit and byte of your business progress. This lets you know if your business is going upward or downward.

This chapter serves you an elementary information on what this means, why it is required and how it is done.

NEED FOR ACCOUNTING

Accounting is considered to be the language of business. Accounting is as old as money itself. However, the act of accounting was not as developed as it is today, because in the early stage of civilization, business was very small, simple and manageable by only one person i.e. the owner himself.

In the recent years large-scale productions, developed methods of production, cut-throat competition and changes in the technology have brought remarkable changes in the field of accounting. Profit calculation now is no longer a simple comparison of financial values at the beginning and end of a transaction or a series of transactions.

It is very important for any person or a firm to spend money carefully .There are certain sources from which the firm receives money like sales of goods and interest from banks and in turn it has to spend money on payments, maintenance of the firm etc. It has to be seen that affairs are managed in such a way that the firm should earn more than it spends .If the expenses are more than a firm's income, it will have to meet its expenses from the amount invested in the firm by the owner. i.e. capital.

Suppose the owner invests Rs. 10, 00,000 in the firm. He purchases 100 units of goods at the rate of Rs 10,000 per unit and he sells them for Rs. 9,500 per unit. This loss of Rs. 500 per unit which for 100 units becomes Rs. 50,000 will have to be met from the owner's capital. Owing to this loss the owner's capital will be reduced to Rs. 9,50,000. If this loss is incurred repetitively, a time will come when the firm will become insolvent. Insolvency is the condition when the firm does not have enough funds to meet its liabilities.

Therefore, a firm has to manage its affairs in such a way that it sells the goods for Rs. 10,500 per unit, thus incurring a profit of Rs. 50,000 which further increases the owner's capital to 10,50,000. Thus, it can be said that a profit increases the firm's capital and a loss reduces it.

If the proprietor of the firm is wise he will try to sell the goods at such a price as will enable the firm to not only meet all expenses from the profit but also keep some profit for development and expansion of business. Attempts should be made to keep expenses low and the sales should be kept sufficiently high so that expenses including maintenance of the firm are paid from the profit and the owner's capital remains invested and increase if possible.

Thus, every firm or institution should be very careful and vigilant about its financial position. The firm, at the end of each year, ascertains its earnings and financial position in teams of capital invested and assets of the business firm.

For providing such information, accounting came into existence. It provides information on earnings, expenses, assets, liabilities, debts etc.

MEANING OF ACCOUNTING

Every person, businessman or otherwise, concerned with money matters cannot fully rely upon his memory. The amount, volume and the duration of such money matters make it necessary to create a record of the different transaction during a period. A businessmen need such record for two purpose :-

1. ascertaining the working results of his business;
2. the increase in his net assets.

These purposes can be served by a systematic record of all monetary transactions, relating to his business. For other person also a record of the financial matters is necessary to quantity, the surplus of income over expenditure and of assets over liabilities. This systematic record is accounting.

Accounting is a process-oriented task that follows a prescribed series of steps in order to keep track of, and record, the balances of the various accounts. Accounting is the method in which financial information is gathered, processed, and summarized into financial statements and reports.

When a business makes a transaction, the effect of that transaction is recorded in the accounting system. Accounting is the process of keeping track of the changes, which are brought out by the new transactions, recording and then reporting them.

ACCOUNTING : a detailed report of the financial state or transactions of a firm.

The theory and system of setting up, maintaining, and auditing the books of a firm; art of analyzing the financial position and operating results of a business house from a study of its sales, purchases, overhead, etc. is accounting.

It is not easy to provide a concise definition of accounting since the word has a broad application within businesses and applications.

It is said that accounting is the language of the business, So in order to understand the affairs of a firm financial statements should be very accurate.

In the words of the committee on terminology of the American Institute of Certified Public Accountants:

"Accounting is the art of recording, classifying and summarising in terms of money transactions and events of financial character and interpreting the result thereof."

—AICPA Committee

Definition of Accounting

➪ "Nearly every business enterprise has accounting system. It is a means of collection summarising, analysing and reporting in monetary terms, and of informations about business." — ***R.N. Anthony***

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➪ "Accounting is the science of recording and classifying business transactions and events, primarily of a financial character and the art of making significant summaries, analysis and interpretation of these transactions and events and communicating the results to persons who must make decisions or firm judgement."

— ***Smith and Ashburne***

➪ "Accounting is a disciline which provides financial and other information essential to efficient conduct and evaluation of the activities of any organisations."

— ***American Institute of Certified Public Accountants***

FEATURES OF ACCOUNTING

1. ...***Accounting is the art...***: Accounting records transactions according to the size and nature of business and the type of transaction, thus it enables us to achieve the financial result by showing the best way of recording, classifying and summarizsing the business transactions .Thus, accounting is an art.
2. ***It is the art of recording***: Accounting is an art of recording business transactions in the books of account in a systematic manner soon after their occurrence.
3. ***It is the art of classifying***: it is the process of grouping transactions or entries of one nature at one place. Similar transactions relating to a particular account for a given period are brought together.
4. ***Summarising business transactions***: It is the art of making the activities of the business as classified in the ledger understandable and useful to management and other interested parties.
5. ***It records events of financial character***: Events which are of financial character will be recorded in terms of money. If a transaction has no financial character then it can not be measured in terms of money and will not be recorded.
6. ***It records transactions in terms of money***: In order to make the transactions more meaningful they are expressed in terms of money. For example: if the business has 15 machines, 5 buildings etc., it is not possible to add them and use them for comparison or any other purpose unless they are expressed in terms of money.
7. ***...and interpreting the result thereof...***: accounting creates data through recording, classifying and summarising events and then utilises the information for interpreting. The information so provided helps the management to judge performance of the business and for future planning. The result is then communicated to all the interested parties.

ACCOUNTING CYCLE OR PROCESS

The sequence of activities beginning with the occurrence of a transaction is known as the Accounting cycle or Accounting Process.

Steps in the Accounting cycle

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Identify the transaction Identify the event as a transaction and generate the source document
↓
Post to journal The transactions are first entered into the journals
↓
Post to ledger The journal entries are transferred to the appropriate accounts in the ledger
↓
Adjusting Entries Adjusting Entries are made for accrued and deferred items. The entries are journalized and posted to T accounts in the ledger
↓
Adjusted Trial Balance A new Trial Balance is constructed after making the adjusting entries
↓
Financial Statements Financial Statements are prepared.
↓
Closing Entries Transfer the balance of the temporary accounts to the owner's accounts.
↓
Analysis & interpretation of the financial results.

ACCOUNTING PROCESS

- Every accounting entry is based on a business transaction, which is usually evidenced by a business document, such as a check or a sales invoice.
- A *journal* is a book to record the transactions of a business. The typical journals used to record the chronological day-to-day transactions are sales and cash receipts journals and a cash disbursement journal. A general journal is used to record special entries at the end of an accounting period.
- While a journal records transactions as they happen, a ledger groups records of transactions according to their type, based on the accounts they affect. The general ledger is a collection of all balance sheets, income, and expense accounts used to keep a business's accounting records. At the end of an accounting period, all journal entries are summarized and transferred to the general ledger accounts. This procedure is called "*posting*."
- A trial balance is prepared at the end of an accounting period by adding up all the account balances in general ledger. The sum of the debit balances should equal the sum of the credit balances. If total debits don't equal total credits, it respects error in process.
- Finally, financial statements are prepared from the information in trial balance.

Accounting records are important because the resulting financial statements and reports help in planning and making decisions. They may be used by some third

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parties (bankers, investors, or creditors) and are needed to provide information to government agencies, such as the Income Tax Department.

OBJECTIVES OF ACCOUNTING

The following are the main objectives of accounting:

1. **Maintaining Systematic Business Records**. Accounting enables business firms to maintain systematic records of all financial transactions. It includes proper recording of transactions, classifying them under appropriate accounts and summarising them into financial statements.
2. **Depiction of Financial position**. Maintenance of proper records is necessary to show firm's possessions and the amount the firm owes to others at the end of a particular period. A businessman would be interested in knowing at periodical intervals the net result of business operations i.e. how much profit or loss has been incurred.

   Such information is useful for the management, lenders, investors etc. The management can know whether the policies adopted by it were fruitful or not, lenders can know whether the firm is likely to earn profits in future or not. Investors can decide on this basis whether they should keep their money invested in the firm.
3. **Availability of information to interested parties.** Apart from proprietors and owners various other parties are interested in the accounting information. These are creditors, tax authorities, potential customers, employees, etc. They want to assess the profitability and the financial soundness of the firm. They get this information from the annual reports and financial statements.
4. **Ascertainment of working results.** The working of business ultimately results into profit or loss. To measure the real working performance of an enterprise, profit and loss account must be prepared which help in ascertaining the current costs and current revenues during a particular accounting period. A systematic record of incomes and expenses facilitates the preparation of the income statements that reveals working results of the firm.
5. **Meeting legal requirements.** Yet another objective of accounting is to devise such a system as will meet the legal requirements. Accounting system aims at fulfilling the requirement of law.

Subsidiary Objectives of Accounting

Accounting systems are designed mainly to provide information that managers and outsiders can use in decision making. Some of its subsidiary objects are as follows :

(1) Accounting also server other purposes like producing operating documents, protecting the company's assets, to provide data for company tax returns, and, in some cases, providing the basis for reimbursement of costs by clients or customers.

(2) The Accounting organization is responsible for preparing documents that contain instructions for a variety of tasks, such as payment of customer bills or preparing employee payrolls. It also must prepare documents that serve

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what might be called private information purposes, such as the employees' own records of their salaries and wages.

(3) Accounting systems must provide means of reducing the chance of losses of assets due to carelessness or dishonesty on the part of employees, suppliers, and customers. Asset protection devices are often very simple; for example, many restaurants use numbered meal checks so that waiters will not be able to submit one check to the customer and another, with a lower total, to the cashier.

(4) The accounting system must also provide data for use in the completion of the company's tax returns.

(5) Accounting systems in some companies must provide cost data in the forms required for submission to customers who have agreed to reimburse the companies for the costs they have incurred on the customers' behalf.

(6) Making decision concerning the use of limited resources including identification of crucial decision areas and determination of objectives & goals.

(7) Effectively directing the controlling of an organisation's human and material resources.

(8) Maintaining and reporting on the custodianship of resources.

ACCOUNTING INFORMATION

Accounting is the theory and system of setting up, maintaining, and auditing the books of a firm; an art of analyzing the financial position and operating results of a business house from a study of its sales, purchases, overhead, etc. and the systematic development and analysis of information about the economic affairs of an organization. This information may be used in a number of ways:- by the organization's managers to help them plan and control the organization's operations; by owners and legislative or regulatory bodies to help them appraise the organization's performance and make decisions as to its future; by owners, lenders, suppliers, employees and others to help them decide how much time or money to devote to the organization; by governmental bodies to determine how much tax the organization must pay; and occasionally by customers to determine the price to be paid when contracts call for cost-based payments.

Accounting provides information for all these purposes through the maintenance of files of data, analysis and interpretation of these data, and the preparation of various kinds of reports. Most accounting information is historical that is, the accountant observes the things that the organization does, records their effects, and prepares reports summarizing what have been recorded; the rest consists of forecasts and plans for current and future periods.

Accounting information can be developed for any kind of organization, not just for privately owned, profit-seeking businesses.

Financial reporting should provide information that is:

- *useful to enable potential investors,creditors and other users to make rational investment, credit, and other financial decisions.*
- *helpful to enable potential investors, creditors and other users to assess the amounts, timing, and uncertainty of prospective cash receipts.*

- *about economic resources, the claims to those resources, and the changes in them.*

The accounting information expected by its users is provided through financial statements.

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There are two main purposes of financial statements:

(1) **Information relating to profit.**

(2) **Information relating to financial position.**

1. **Information relating to profit**. Information about the profit earned or loss incurred as a result of operations during an accounting period is made available to the interested users. The income statement provides information about Gross Profit through Trading Account and about Profit through Profit and Loss Account. Gross Profit is the amount of difference between the sales revenue or the proceeds of goods sold and/or services rendered less the direct cost of goods sold and/or services rendered.

   The Excise and the Sales Tax Department compute the taxes due to them on the basis of Trading Account.

   Net Profit is the profit earned after allowing for all the expenses. In case the expenses are more than the revenue, it is net loss. A financial statement informs about the profit or loss suffered during an accounting period.

2. **Information relating to Financial Position**. It makes available the information about the financial wellbeing of the firm. The Position Statement provides the information about the assets owned by the firm, amounts receivable and the cash and bank balance held by it. The information along with the Income Statement after further analysis helps the owner in determining the security of their investment. Similarly investors, lenders and creditors decide about investment, lending and making the credit available from this information.

ADVANTAGES OF ACCOUNTING

The advantages of accounting can be enumerated as follows:

1. *Maintenance of business records*. All financial transactions are recorded in a systematic manner inbooks of accounts. It is not possible to remember all the daily operations of business. The records provide the necessary information as and when required.
2. *Preparation of financial statements*. Records enable the preparation of financial statements to calculate profit or loss during a particular period and that of balance sheet to state the financial position of the business on a particular date.
3. *Assessment of results*. Profit of one year is compared with those of earlier years to know the significant facts about the changes.
4. *Decision making*. Management is faced at times with a number of problems requiring an appropriate decision. For making such decisions, only accounting can provide the relevant information.
5. *Evidence in courts*. Records of business transactions are treated as satisfactory evidence in the courts of law.

6. *Planning and controlling operations*. Planning of operations like sales, production, cash requirements for next accounting periods is achieved. Management is also interested in observing that the operations in the business are going on according to plan and all departments are spending within the specified limit.

7. *Provides information to interested groups*. Parties like owners, creditors, management, employees, government, consumers and creditors are interested in accounting information related to sales, profits, production, etc.

8. *Taxation problems*. In settlement of taxation matters, systematic records are of great help.

9. *Valuation of business*. Accounting records kept in a proper way enable a business unit to determine the purchase or sale price.

10. *Assistance to an Insolvent person*. An insolvent person is able to explain the past transactions if proper records are maintained.

Attributes of Accounting Information

- **Relevant**: relevant information makes a difference in a decision. It also helps users make predictions about past, present and future events (it has predictive value). Relevant information helps users confirm or correct prior expectations (it has feedback value). It must also be available on time, that is before decisions are made.

- **Reliable**: reliable information is verifiable (when independent auditors using the same methods get similar results), neutral (free from bias), and demonstrate representational faithfulness (what really happened or existed).

- **Comparable**: information must be measured and reported in a similar manner for different enterprises (allows financial statements to be compared between different companies).

- **Consistent**: the same accounting methods should be applied from period to period and all changes in methods should be well explained and justified.

- **Understandability**: information must be presented in such a simple and logical manner that a person who has no knowledge of accounting can also understand it. This can be done by giving relevant explanatory notes to explain the information given in financial statements.

LIMITATION OF ACCOUNTING

The limitations of accounting may include :

(1) Omission of Qualitative Information : Accounts contain only the information which can be expressed in terms of money and thus non-monetary items are ignored. For example, changes in management, reputation of business, efficiency of management, satisfaction of firm's customer etc. cannot be recorded.

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(2) **Based on Historical Costs :** Accounts are prepared on the basis of historical (original) cost and thus the figures given in financial statements do not show the effect of changes in price level.

(3) **Influenced by Personal Judgements :** Accounting is not an exact science and an accountant has to exercise his personal judgement in respect of various items, for example, selection of method of depreciation, valuation of stock, provision for doubtful debts etc. Hence, the figure of profit cannot be taken as an exact figure.

(4) **Unrealistic :** Accounting information may not be realistic as accounting statments are prepared by following basic concepts and conventions, these are flexible in nature.

ACCOUNTING AS AN INFORMATION SYSTEM

Accounting provides useful information about the activities of an entity to various users for their use in making informed judgements and decisions. These users use accounting information in order to satisfy some of their varied needs for information.

Following are some of the users :

USERS

Internal	**External**
• Owner	• Investors
• Management	• Creditors
• Employees	• Lenders
	• Consumers
	• Researchers
	• Government & Regulatory Agencies

1. **Owners :** Owners expect reasonable return on their funds and safety of their investment. Thus, they want to know about profitability and financial soundness of the business. They find out the profits/losses, costs of fixed and floating assets etc. from financial statements.

2. **Management :** Management needs to decide continuously what to do, how to do it and whether the actual results tally the original plans and targets. Accounting provides timely and useful information to management for planning, control, performance measurement, decision-making and for performing functions in the company. The accounting information provides "eyes and ears to the management".

3. **Employees :** Employees and their representative groups are interested in information about the stability and profitability of the employers. They are also interested in information which enables them to assess the ability of the enterprise to pay remuneration, retirement benefits and to provide employment opportunities.

4. **Investors :** Investors have invested their wealth in a business enterprise, so they are interested in knowing periodically about the profitability of the

enterprise, soundness of their investment and growth prospects of the enterprise. They need information to judge the future prospects of their investment and to determine whether they sould buy, hold or sell the shares.

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5. **Creditors, Bankers and the Other Lending Institutions :** They want to be sure that the concern will not experience any difficulty in making their payment in time. It can be decided by calculating current and liquidity rations and ascertaining short term solvency.

6. **Consumers :** Consumers want accounting information for finding out the possibility of reduction of cost and in return reduction in selling price. They use data in estimating the value of a warranty or in predicting the availability of the supporting services and supply of goods.

7. **Government and Regulatory Agencies :** Government and other agencies are interested in the allocation of resources and therefore the activities of enterprise. They also require information in order to regulate the activities of enterprise and to determine taxation policies and on the basis of these the national income and similar statistics.

BRANCHES OF ACCOUNTING

The main branches of accounting are :

* **Financial Accounting**
* **Social Responsibility Accounting**
* **Cost Accounting**
* **Tax Accounting**
* **Management Accounting**
* **Human Reaource Accounting**

With increases in the scale of business operations and social awareness, management requires various types of information to perform its functions more efficiently. To meet the increasing requirement of management, various specialised branches of accounting have come into existence such as financial accounting, cost accounting, tax accounting etc. These branches are explained as under :

Financial Accounting : The accounting system that is concerned only with the financial state of affairs is called Financial Accounting. It includes ascertainment of profit earned or loss incurred and position of the business at the end of the accounting period. It also provides financial information required by the management and other parties interested in them.

Cost Accounting : The field of accounting that measures, classifies, and records costs. It is a systematic procedure for determining the unit cost of output produced or services rendered. The primary functions of cost accounting are ascertaining cost of a product and helping the management in the control of cost. Cost Accounting is that branch of accounting which deals with the classification, recording, allocation, summarization and reporting of current and prospective cost. A cost accountant, for example, might be required to establish

Check Your Progress

1. Define Accounting?
2. What is Accounting Cycle?
3. What do you mean by a journal?

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a system for identifying and segmenting various production costs so as to assist a firm's management in making prudent operating decisions.

Management Accounting : Management accounting is the term used to describe the accounting methods, systems and techniques which, coupled with special knowledge and ability, assist management in its task of maximizing profit or minimising losses. Management accounting is the blend of financial accounting, cost accounting and all aspects of financial management.

Tax Accounting : The branch of accounting which is used for tax purpose is called Tax Accounting. Income tax and Sales tax are computed and recorded under this head of accounting.

Social Responsibility Accounting : Social responsibility accounting is the process of identifying, measuring and communicating the contribution of a business to the society. The contribution of a business to the society consists of providing employoment to underprivileged, providing financial and man power support to public programmers, environmental contribution, product safety, product durability, customer satisfaction etc. For example, Nokia company changed BL5C batteries free for various mobile sets for safety of its customers.

Human Resource Accounting : It is a method of putting a value on human resources of business as a vital asset and showing it as part of or along with financial statements. However, there is no agreed and generally accepted methodology available so far.

BOOK- KEEPING Vs ACCOUNTING

Basis of Difference	Book-Keeping	Accounting
1. Definition	Book-keeping is an art of recording in books of accounts the monetary aspects of commercial or financial transactions.	Accounting is the art of recording, classifying and summarizing in terms of money transactions and events of financial character and interpreting the result there of.
2. Posting	Making posting in the ledger.	Examining the posting in order to ensure accuracy.
3. Nature of work	It is clerical.	It is analytical and needs skill.
4. Scope of work	It is limited up to an extent.	It is quite wide and involves preparation of final accounts and their analysis.
5. Dependence	It is an independent work.	It is dependent on Book-keeping.
6. Special knowledge	It does not require very high skill and knowledge.	It requires special skills and knowledge.
7. Status	Usually by junior employee.	Usually by senior officer.

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8. Time of transaction	Made on the same day of transaction.	Done at the end of financial or calendar year.
9. Liability	Book-keeper is not liable for accountancy work.	Accountant is liable for work of book-keeper.
10. Adjustments & Rectification of error	Adjustment & rectification of errors are not part of Book-keeping.	Adjustment & rectification of errors are necessary for complete accounting.
11. Total and balance	It includes ledger total and its balancing.	Create Trial balance from ledger balances.
12. Trading, P&L a/c & Balance-sheet	Do not include Financial statements.	Incomplete without Trading, P&L a/c and Balance-sheet

IMPORTANT TERMS

1. ***Business***. Any trade, manufacture or some work of enterprise which is meant to earn profit.
2. ***Transaction.*** The act of exchanging goods/services for a valuable consideration.
3. ***Goods.*** These are the commodities which are dealt in business transactions. They may be raw material, manufactured goods or services.
4. ***Discount.*** Discount is the amount deduction allowed by a businessman to increase the sale of a product. Discount is of two types :
   (a) Trade discount – The discount allowed by a seller to its customers at a fixed percentage on the listed price of goods is termed as Trade discount.
   (b) Cash discount – This discount is allowed to the debtors for making prompt payment within a fixed period
5. ***Bad debts.*** Person to whom goods have been sold on credit are known as 'Debtors'. Sometimes due to dishonesty, death or insolvency of a debtor, full or partial amount can not be recovered which is known as 'Bad debts'.
6. ***Liability.*** Those items that the concern business owes to the outside world are known as liability. Liabilities are debts and are amount owned to creditors. It can be expressed as :

   Liabilities = Assets – Capital

   Examples of liabilities are Loans, Creditors, Bills payable, Debentures etc. Liabilities may be classified into two parts :
   (i) Long-term/fixed liabilities – These refer to those liabilities which are due for payment in a relatively long period (normally after more than one year). For example : Debentures, Long term, loans etc.
   (ii) Current Liabilities – These refer to those liabilities which are to be paid in near future (normally within one year). For example : Bills payable, Creditors, Bank Overdrafts, Outstanding expenses & short term loans etc.
7. ***Assets.*** Any thing which is in the possession or is the property of business enterprise including the amount due to it from others, is called an asset. In other words, anything which will enable a business enterprise to get cash or a benefit

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in future is an asset. For exemple : Building, Land, Furniture, Debtors, Goodwill etc. Assets can be classified in following category :

(a) Fixed Asset : The assets which are purchased for long-term use in business or production are known as fixed assets. Generally, such assets are not purchased for the purpose of sale. Such assets are not valued at market price. Example-Machinery, Land, Furniture etc.

(b) Floating/Current/Active Assets : Those assets which are meant for sale or which the management want to convert in cash within one year. Such assets are Debtors, Stock, Bill receivable etc.

(c) Wasting Assets : Those assets which are consumed through being worked or used, such as mines. As soon as all the minerals have been extracted the mine becomes valueless. Other examples are Oil-wells, Patents, Trademarks, Leasehold properties etc.

(d) Nominal or Fictitious Asset : The assets which are not material assets and carries no market value but are mentioned in the assets side of balance-sheet are known as fictitious assets. Examples- Goodwill, Prepaid expenses etc.

8. ***Debtors***. A person who owes money to the firm generally on account of credit sales of goods is called a debtor. A debtor pays the price of goods he purchases in future. He is called a debtor because he owes the money to the firm.
9. ***Stock***. The term 'stock' includes goods lying unsold on a particular date. To ascertain the value of closing stock, it is necessary to make a complete list of all the items in the store together with quantities. The stock may be opening and closing stock. The term 'opening stock' means goods lying unsold in the beginning of the accounting year whereas the term 'closing stock' includes goods lying unsold at the end of the accounting year.
10. ***Receivables***. The amount that is receivable by the firm, other than the amount due from the debtors.
11. ***Creditors***. A person to whom the firm qwes money is called a creditor.
12. ***Payables***. The term payables is used for the amount payable by the firm, other than the amount due to creditors.
13. ***Losses***. Loss means something against which the firm receives no benefit like theft.
14. ***Proprietor***. The person who makes the investment and bears all the risks connected with the business is called the proprietor.
15. ***Drawings***. It is the amount of money or the value of goods which the proprietor takes for his domestic or personal use.
16. ***Revenue***. Revenue means the amount which, as a result of operations, is added to the capital. Revenue is an inflow of assets which results in an increase in the owner's equity.
17. ***Expense***. It is the cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period.

Check Your Progress

4. Why Accounting records are important?
5. What are main purposes of financial statements?

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18. ***Income.*** Income is the profit earned during a period of time. In other words the difference between revenue and expense is called income.
19. ***Gain.*** It is the term used to describe profit of an irregular nature, for example capital gains.
20. ***Purchases.*** The amount of goods purchased by a business for selling purposes or sale or consumption is called purchases. Purchases may be on cash or credit basis. In the latter case the payment is made at a future date.
21. ***Sales.*** These are goods sold out by the business. Sales may be cash sales or credit sales. In the latter case, the customers do not pay cash immediately but promise to pay in future.
22. ***Gross Profit.*** It is the difference between the sales revenue or the proceeds of goods sold and/or services rendered over its direct cost.
23. ***Net Profit.*** It is the profit made after allowing for all expenses. In case, expenses are more than the revenue, it is net loss.
24. ***Cost of goods sold.*** It is the direct costs of the goods or services sold.
25. ***Equity:*** The net worth of your company. Also called owner's equity or capital. Equity comes from investment in the business by the owners, plus accumulated net profits of the business that have not been paid out to the owners.
26. **Capital :** The resources of a business entity funded by the proprietors are known as capital.

CASE STUDY:

Q)1. The following figure relate to the business of X for the year 2011

	Rs.
Opening stock	5,000
Purchases	35,000
Direct expenses	2,000
Closing stock	10,000

Calculate cost of goods sold.

Q)2. The following figures are available relating to the business of Shyam for the year 2011

	Rs.
Opening stock	30,000
Purchases	80,000
Direct expenses	3,000
Closing stock	20,000
Sales	1,25,000

Calculate cost of goods sold and gross profit.

SUMMARY

- Accounting is the backbone of the business in financial world.
- It is very important for any person or a firm to spend money carefully .There are certain sources from which the firm receives money like sales of goods and interest from banks and in turn it has to spend money on payments, maintenance of the firm etc.

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- Attempts should be made to keep expenses low and the sales should be kept sufficiently high, so that expenses including maintenance of the firm are paid from the profit and the owner's capital remains invested.
- Accounting is a process-oriented task that follows a prescribed series of steps in order to keep track of and record the changes which are brought out by the new transactions.
- "Accounting is the art of recording, classifying and summarizing in terms of money transactions and events of financial character and interpreting the result thereof."
- Accounting is an art of recording business transactions in the books of account in a systematic manner soon after their occurrence.
- It is the process of grouping transactions or entries of one nature at one place.
- It is the art of making the activities of the business classified in the ledger so that it is understandable and useful to management and other interested parties.
- Events which are of financial character will be recorded in terms of money.
- In order to make the transactions more meaningful they are expressed in terms of money.
- The sequence of activities beginning with the occurence of a transaction is known as the Accounting Cycle or Accounting Process.
- Every accounting entry is based on a business transaction, which is usually evidenced by a business document, such as a check or a sales invoice.
- A journal is a book to record the transactions of a business.
- The general ledger is a collection of all balance sheets, income, and expense accounts used to keep accounting records of a business.
- Accounting records are important because the resulting financial statements and reports help in planning and making decisions. They may be used by some third parties (bankers, investors, or creditors) and are needed to provide information to government agencies, such as the Income Tax Department.
- Accounting enables business firms to maintain systematic records of all financial transactions.
- A businessman would be interested in knowing at periodical intervals the net result of business operations i.e. how much profit or loss has been incurred.
- Accounting is the theory and system of setting up, maintaining, and auditing the books of a firm; an art of analyzing the financial position and operating results of a business house from a study of its sales, purchases, overheads, etc.
- Accounting provides information for various purposes through the maintenance of files of data, analysis and interpretation of these data, and the preparation of various kinds of reports.
- Financial reporting should provide information about economic resources, the claims to those resources, and the changes their in.
- The income statement provides information about Gross Profit through Trading Account and about Net Profit through Profit and Loss Account. Gross Profit is the amount of difference between the sales revenue or the

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proceeds of goods sold and/or services rendered less the direct cost of goods sold and/or services rendered.

- Net Profit is the profit earned after allowing for all the expenses.
- It makes available the information about the financial wellbeing of the firm. The Position Statement provides the information about the assets owned by the firm, amounts receivable and the cash and bank balance held by it.
- The accounting organization is responsible for preparing documents that contain instructions for a variety of tasks, such as payment of customer bills or preparing employee payrolls.
- The accounting system must also provide data for use in the completion of the company's tax returns and fullfilment of other obligations.
- All financial transactions are recorded in a systematic manner in books of accounts.
- Profit of one year is compared with those of earlier years to know the significant facts about the changes.
- Records of business transactions are treated as satisfactory evidence in the courts of law.
- Planning of operations like sales, production, cash requirements for future accounting periods is achieved. Management is also interested in observing that the operations in the business are going on according to plan and all departments are spending within the specified limits.
- Accounting records kept in a proper way enable a business unit to determine the purchase or sale price.
- Reliable information is verifiable (when independent auditors using the same methods get similar results), neutral (free from bias), and demonstrate representational faithfulness (what really happenened or existed).
- The accounting system that is concerned only with the financial state of affairs is called Financial Accounting.
- Cost Accounting is that branch of accounting which deals with the classification, recording, allocation, summarization and reporting of current and prospective cost.
- Management accounting is the blend of financial accounting, cost accounting and all aspects of financial management.
- Book-Keeping is the work or skill of keeping account books or systematic recording of money transactions.

ANSWERS TO 'CHECK YOUR PROGRESS'

1 Nearly every business enterprise has accounting system. It is a means of collection summarising, analysing and reporting in monetary terms, and of informations about business.
2. The sequence of activities beginning with the occurrence of a transaction is known as the Accounting cycle or Accounting Process.
3. A journal is a book to record the transactions of a business. The typical journals used to record the chronological day-to-day transactions are sales and cash receipts journals and a cash disbursement journal.
4. Accounting records are important because the resulting financial statements and reports help in planning and making decisions.
5. There are two main purposes of financial statements: (1) Information relating to profit. (2) Information relating to financial position.

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TEST YOURSELF

1. What is Accounting Cycle or Process ?
2. Explain in brief the meaning of Book Keeping.
3. What is Cost Accounting ?
4. What is Management Accounting ?
5. What is the difference between Book Keeping and Accounting ?
6. Define accounting and elaborate its characteristics.
7. Classify different types of accounting.
8. What is Financial Accounting ? What are its advantages and limitations ?
9. How accounting works as information system ? who are the different users of accounting information ?

FURTHER READINGS

- Accounting for Managers: Sharma and Gupta
- Management Accounting: Mr. Agrawal
- Fundamentals Accounting: Jain, Khandelwal, Pareek

2 Accounting Concepts

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The Chapter Covers :

Learning Objectives:

After going through this chapter, you should be able to:

- Understand accounting principles, concepts and conventions
- Explain accounting standards
- Elucidate accounting equation
- Learn rules of debit and credit
- Understand mechanic of accounts

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INTRODUCTION

Accounting statements disclose the profitability and solvency of the business to various parties. Thus, it is necessary that these statements should be prepared as per some standard language and set rules. These rules are usually called 'Generally Accepted Accounting Principles (GAAP)'. These principles have been generally accepted by accountants all over the world as general guidelines for preparing the accounting statements of course, the principles are not static and are, bound to change with the passage of time in response to the changing needs of the business.

This chapter explains different accounting concepts and conventions. Generally accepeted principles of accounting have also been elaborated with a view to provide entire framework of accounting at one place. The fundamental rules for entering business transaction into books of accounts have along with accounting equation to enable students know how different transactions affect the financial statements.

ACCOUNTING PRINCIPLES

Since various parties use the financial statements of the business, it becomes necessary to have a uniform and generally accepted approach to record and report the business transactions else the accountents may choose their non approach which would limitise the value and importance of such statements. Moreover, flaxibility and freedom in selecting ones own approach would make these statement uncorporatble and difficult to understand. Hence, a need of standardised language that gives similar understanding of accounting records arises. The accounting bodies, authors in accounting and pructitioners have therefore, developed over a period of time certain generally accepted accounting principles. These principles are not static and are bound to change in response to the needs of business and society. Since there principles and based on general acceptance from their users, they are alternatively called as concepts, convertions and postulates.

Definitions : The Canadian Institute of chartered accountants have defined accounting principles as the body of doctrives commonly awociated with the theory and procedure of accounting saving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternative exist. Rules governing the tomation of accounting axioms and the principles derived from them have arisen from common experience, historical precedent, statements by individuals and professional bodies and regulations of governmental agencies.

1. They are man-made, so they do not have the authoritativeness as universal principles.
2. They are the result of experience, business practices and customs, ideas and beliefs of users of financial statements, government agencies, etc.
3. They are not static in nature and keep an changing with changing needs of business.

4. The general acceptance of an accounting principle usually depends on three criteria, objectivity, feasibility and relevance.

Accounting principles are grouped into :

1. Accounting Concepts (Postulates)
2. Accounting Conventions

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ACCOUNTING PRINCIPLES

Accounting Concepts	Accounting Conventions
1. Business Entity	1. Full Disclosure
2. Dual Aspect	2. Materiality
3. Going concern	3. Consistency
4. Accounting Period	4. Conservatism/Prudence
5. Money measurement	
6. Cost	
7. Revenue	
8. Matching	
9. Verifiable objective evidence	
10. Realization	
11. Accual	

ACCOUNTING CONCEPTS

The term 'concept' is used to cannote the accounting postulates. In other words concepts refers to necessary assumptions which are fundamental to accounting practice. To make the accounting language convey the same meaning to all people and to make it meaningful there are a number of concepts which are followed in the preparation of financial statements. These concepts are not specifically stated because their use and acceptance are usually assumed.

(1) Business Entity Concept / Business Entity Assumption

According to this concept, the business is an entity that is separate and distinct from its owners, hence the funds of the firm are not mixed with the funds of the owners. All the transactions of the business are recorded in the books of the business from the point of view of the business. When the proprietor invests money in the business, it is deemed that the proprietor has given money and the business has received money. Revenues and expenses are kept separate from personal expenses. This applies for all forms of business like partnership sole proprietorship and corporate.

(2) Dual Aspect Concept / Duality principle

It is the basis or foundation of accounting. According to this principle, every transaction has a dual aspect, i.e. two-fold effect. Every receiver is also a giver and every giver is also a receiver. For Example, Mr. X purchases machinery for a cash of Rs. 25,000, he receives machinery on one hand and pays Rs. 25,000 cash on the other. Thus, two-fold effect as increase in one asset i.e., machinery and decrease in other asset i.e., cash. Thus, receiving and giving are the two aspects of every business transaction.

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(3) Going Concern Concept / Going Concern Assumption

It holds that the business is going to be operated for the foreseeable future. It is assumed that business will exist for an indefinite period of time and therefore transactions are recorded from that point of view. This validates the methods of asset capitalization, depreciation, and amortization. Only when liquidation is certain this assumption will not be applicable. A firm is said to be a going concern when there is neither the intention nor the necessity to wind up its affairs. In other words, it would continue to operate at its present scale in near future.

(4) Accounting Period Concept / Accounting Period Assumption

Life of the business is assumed to be indefinite, if the proprietor has to take any corrective measure he will have to wait till the time of liquidation but by that time it will be too late and the resources will remain underutilized. Therefore accountants choose some shorter and convenient time for the measurement of income. A period of twelve months, which is called accounting period, is normally adopted for this purpose.

The net income of a business can be measured by comparing the assets of the business existing at the begining of accounting period with those existing at the end of the same.

(5) Money Measurement Concept / Money Measurement Assumption

Only those transactions and events are recorded in accounting which can be expressed in terms of money. It omits to record those transactions which can not be measured in terms of money no matter how much they affect the earning capacity of the business. This explains the need of expressing every transaction in monetary terms.

The second limitation is that it does not consider changes in purchasing power of money. Due to quick changes in the purchasing power of money, the financial statements may present misleading results of the business.

(6) Cost Concept / Historical Cost Principle

The underlying idea of cost concept is that all assets should be recorded at the price paid to acquire it-that is, at cost. This cost is the basis for all subsequent accounting for the asset. The assets recorded at cost price at the time of purchase are systematically reduced by the process called depreciation. These assets disappear from the balance sheet when their economic life is over.

It states that the benefit of providing the financial information should also be weighed against the cost of providing it.

(7) Revenue Concept / Principle of Revenue Recognition

The revenue principle holds that revenue is realized when everything that is necessary to earn the revenue has been completed i.e., revenue is considered to have been realized.

This assumption recognizes the assets, liabilities, incomes and expenses as and when transactions relating to it are entered into. This assumption makes available the information as to what amount he owes to the outsiders (liabilities) or how much he owns (assets).Besides this it also informs about profit earned or loss suffered.

(8) Matching Concept / The Matching Principle

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It matches revenues and expenses in the period earned and incurred. It provides the guidelines as to how the expense be matched with revenue. For matching expenses with revenue, first revenues should be recognized and then costs associated with these revenues should be identified. In revenue or accrual basis of accounting, revenue is recognized when sale is complete or services are rendered rather than when cash is received. Only if no connection with revenue can be established, cost can be charged as expenses to the current period (e.g. office salaries and other administrative expenses). This principle allows evaluation of actual profitability and performance (shows how much was spent to earn revenue). Depreciation and cost of goods sold are good examples of application of this principle.

Expenses are recognized when assets or services have been used to generate revenues during a period.

(9) Verifiable Objective Evidence Concept / Verifiability & Objectivity of Evidence Principle

It means that all accounting transactions should be supported with business documents for making accounting entries and for verification by auditors. The evidence substantiating the business transaction should be objective evidence, i.e., it should state facts without bias towards the other side.

(10) Realization concept / Principle of Revenue Realization

It deals with the determination of the point of time when revenues are earned. According to this concept, revenue is realised when goods or services produced or rendered by a business enterprise are transferred to a customer either for cash or some other asset or for a promise to pay cash in future. It should be remembered that revenue is recognized and earned when a firm actually sells goods to a customer.

(11) Accrual Concept / Accrual Assumption

Many small businesses utilize an accounting system that recognizes revenue and expenses on a cash basis, meaning that neither revenue nor expenses are recognized until the cash associated with them actually is received. Larger businesses, however, use the accrual method.

Under the accrual method, revenues and expenses are recorded exactly to when they are earned and incurred, not necessarily when the cash is received or paid. For example, an expense is recognized when the bill is received, not when payment is made.

Under accrual accounting, even though employees may be paid in the next accounting period for work performed near the end of the present accounting period, the expense still is recorded in the current period since the current period is when the expense was incurred.

This assumption is important because it recognizes the assets, liabilities, incomes and expenses as and when the transactions relating to it are entered into.

ACCOUNTING CONVENTIONS

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The term 'convention' denotes traditions or customs which guide the accountants while preparing the accounting statements. The common conventions include :

(1) Convention of Full Disclosure / Principle of Full Disclosure

All of the information about the business entity that is needed by users is disclosed in understandable form. The purpose of this principle is to communicate all relevant facts concerning financial position and the results of operations to the users. Ifany fact does not find place in accounting statements, it should be appended as note. e.g. contingent liability, market value of investments etc.

(2) Convention of Materiality / Principle of Materiality

It refers to the relative importance of an item or event. Materiality of an item depends on its amount and nature.

Unimportant items are either left out or merged with other items. Sometimes the items are shown as footnotes or in parentheses according to their relative importance. Deciding what is material in accounting is a matter of judgement and not of applying specific rules. An item should be regarded as metarial if there is reason to believe that knowledge of it would influnence the decision of informed stakeholder.

(3) Convention of Consistency / Principle of Consistency

The Consistency approach holds that accounting procedures and practices being followed shall remain same year after year. If the practices followed do not remain consistent, the results of one year shall not remain comparable with that of another year.

This concept is particularly important when alternative accounting practices are equally acceptable. For example, depreciation may be charged on Straight Line Method or Written Down Value Method. If the change becomes necessary the change and its effect on the results should be clearly stated.

(4) Convention of Conservatism or Prodence / Principle of Conservatism

It takes into consideration all prospective losses and leaves all prospective profits. Valuing stock at cost or market price whichever is lower and creating provision for doubtful debts are the good examples of the application of the principle of conservatism. This is the policy of playing safe. It is necessary from the point of view of not only shareholders but also of society, point of view in general. Conservatism states that while choosing between two solutions, the one that will be least likely to overstate assets and income should be picked.

ACCOUNTING STANDARDS

Accounting standards are the norms of accounting policies and practices by way of codes and guidelines to direct as to how the items which go to make up the financial statments should be dealt with in account and disclosed in the annual reports of performance. The main object of setting standards is to harmonise the diverse and flexible policies and practices adopted by different enterprises and to ensure consistency in the reported information from year to year. The need for the common accounting principle is becoming more apparent when the chaotic conditions take place as a result of following different practices by different accoun-

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tants about the measurement of revenues and expenses. The Institute of Chartered Accountants of India, recognizing the need to harmonize the diverse accounting policies and practices, constituted an Accounting Standard Board (ASB) on 21st April, 1977. The Accounting Standard Board carries out the responsibility of bringing out new accounting standard and revision of current standards in the light of changing international business and accounting environment. The board has issued 28 accounting standards so far.

These standards are as follows :

AS No.	Title
AS-1	Diclosure of Accounting Policies
AS-2	Valuation of Inventory
AS-3	Cash flow statement
AS-4	Contingencies and events occuring after the Balance Sheet date (Revised)
AS-5	Prior Period and extraordinary items and changes in Accounting Policies.
AS-6	Depreciation Accounting (Revised)
AS-7	Accounting for construction contracts
AS-8	Accounting for Research & Development
AS-9	Revenue Recognition
AS-10	Accounting for Fixed Assets
AS-11	Accounting for the effects of changes in foreign exchange rates (Revised)
AS-12	Accounting for Government Grants
AS-13	Accounting for Investments
AS-14	Accounting for Amalgamations
AS-15	Accounting for retirement benefits
AS-16	Borrowing Cost
AS-17	Segment Reporting
AS-18	Related parties Disclosures
AS-19	Leases
AS-20	Earning per share
AS-21	Consolidated financial statements
AS-22	Accounting for Taxes on Income.
AS-23	Accounting for Investments in associates in consolidated financial statements
AS-24	Discontinuing Operations
AS-25	In term financial reporting
AS-26	Intangible Assets
AS-27	Financial Reporting of interests in Joint Venture
AS-28	Impairment of Assets

ACCOUNTING EQUATION

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All transactions of a business have a dual aspect. According to this basic concept, every business transaction has a two-fold effect i.e., every receiver is also a giver and every giver is also a receiver.

The resources controlled by a business are referred to as its assets. For a new business, those assets originate from two possible sources:

- Investors who buy ownership in the business
- Creditors who extend loans to the business

Those who contribute assets to a business have legal claims on those assets. Since the total assets of the business are equal to the sum of the assets contributed by investors and the assets contributed by creditors.

At any point of time, the resources of a business firm must be equal to the claims of the parties who have financed the resources. The resarces are provided by its propriters and some outside parties. The claims of the proprietors is claled capital whereas the claims of the outside parties and known as liabilities.

This fact is expressed in the form of following equation ;

Assets	=	**Liabilities**	+	**Owner's Equity**
Resources	=	*Claims on the resources*		

It is called the fundamental accounting equation because every transaction that takes place in a business firm influences its accounting equation in one way or the other.

Initially, owner equity is affected by capital contributions such as the issuance of stock. Once business operations commence, there will be income (revenues minus expenses, and gains minus losses) and perhaps additional capital contributions and withdrawals such as dividends. At the end of the reporting period, these items will impact the owner's equity as follows:

Assets	=	**Liabilities**	+	**Owner's Equity**
			+	*Revenues*
			–	*Expenses*
			+	*Gains*
			–	*Losses*
			+	*Contributions*
			–	*Withdrawals*

The accounting equation holds at all times over the life of the business. When a transaction occurs, the total assets of the business may change, but the equation will remain in balance. The accounting equation serves as the basis for the balance sheet.

Assets : It is an expenditure for acquiring valuable resources which benefit the future activities of the concern. Land, building, debtors, cash in hand, etc. are some of the assets.

Capital : The proprietor of the business brings capital into the business out of which the business purchases assets for its use. The amount of assets of the business is equal to the owner's capital.

Capital = Assets

Creditors : when the capital contributed by the proprietor is insufficient, the business takes to borrowings from other sources. In hat case

Capital + liabilities (Equity) = Assets

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The term 'equities' denotes the claims of various parties against the assets. Equities are of two types: Owner's equity and outsider's equity. Owner's equity is called the capital of the business which is the claim of the owners against the assets of the business. Payments which have to be made to the outsiders are called liabilities.

The equality of total assets and total liabilities is called Accounting equation.

Owners' equity

This is the difference between assets and liabilities. If it's positive, i.e., assets exceed liabilities, we have a positive owners' equity.

Capital is what remains to the owner when all outside claims have been settled from the assets of the firm.

Capital	**+ Liabilities**	**= Assets**
	(Loans, Bank Overdraft, Creditors, Bills Payable, Outstanding Expenses, Bank overdraft, Loan.)	(Buildings, land, Machinery, Furniture, Stock-in-trade, Debtors, Cash, Bills receivable, Bank)

Any change in the amount of assets or the liabilities will bring corresponding change in owner's capital. If asset increases and liabilities do not, the capital will increase; a reduction in the amount of asset or an increase in the amount of liabilities means reduction in the amount of capital.

We shall follow the following procedure to work out an accounting equation.

(i) Transactions are analysed in terms of variables as assets, liabilities, capital, revenues and expenses.

(ii) Effect of transactions is decided in terms of increase or decrease on variables, then

(iii) Effect on the relevant side of equation is recorded.

Example 1. Suppose (1) The owner A commences business with Rs. 30,000.

It means that the firm has an asset of Rs. 30,000 in the form of capital and the claims against the firm are also Rs. 30,000 in the form of capital.

Assets	*= Liabilities*	*+ Capital*
30,000 =	0	+ 30,000

(2) The business purchases a table for Rs, 400 in cash. This will reduce the cash by Rs. 400 but a new asset has been acquired so the total of the assets remain unchanged.

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	Assets		=	Liabilities	+	Capital
	Cash +	Furniture(table)				
Old balance	30,000 +	0	=	0	+	30,000
New transaction	–400 +	400	=	–	+	–
New balance	29,600 +	400	=	0	+	30,000

(3) Business purchases raw material of Rs. 2,000 in cash, we see that the cash balance will be lowered by 2,000 and another asset, i.e., raw material has come into existence, but the total of assets remain unchanged. The equation will be as follows:

	Assets			=	Liabilities	+	Capital
	Cash	+ Furniture	+ Raw Material				
Old balance	29600 +	400 +	0	=	0	+	30,000
New transaction	–2,000 +	0 +	2,000	=	0	+	0
New balance	27,600 +	400 +	2,000	=	0	+	30,000

(4) The business purchases raw material of Rs. 4000 on credit. It will increase raw material by Rs. 4,000 making the total asset to Rs. 34,000. Now, Rs.4,000 is due to be paid to the supplier of the raw material.

	Assets			=	Liabilities	+	Capital
	Cash	+ Furniture	+ Raw Material				
Old balance	27,600 +	400 +	2,000	=	0	+	30,000
New transaction	0 +	0 +	4,000	=	4,000	+	0
New balance	27,600 +	400 +	6,000	=	4,000	+	30,000

(5) The business sells goods on credit for Rs. 4,000; the cost of goods is Rs. 3,000.

On account of this credit transaction, the accounting equation is maintained, i.e., debtors, has come into existence to the extent of Rs. 4,000. But the raw material will be reduced only by Rs. 3,000, being the cost of goods sold. The net increase in assets, Rs.1, 000 i.e., Rs. 4,000 – Rs. 3,000; is profit and will be added to the capital.

	Assets				=	Liabilities	+	Capital
	Cash+	Furniture+	Raw M.+	Debtors	=	Creditors	+	A's
Old balance	27,600	+ 400	+ 6,000 +	0	=	4,000	+	30,00
New transaction	0	+ 0	– 3,000 +	4,000	=	0	+	1,000
New balance	27,600	+ 400	+ 3,000 +	4,000	=	4,000	+	31,000

The total of assets will be equal to the total of liabilities and the capital.

Example 2:

Mr. 'A' had the following transactions. Use accounting Equation to show their effects on his assets, liabilities and capital:

(i) Invested Rs. 1,00,000 in cash.

(ii) Purchased equity shares for cash in worth Rs. 15,000.

(iii) Purchased a land for Rs. 15,000, giving Rs.5,000 in cash and balance through a loan.

(iv) Sold Equity shares costing Rs. 2,000, for Rs. 2,500.

(v) Purchased an old car for Rs. 10,000 cash.

(vi) Received a cash of Rs. 4,000 as commission.

(vii) Paid cash Rs. 1,000 for loan and Rs. 100 for interest.

(viii) Paid a cash Rs. 500 for domestic expenses.

(ix) Received a cash of Rs. 200 for dividend on shares.

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Solution :

Transactions	Assets =	Liabilities +	Owner Equity
(i) Invested Rs. 1,00,000 cash	1,00,000 =	0 +	1,00,000
(ii) Purchased Equity shares in A	–15,000 =	0 +	0
Co. Ltd. for Rs. 15,000	+15,000 =	0 +	0
	1,00,000 =	0 +	1,00,000
(iii) Purchased land for Rs. 15,000	(+) 15,000 =	0 +	0
giving Rs. 5,000 in cash and	(–) 5,000 =	10,000 +	0
balance through a loan			
	1,10,000 =	10,000 +	1,00,000
(iv) Sold equity shares of Rs.2,000	(+) 2,500 =	0 +	500
for Rs. 2,500	(–) 2,000 =	0 +	0
	1,10,500 =	10,000 +	1,00,500
(v) Purchased an old car for	(+) 10,000 =	0 +	0
Rs. 10,000 in cash	(–) 10,000 =	0 +	0
	1,10,500 =	10,000 +	1,00,500
(vi) Received cash as commission			
Rs. 4,000	(+) 4,000 =	0 +	(+) 4,000
	1,14,500 =	10,000 +	1,04,500
(vii) Paid cash of Rs. 1,000 for loan	(–) 1,000 =	(–) 1,000 +	0
and Rs. 100 for interest.	(–) 100 =	0 +	(–) 100
	1,13,400 =	9,000 +	1,04,400
(viii) Paid cash for domestic	(–) 500 =	0 +	(–) 500
expenses Rs. 500			
	1,12,900 =	9,000 +	1,03,900
(ix) Received cash for dividend	(+) 200 =	0 +	(+) 200
on shares Rs. 200			
	1,13,100 =	9,000 +	1,04,100

RULES OF DEBIT AND CREDIT- JOURNAL & LEDGER

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Double entry system

A business transaction involves an exchange between two accounts. Each transaction is recorded in its two-fold aspects. For example, for every asset there exists a claim on that asset, either by those who own the business or by those who level money to the business. Similarly, the sale of a product affects both the amount of cash held by the business and the inventory held. The fundamental principle is that every transaction has two aspects. Under the double-entry system, both these aspects, receiving and giving, are recorded in terms of account. This is called 'Dual Aspect Analysis' in accounting.

Double-entry accounting : The cordianal rule of double-entry accounting is that the total amount debited to one or more accounts must equal the amount credited to different account(s).Because debits equal credits, double-entry accounting prevents some common book-keeping errors. Errors that do occur are easier to find. In double-entry accounting, every transaction in business affects at least two accounts, since there is at least one debit and one credit for each transaction. Entries that are not made to a balance sheet account are made to an income or expense account. Income and expenses affect the net profit of the business, which affects owner's equity and ultimately the balance-sheet.

Thus, ***it can be seen that under double entry system, the total of the debit entries and credit entries on the various accounts must be equal***. Each debit entry has a corresponding credit and each credit has a corresponding debit entry.

Under the double entry system, both the aspects of all the transactions are recorded and thus, complete and reliable records of all the transactions are provided, based on which the management gets a position to take proper decisions. A trial balance are drawn to check accuracy of the books of accounts. Profit and loss account indicates correct profit or loss made during a particular accounting period, while the balance sheet presents the true financial position of the business on a particular date.

Advantages of double entry system.

- Accurate calculation of profit and loss in complex organizations.
- Inclusion of assets and liabilities in the book-keeping accounts.
- Preparation of financial statements directly from the accounts.
- Easier detection of errors and frauds.
- Complete and reliable records of all business transactions since it records both the aspects of a transaction.
- A trial balance can be prepared and arithmetical accuracy can easily be verified.
- The balance sheet of the business can be prepared to ascertain the financial position of a firm.

Check Your Progress

1. Explain GAAP?
2. Give formula for calculating assets?

NOTES

Single entry system does not record the two fold effect of each and every transaction. The accounts are prepared in a defective and unscientific manner and thus are not so reliable. It is suited for small sized concerns which are personally supervised by the owners. In single entry system trial balance cannot be extracted and arithmetical accuracy cannot be checked.

Different between Double entry system and single entry system of book keeping

- Under the double entry system both the aspects, i.e., debit and credit, of all the transactions are recorded. Under single entry system, some transactions are recorded only in one of their aspects whereas some other transactions are recorded in both of their aspects.
- Under double entry system, various subsidiary books like sales book, purchases book, etc. are maintained. Under single entry system, no subsidiary books except cash book, which is also considered as a part of ledger, is maintained.
- Under double entry system there is a ledger which contains personal, real and nominal accounts. But under single entry system, the ledger contains some personal accounts only.

Account

An account is a summarized record of relevant transactions at one place relating to a particular head.

All the transactions that lead to an increase are recorded in one column and those that reduce the cash balance in another column; then the net result can be ascertained. If to the opening balance of cash we add all increases and then deduct the total of all decreases, closing balance can be ascertained.

MECHANICS OF AN ACCOUNT

An account maintained in the ledger has two sides. Convertionally the left side is known or debit side whereas the right side is known as credit side. This way the form of account seems like 'T' and, therefore, it is also know as T Account. A sample format of an account is here below :

Name of Account

	Rs.		Rs.
Debit Side		Credit Side	

T-Accounts are used as a tool to illustrate business transactions, debits and credits, double entry book-keeping, and the purpose of accounts. It is called this because it has the form of the letter T. On the top of the horizontal bar there is the account title (name). Increases and Decreases are placed on the side of the vertical bar, depending on whether the account type is an asset, liability or equity account. The left side of the T-account is called Debit, and the right side is called Credit. These terms are often abbreviated as Dr. and Cr.

NOTES

The difference between the debit and the credit side of an account (total increases less total decreases) is called the account balance.

Example 3 :

Open an shape account for furniture and write the following on the proper side.

1. Furniture purchased for Rs 20,000
2. Furniture sold costing Rs. 5,000
3. Furniture again purchased for Rs. 8,000
4. Old furniture discarded for Rs. 2,500
5. Value of furniture was reduced by Rs. 2,000

Solution :

Dr. Furniture Account Cr.

Recorded Increase in furniture	1.	20,000	Recorded decrease in furniture	2.	5,000
	3.	8,000		4.	2,500
				5.	2,000
Total		28,000	Total		9,500
			Balance		18,500
		28,000			28,000

CLASSIFICATION OF ACCOUNTS

Transactions of a business can be classified into the following three categories:

Types of Accounts

- Personal Accounts
- Impersonal Accounts
  - Real Accounts
  - Nominal Accounts

- Transactions relating to persons, individuals or organisations – Personal accounts;
- Transactions relating to property, assets or possessions – Real accounts;
- Transactions relating to incomes and expenses- Nominal accounts;

Real and nominal accounts are categorized as impersonal accounts.

PERSONAL ACCOUNTS

Personal accounts record the dealings of a *trader* with persons or firms. A separate account is opened for each such person or firm for recording transactions. The account of each person or firm is debited when it receives any benefit and is credited with any benefit such person or firm imparts.

For Example, Proprietor's account, Suppliers' accounts, Receivers' accounts (like Mohan's A/c), bank account, any firm's account, any government's account, any institution's account, Unexpired insurance account, Rent prepaid account, etc.

REAL ACCOUNT

The real accounts represent items which are more or less permanent. It deals with property, assets and possessions. A separate account is kept for each class of property such as furniture, cash, equipment, machinery etc. so that by recording particulars of each asset received or given away, the businessman can find value of each asset on hand on any particular date. For example, Accounts of things which can be touched, felt, measured, purchased, sold etc. like land account, building account, furniture account etc and also accounts of things which are difficult to touch in the physical sense but can be measured, like: Goodwill, Trademarks and patent rights.

NOMINAL ACCOUNTS

They are used to define the nature of transactions i.e., expenses and gains of traders. For example, if in a factory the manager gets salary, the commission agents get commission, the worker gets wages, in fact they all get cash. Cash is the real thing which exists and salary, commission, wages etc., are only ways of describing the nature of heads for which cash has been paid.

Thus, a separate account is opened for each head of expenditure or income such as rent, salaries, commission, etc. Each such account is debited when an expense or loss is incurred and is credited when there is any gain.

Examples of Different Types of Accounts

Personal Accounts	Real Accounts	Nominal Accounts
Capital a/c	Purchase a/c	Interest a/c
Drawings a/c	Sales a/c	Discount a/c
Ram a/c	Stock a/c	Salary a/c
Rotary club a/c	Purchase Return a/c	Repairs a/c
HDFC Bank a/c	Cash a/c	Insurance a/c
Makhan Lal Chaturvedi	Land a/c	Advertisement a/c
University a/c	Goodwill a/c	Commission a/c
Prepaid Rent a/c	Machinery a/c	Trade Exp. a/c
Outstanding Salary a/c	Oil wells a/c	Charity a/c
Unexpired Insurance a/c	Mines a/c	Sales Tax a/c
	Patents a/c	Depreciation a/c

NOTES

RULES OF DEBIT AND CREDIT

Each transaction has two aspects; one aspect is the receiving or the 'debit' aspect. Another aspect is giving or the 'credit' aspect. Debit and credit aspects of a transaction form the basis of double entry system.

Rules of double entry are framed on the basis of these two aspects in each of the business transactions.

The two sides are put together in"T" form, the left side is called the 'debit' side and the right side is called the 'credit' side. Rules can be obtained as –

Debit	Credit
Increase in assets (e.g., purchase of machinery of Rs. 10,000 will be debited, because of increase in the amount of asset)	**Decrease in assets** (e.g., sale of machinery)
Decrease in liabilities (e.g., if a firm borrows from X and the loan is repaid)	**Increase in liabilities** .(e.g., when a firm borrows from Mohan his account will be credited)
Decrease in capital (e.g., withdrawal of money from capital account)	**Increase in capital**(e.g., introduction of capital by the proprietor)
Increase in Expenses and Losses is debited	**Decrease in Expenses and losses is credited.**
Decrease in revenues or incomes is debited.	**Increase in revenues or incomes (Profits) is credited**

Since, incomes and gains increase capital, the rule is to credit all gains and incomes and since expenses and losses decrease capital, the rule is to debit all expenses and losses in the accounts concerned. If there is a reduction in any income or gain, the account concerned will be debited; similarly for any reduction in an expense or loss, the concerned account will be credited.

Transation Analysis of various accounts

Account Type	Debit	Credit	Normal Account Balance
Assets	Increase	Decrease	Debit Balance
Liabilities	Decrease	Increase	Credit Balance
Owner's Equity	Decrease	Increase	Credit Balance
Revenue	Decrease	Increase	Credit Balance
Expense	Increase	Decrease	Debit Balance

How To Use and Apply The Debit and Credit Rules:

(1) Determine the type of account(s) the transactions affect-asset, liability, revenue, or expense account.

(2) Determine if the transaction increases or decreases the account's balance.

(3) Apply the debit and credit rules based on the type of account and whether the balance of the account will increase or decrease.

NOTES

We can understand these rules in another manner:

1. ***Debit the receiver and credit the giver.*** One who receives should be debited and one who gives credited.

2. ***Debit what comes in and credit what goes out.*** This rule is mainly applicable to asset accounts like furniture etc. When cash comes in Cash account should be debited; on payments this account will be credited.

3. ***Debit all losses (and expenses) and credit all gains (and profits).*** Whenever money is paid because of an expense, the debit should be to an account showing the nature of the expense and not to the personal account of the receiver. Similarly, when cash is received on account of an income or gain, the credit should be to an account indicating the fact.

The three rules can be stated as:

1. ***Debit the receiver and credit the giver in case of personal account.***

2. ***Debit what comes in and credit what goes out in case of Real Account.***

3. ***Debit all expenses and losses and credit all gains and profits in case of Nominal account.***

   (i) ***Rule for personal accounts.*** Debit that person's account who receives something from the business and credit that person's account who gives something to the business.

   (ii) ***Rule for real account.*** Debit what comes into the business and credit what goes out of the business.

   (iii) ***Rule for nominal account.*** Debit all expenses and losses and credit all gains and incomes.

SIGNIFICANCE OF DEBIT AND CREDIT IN ACCOUNTS

(i) **Personal accounts.** Whenever the business sells goods on credit to a customer, the account of the customer is debited. Debit in personal accounts means that the person whose account is being debited becomes a debtor or that he owes a certain sum to the business. Whenever the business purchases goods on credit from suppliers the account of the suppliers is credited. A further credit in the account of supplier implies increase on the credit side. If the account of a debtor is credited, it implies decreases in the debt of customers.

(ii) **Real accounts**. Debit in a real account implies purchase of an asset. Any further debit in real account means more acquisitions of the asset and this will increase the value. Any credit in real account implies that some part or whole of the asset has been sold off.

(iii) **Nominal accounts.** Debit implies that expenditure has been incurred or some loss has taken place. When any expenditure on account of salary, rent, interest, commission is incurred, these nominal accounts will be debited. Credit in a nominal account signifies that income or profit has taken place or some expenditure or loss has decreased by the amount of credit.

NOTES

EXAMPLE 4 :

State the nature of account (nominal, real or personal) and show which account will be debited and which account will be credited:

(i) Rent paid
(ii) Interest received
(iii) Building purchased
(iv) Machinery sold
(v) Discount allowed
(vi) Capital introduced

Solution :

Account	Nature of account	Debited/ Credited
Rent paid account	Nominal	Debited
Interest received account	Nominal	Credited
Building account	Real	Debited
Machinery account	Real	Credited
Discount allowed account	Nominal	Debited
Capital account	Personal	Credited

EXAMPLE 5 : On what side the decrease in the following accounts will be recorded?

Also mention the nature of account:

(1) Ram account, the proprietor (2) Cartage account
(3) Power account (4) Bank account
(5) Land account (6) Bills payable account
(7) Salary outstanding account (8) A (a supplier)
(9) X (a customer)

Solution:

(1) Debit- Capital or Personal (2) Credit- Expense or Nominal
(3) Credit- Expense or Nominal (4) Credit- Asset or Personal
(5) Credit- Asset or Real (6) Debit- Liability or Personal
(7) Debit- Liability or Personal (8) Debit- Liability or Personal
(9) Credit- Asset or Personal

Check Your Progress

3. What is Owner's Equity?
4. Define Account?
5. What is real account?

CASE STUDY:

Q)1. Prove that the accounting equation is satisfied in all the following transaction of Suresh:

i. Commenced business with cash Rs. 60,000

ii. Rent paid in advance Rs. 500

iii. Purchased goods for cash Rs.30,000 and credit Rs.20,000

iv. Sold goods for cash Rs. 30,000;costing Rs. 20,000

v. Paid salary Rs. 500 and salary outstanding Rs. 100

vi. Bought motorcycle for personal use Rs. 5,000

NOTES

SUMMARY

- The uniformity in understanding of accounting records is possible only when some standard language is used.
- The accounting language is a standard language in which certain accounting principles and concepts have been developed.
- According to seperate entity concept, the business is an entity that is separate and distinct from its owners, so that the finances of the firm are not mixed with the finances of the owners. All the transactions of the business are recorded in the books of the business from the point of view of the business.
- Dual Aspect Concept is the basis or foundation of accounting. According to this principle, every transaction has a dual aspect.
- Life of the business is assumed to be indefinite, if the proprietor has to take any corrective measure he will have to wait till the time of liquidation but by that time it will be too late and the resources will remain underutilized.
- The net income of a business can be measured by comparing the assets of the business existing at the time of its commencement with those existing at the time of its liquidation.
- Only those transactions and events are recorded in accounting which can be expressed in terms of money.
- The another limitation is that it does not consider changes in purchasing power of money.
- Any asset is recorded at the price paid to acquire it-that is, at cost. This cost is the basis for all subsequent accounting for the asset. The assets recorded at cost price at the time of purchase are systematically reduced by the process called depreciation. These assets disappear from the balance sheet when their economic life is over.
- The revenue principle holds that revenue is realized when everything that is necessary to earn the revenue has been completed.
- The above assumption recognizes the assets, liabilities, incomes and expenses as and when transactions relating to it are entered into.
- All accounting transactions should be supported with business documents for making accounting entries and for verification by auditors.
- Realization concept deals with the determination of the point of time when revenues are earned.
- All of the information about the business entity that is needed by users is disclosed in understandable form through accounting.
- All transactions of a business have a dual aspect. According to this basic concept, every business transaction has a two-fold effect.
- Investors who buy ownership in the business
- Creditors who extend loans to the business
- Owners'equity is the difference between assets and liabilities.

NOTES

- A business transaction involves an exchange between two accounts.
- Double-entry accounting : Debits must always equal credits.
- It can be seen that under double entry system, the total of the debit entries and credit entries on the various accounts must be equal.
- Single entry system does not record the two fold effect of each and every transaction.
- In single entry system trial balance cannot be extracted and arithmetical accuracy cannot be checked.
- Under the double entry system both the aspects, i.e., debit and credit, of all the transactions are recorded. Under single entry system, some transactions are recorded only in one of their aspects whereas some other transactions are recorded in both of their aspects.
- An account is a summarized record of relevant transactions at one place relating to a particular head.
- T-Accounts are used as a tool to illustrate business transactions, debits and credits, double entry book-keeping, and the purpose of accounts.
- Personal accounts record the dealings of a trader with persons or firms. A separate account is opened for each such person or firm for recording transactions.
- The real accounts represent items which are more or less permanent. It deals with property, assets and possessions. A separate account is kept for each class of property such as furniture, cash, equipment, machinery etc.
- Nominal Account are used to define the nature of transactions i.e., expenses and gains of traders. For example if in a factory the manager gets salary, the commission agents get commission, the worker gets wages, in fact they all get cash. Cash is the real thing which exists and salary, commission, wages etc. ae only ways of describing the nature of heads for which cash has been paid.
- RULES OF DEBIT AND CREDIT. A transaction has two aspects; one aspect is the the 'debit' aspect. Another aspect is the 'credit' aspect. Debit and credit aspects of a transaction form the basis of double entry system.

ANSWERS TO 'CHECK YOUR PROGRESS'

1 Accounting statements disclose the profitability and solvency of the business to various parties. Thus, it is necessary that these statements should be prepared as per some standard language and set rules. These rules are usually called 'Generally Accepted Accounting Principles (GAAP)'.

2. Assets = Liabilities + Owner's Equity

3.. Owners'equityis the difference between assets and liabilities. If it's positive, i.e., assets exceed liabilities, we have a positive owners' equity.

4. An account is a summarized record of relevant transactions at one place relating to a particular head.

5. The real accounts represent items which are more or less permanent. It deals with property, assets and possessions.

TEST YOURSELF

1. Distinguish between Real Account and Nominal Account.
2. What are the Rules of Debit and Credit ?
3. What is classification of Accounts ?
4. What are the various Accounting Concepts ?
5. What is the difference between double entry system and single entry system of book-keeping?
6. What are T-accounts ?
7. What is Accounting Equation ?
8. What do you understand by double entry system ? Write the advantage of double entry system.

PRACTICAL QUESTIONS

1. Calculate total assets if -
   (a) Capital is Rs. 5,00,000
   (b) Creditors are Rs. 1,00,000
   (c) Revenue during the period is Rs. 3,50,000
   (d) Expenses during the period are Rs. 1,40,000
   [Ans. : Rs. 8,10,000]
2. Open a 'T' shape account for Machinery and write the following on the proper side :
   (i) Machinery purchased for Rs. 5,00,000
   (ii) Machinery sold for Rs. 1,20,000
   (iii) Machinery discarded of Rs. 50,000
   (iv) New Machinery purchased for Rs. 2,00,000
   (v) Machinery destroyed of Rs. 40,000
   [Ans. : Debit Side - 1, 4 & Credit Side - 2, 3, 5]
3. Prepare accounting equation from the following :
   (i) Started business with cash - Rs. 1,20,000
   (ii) Purchased a typewriter for cash for Rs. 8,000 for office use.
   (iii) Purchased goods for Rs. 50,000 for cash
   (iv) Purchased goods for Rs. 40,000 on credit.
   (v) Goods costing Rs. 60,000 sold for Rs. 80,000 on credit.
   (vi) Paid for Rent Rs. 1,500 and for salaries Rs. 2,000.
   (vii) Received Rs. 800 for commission.
   (viii) Withdraw for private use Rs. 5,000 in cash.
   [Ans. : Cash Rs. 54,300; Typewriter Rs. 8000; Stock Rs. 30,000;
   Debtors 80,000; Creditors Rs. 40,000; Capital Rs. 1,32,300]
4. Prepare Accounting Equation from the following :
   (i) Started business with cash Rs. 75,000 and goods Rs. 25000/-
   (ii) Paid for Rent Rs. 2000/-
   (iii) Bought goods for cash Rs. 30,000 and on Credit for Rs. 44,000.

NOTES

(iv) Goods costing Rs. 50,000 sold at a profit of 25%, out of which Rs. 27,500 received in cash.

(v) Purchased a Motor-cycle for personal use for Rs. 20,000.

[Ans. : Cash Rs. 50,500; Stock Rs. 49,000; Debtors Rs. 35,000;
Creditors Rs. 44,000; Capital Rs. 90,500]

FURTHER READINGS

- Accounting for Managers: Sharma and Gupta
- Management Accounting: Mr. Agrawal
- Fundamentals Accounting: Jain, Khandelwal, Pareek

NOTES

3 Journal

The Chapter Covers :

- INTRODUCTION
- JOURNAL
- RULES OF JOURNALISING
- COMPOUND JOURNAL ENTRY
- ENTRIES OF DISCOUNT
- TRANSACTIONS REGARDING BAD DEBTS AND BED DEBTS RECOVERY

Learning Objectives:

After going through this chapter, you should be able to:

- Understand concept of journal
- Explain the rules of journalising
- Do entries of discount
- Describe what is compound journal entry
- Understand variety of transactions

NOTES

INTRODUCTION

Journal is something you start with your accounting process. Accounting in other terms, starts from here and goes to finalising the accounts. The book in which a transaction is recorded for the first time from a source document are called 'Books of Original Entry'. Journal is one of the basic books of original entry in which transactions are recorded in a chronological (day-to-day) order according to the principles of double entry system. This chapter introduce us to journal and journalising our account in a systematic manner. By the end of this chapter you will be in a position to hawk journalasing of your transactions.

JOURNAL

The Journal is called the book of original entry and the process of recording transactions in the journal is called journalising. It is a book of original entry wherein transactions are recorded chronologically, showing date, amounts and accounts to be debited and credited and an explanation on the transaction. With the growth in the business activities several journals are required for recording the large number of activities e.g., sales journal etc. These journals are called *special journals.*

According to Cortex– "The Journal, or 'Daily Record' as originally used was a book of primary entry in which transactions were copied in order of date, from a Memorandum or waste Book. The entries as they were copied, were classified into debits and credits so as to facilitate their being correctly posted afterwards in the ledger."

Object / Importance of Journal

(1) One can have a clear picture of the business by study of its journal book.

(2) A journal makes the postings of transactions in ledger very easy.

(3) It shows us all effects of a transaction.

(4) It plays an important role in solving business disputes.

(5) Journal reduces the possibility of errors. The two sides can be compared easily and it can be seen whether they are equal or not.

(6) It provides an explanation to the transaction.

(7) It provides a chronological record of all transactions and, therefore, record of any transaction can be searched out easily.

STEPS FOR JOURNALISING

The following are the steps for journalising transactions:

- The year is recorded at the top of the page and the month and the date are recorded on the first line in the first column of the date section. This information is repeated for every new journal page.
- The name of the account(s) to be debited is entered in the particulars column and the amount of the debit is recorded in the Debit column. When more than two accounts are involved in the transaction the entry is called a compound entry.
- The name of the account(s) to be credited is entered on the next line and indented. The amount of the credit is recorded in the Credit column.
- An explanation of the transaction is included in the particulars column on the line below the credit entry.

Format of journal.

JOURNAL

Date (1)	Particulars (2)	L.F. (3)	Debit (4)	Credit (5)

NOTES

(1) **Date :** The date on which transaction has taken place is written in this column.

(2) **Particulars :** Every transaction has two effects-Debit & Credit, which are recorded in it. This is accomplished by a debit description of the deal known as Narration and a line is drawn at the end.

(3) **L.F./Ledger Folio :** This column contains the folio number of ledger where the account is opened.

(4) **Amount :** This column is divided into two parts : (a) Debit, (b) Credit. In these two columns debit & credit amounts are recorded respectively.

Important points to be kept in mind at the time of Journalising

(1) Before recording a Journal entry, it is essential to analyse a transaction in order to determine the two accounts which are affected. Then, on the basis of the rules of journalising it must be debited or credited.

(2) The name of the account to be debited is written first and the word 'Dr.' is also written towards the end of the column.

(3) The eredit account starts with the word of 'To', a few space away from the margin to make it distinct from the debit account.

(4) It is necessary to write the narration after each entry and should be short, complete and clear.

(5) After every Journal entry, a line should be drawn in particulars column, so that each entry is separated from the preceding one.

(6) Two words 'For'/'Being' are customarily used before starting to write down narration.

(7) It is not necessary to use the word 'Account' or A/C after the personal accounts.

(8) At the end of each page, both the Dr. and Cr. columns are totalled up just in front of each other.

These totals must be equal because the amount debited in each entry equals the amount credited. These totals are carried forward to the next page progressively upto the end of accounting period.

RULES OF JOURNALISING

(1) **Personal Accounts :** "Debit the receiver and credit the giver" for e.g. : Cash of Rs. 2000 is given to Gopal.

Gopal	.....Dr.	2,000	
To cash a/c			2,000
(To cash paid to Gopal)			

Note : Here Gopal is debited as he is the one who received cash

NOTES

(2) **Real Accounts :** "Debit what comes in and credit what goes out". In the above e.g. cash goes out to Gopal. So cash is credited. Again if machinery is bought for Rs. 10,000 then Machinery came to business and cash went out of business.

Machinery a/c	.....Dr.	10,000	
To cash a/c			10,000
(For Machinery purchased for cash)			

(3) **Nominal Account :** "Debit all expensess & losses and credit all Incomes & gains" for e.g.: Paid salary of Rs. 2,000 and received rent of Rs. 5,000. Here Salary is an expense, so debited where as rent is an income thus credited.

Salary a/c	.....Dr.	2,000	
To cash a/c			2,000
(For Salary paid)			
Cash a/c	.....Dr.	5,000	
To Rent a/c			5,000
(For Rent received)			

Example 1.

Transactions of Shyam for the month of June are given below. Journalise them.

2003		Rs.
June 1	Shyam started business with cash	1,00,000
June 2	Cash deposited in bank	25,000
June 3	Bought raw material for cash	5000
June 4	Drew cash from bank for office	1000
June 13	Sold to Ram goods on credit	1500
June 20	Bought from Mohan raw material on credit	225
June 24	Received cash from Ram	1500
June 28	Paid cash to Mohan and	215
	discount allowed	10
June 30	Paid rent	50
June 30	Cash sales for the month	800
June 30	Paid salary to Ashok	100

Solution 1 :

No.	Transactions	Affected A/C	Types of A/C	Dr.	Cr.
June 1	Commenced Business *(Owner brings capital, cash comes in)*	Cash A/C & Capital A/C	Real Personal	Cash A/C	Capital A/C
2	Deposited in bank *(Bank is receiver & cash goes out)*	Bank A/C & Cash A/C	Personal Real	Bank A/C	Cash A/C

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3.	Goods purchased for cash *(Goods comes in & cash goes out)*	Pur. A/C & Cash A/C	Real Real	Purchase A/C	Cash A/C
4.	Withdrew cash from bank *(cash comes in & bank is giver)*	Bank A/C & Cash A/C	Personal Real	Cash A/C	Bank A/C
13	Sold goods to Ram on credit *[Ram is receiver goods goes out]*	Ram & Goods	Personal & Real	Ram	Sales A/C
20	Pur. Material from Mohan on Credit *[Mohan is giver goods comes in]*	Mohan Goods	Personal Real	Pur. A/C	Mohan
24	Cash paid by Ram *[cash comes in, Ram is giver]*	Ram Cash A/C	Personal Real	Cash A/C	Ram
28	Cash paid to Mohan *[cash goes out, Mohan is receiver and discount profit is given]*	Mohan Cash A/C Discount-A/C	Personal Real Nominal	Mohan	Cash A/C Discount A/C
30	Rent paid in cash *[Rent (expenses paid,cash goes out]*	Rent A/C Cash A/C	Nominal Real	Rent A/C	Cash A/C
30	Goods sold for cash *[Goods goes out, cash comes in]*	Goods A/C Cash A/C	Real Real	Cash A/C	Sales A/C
30	Salary paid *[expenses paid, cash goes out]*	Salary A/C Cash A/C	Nominal Real	Salary A/C	Cash A/C

JOURNAL ENTRIES (In the books of Shyam)

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
2003				
June 1	Cash A/c ....Dr.		1,00,000	
	To Capital A/c			1,00,000
	(Being the amount invested by Shyam in the business as capital)			
June 2	Bank A/c ....Dr.		25,000	
	To Cash A/c			25,000
	(Being the amount deposited in bank)			
June 3	Purchases A/c ....Dr.		5,000	
	To Cash A/c			5,000
	(Being raw material purchased for cash)			

NOTES

June 4	Cash A/c ....Dr. To Bank A/c *(Being cash withdrawn from bank)*	1,000	1,000
June 13	Ram ....Dr. To Sales A/c *(Being goods sold to Ram on credit)*	1,500	1,500
June 20	Purchases A/c ....Dr. To Mohan *(Being goods bought from Mohan on credit)*	225	225
June 24	Cash A/c ....Dr. To Ram *(Being cash received from Ram)*	1,500	1,500
June 28	Mohan ....Dr. To Cash A/c To Discount A/c *(Being cash paid to Mohan discount received)*	225	215 10
June 30	Cash A/c ....Dr. To Sales A/c *(Being goods sold for cash)*	800	800
June 30	Rent A/c ....Dr. Salaries A/c ....Dr. To Cash A/c *(Being amount paid for rent and salary)*	50 100	150
	Total	1,35,400	1,35,400

COMPOUND JOURNAL ENTRY

When two or more transactions of the same nature take place on the same date, a compound journal entry is passed for them. Thus total number of book-keeping entries may be reduced.

Sometimes, on the same date several similar dealings take place or transactions related to a single account take place. In such, cases in place of passing different entries, consolidated entry is passed. This is known as compound entry.

In a compound entry, either only one account is debited and several other accounts are credited or vice-versa. The total amount debited should be equal to the total of the accounts credited and all these transactions should take place on the sameday.

In a compound journal entry there may be:

(1) One account to be debited and two or more accounts to be credited. For example, if X pays to his creditor, Mr. Z Rs. 5,000 and Z allows X a discount of Rs. 500, then the entry will be,

Z's account	.....Dr.	5,000	
To Cash account			4,500
To Discount Account			500
(Being payment of cash to Mr. Z, discount received Rs. 500)			

This compound entry is a result of two indivdual entries :

(i) Z'	.....Dr	4,500	
To Cash account			4,500
(Being payment of cash to Mr. Z)			

Check Your Progress

1. What is a journal?
2. What is the rule for journalising real accounts?
3. Define compound journal entry?

(ii) Z' .....Dr 500
    To discount account 500
(Being discount received)

(2) Two or more accounts to be debited and only one to be credited. For example, if on the last day of the month, Rs. 15,000 is paid as rent and one of the partner, X withdraws Rs. 8,000 cash for private use,

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Rent account	....Dr.	15,000	
Drawings account	....Dr.	8,000	
To Cash account			23,000
(Being rent paid, drawings for private use made in cash)			

Example 2 : Pass enteries in the Journal of Shri Ashish Jain :

2007		Rs.
Aug 1.	Started Business with :	
	Cash	15,000
	Goods	3,500
	Furniture	500
Aug 2.	Bought Goods :	
	Cash	500
	From Kumar	300
	From Triloki	700
Aug 12.	Paid wages	10
	Paid to Triloki	500
	Paid to Kumar	200
Aut 16	Sold goods for cash	600
	Sold goods to Rajan	250
	Sold to Vishwas on credit	350
Aug 25	Received cash from Rajan	245
	Discount allowed to him	5
Aug 31	Paid to kumar in full settlement	90
Aug 31	Furniture purchased	100
	Paid for Repairs	25
	Cleared Triloki's a/c	90
	Discount Received from Triloki	10

Solution 2 :

Journal of Shri Ashish Jain

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
2007				
Aug 1	Cash A/C .....Dr.		15,000	
	Furniture A/C .....Dr.		500	
	Purchase A/C Dr.		3,500	
	To Capital A/C			19,000
	(for commencement of business for cash furniture and goods)			

NOTES

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
Aug 2	Purchase A/C	.....Dr.	1,500	
	To Cash A/C			500
	To Kumar			300
	To Triloki			700
	(for purchase of goods for cash and credit)			
Aug 12	Wages A/C	.....Dr.	10	
	Triloki	.....Dr.	500	
	Kumar	.....Dr.	200	
	To Cash A/C			710
	(For payment of wages and cash to Triloki and Kumar)			
Aug 16	Cash A/C	Dr.	600	
	Rajan	Dr.	250	
	Vishwas	Dr.	350	
	To Sales a/c			1200
	(Being goods sold on cash & credit)			
Aut 25	Cash A/C	Dr.	245	
	Discount A/C	Dr.	5	
	To Rajan			250
	(for receipt of cash and discount allowed)			
Aug 31	Kumar	Dr.	100	
	To Cash A/C			90
	To Discount A/C			10
	(for amount paid and discount received)			
Aug 31	Furniture A/C	Dr.	100	
	Repairs A/C	Dr.	25	
	Triloki	Dr.	200	
	To Cash A/C			315
	To Discount A/C			10
	(for payment of cash and receipt of discount)			
		Total	23,085	23,085

ENTRIES OF DISCOUNT

Discount is of two types :

(1) Trade Discount, and

(2) Cash Discount

(1) Trade Discount : The discount allowed by seller to its customer at a fixed percentage on the listed price of goods is known as Trade Discount. No separate entry is made for it. The amount of transaction is reduced by the amount of trade discount. For example, Goods of list price Rs. 10,000 sold at a trade discount of 20%.

List price	10,000
(–)Trade discount (20%)	2,000
	8,000

Now entry will be :

Cash A/C	.....Dr.	8,000	
To Sales A/c			8,000

(2) **Cash Discount :** This discount is allowed only if the customers are ready to make prompt payment. This is also offered to customer to induce them to pay early. In entry it is debited if it is allowed to customer and credited when it is received.

NOTES

Example 3 : Journalise the following transaction

2007

July 1 Vikas commenced business with Rs. 15000.

July 2 Bought goods of the list price Rs. 6000 from Anupam, less 10% trade discount and 5% cash discount for cash.

July 9 Withdrew goods worth Rs. 200 and Rs. 300 in cash for private use.

July 13 Sold goods worth Rs. 1,000 less 5% trade discount & 2% cash discount to Ram for cash.

July 19 Sold goods worth Rs. 5,000 less 5% trade discount to Asit.

July 21 Asit returned goods worth Rs. 800.

July 31 Paid rent, salary & expenses of Rs. 200, Rs. 350 and Rs. 50 respectively.

Solution 3 :

Journal of Vikas

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
2007			Rs.	Rs.
July 1	Cash A/C .....Dr.		15,000	
	To Capital A/C			15,000
	[For amount introduced as capital]			
July 2	Purchase A/C .....Dr.		5,400	
	To Cash A/C *1			5,130
	To Discount A/C			270
	[For goods worth Rs. 6000 bought at a tradediscount 10% & cash discount 5%]			
July 9	Drawings A/C .....Dr.		500	
	To Purchase A/C			200
	To Cash A/C			300
	[For goods and cash taken for personal use]			
July 13	Cash A/C *2 .....Dr.		931	
	Discount A/C .....Dr.		19	
	To Sales A/C			950
	[For goods worth Rs. 1000 sold for cash at a trade discount 5% and cash discount 2%]			

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July 19	Asit *3 .....Dr.		4,750	
	To Sales A/C			4,750
	[For goods worth Rs. 5000, sold at a trade discount of 5%]			
July 22	Sales Return A/C *4 .....Dr.		760	
	To Asit			760
	[For goods worth Rs. 800 returned by him after deducting 5% trade discount]			
July 31	Rent A/C .....Dr.		200	
	Salary A/C .....Dr.		350	
	Expenses A/C .....Dr.		50	
	To Cash A/C			600
	[For amount paid for rent, salary, expenses]			
	Total		27,960	27,960

*1 Rs 6000 less 10% Trade discount

= 6000 − 600 = Rs. 5,400

Again, Rs 5400 less 5% Cash discount

= 5400 − 270 = Rs. 5,130

*2 Rs. 1000 less 5% Trade discount

= 1000 − 50 = Rs. 950

Rs 950 less 2% Cash discount

= 950 − 19 = Rs. 931

*3 Rs. 5000 less 5% Trade discount

= 5000 − 250 = Rs. 4750

*4 Rs. 800 less 5% Trade discount

= 800 − 40 = Rs. 760.

TRANSACTIONS REGARDING BAD DEBTS

When a debtor, fails to pay the whole amount due to him the unrealized amount is called 'bad debts'. It is a loss to the business and has to be written off. For example, if Mr. X, a debtor, fails to pay Rs. 15,000 out of Rs. 35,000 due to him, then the unrealized sum, i.e., Rs. 15,000, will be written off as bad debt.

Bad debts account	.....Dr.	15,000	
To X's account			15,000
(Being Rs. 15,000 bad debts written off as irrecoverable from Mr. X)			

> **Check Your Progress**
> 4. What is Trade Discount?
> 5. Explain Cash Discount?

Sometimes it so happens that the debtor pays the whole or part of the bad debts amount later on. It shall be considered as gain to the business. It will be credited to bad debts recovered account. For example, Mr. X who could not pay 15,000 earlier, now paid 10,000 out of it. They entry will be :

Cash a/c	10,000	
To Bad debts recovered a/c		
(Being bad-debts recovered)		

NOTES

CASE STUDY :

1. Journalise the following transactions in the books of Shankar & Co.

June 1 Started business with a capital of 60,000
June 2 Paid into bank 30,000
June 4 Purchased goods from Kamal on credit 10,000
June 6 Paid to Shiram 4,920
June 6 Discount allowed by him 80
June 8 Cash Sales 20,000
June 12 Sold to Hameed 5,000
June 15 Purchased goods from Bharat on credit 7,500
June 18 Paid Salaries 4,000
June 20 Received from Prem 2,480
June 20 Allowed him discount 20
June 25 Withdrew from bank for office use 5,000
June 28 Withdraw for personal use 1,000
June 30 Paid Hanif by cheque 3,000

SUMMARY

- The Journal is called the book of original entry and the process of recording transactions in the journal is called journalising. It is a book of original entry wherein transactions are recorded chronologically, showing date, amounts and accounts to be debited and credited an explanation to the transaction. With the growth in the business activities several journals are required for recording the large number of activities e.g., sales journal etc. These journals are called special journals.
- First step is to ascertain the increase or decrease in business assets, liabilities, proprietor's capital and income and expenditure on account of a business transaction.
- The details of the transaction is written in the particulars column called "narration".
- When two or more transactions of the same nature take place on the same date, a compound journal entry is passed for them. Thus total number of book-keeping entries may be reduced.
- When a debtor, fails to pay the whole amount due to him the unrealized amount is called 'bad debts'. It this unrealived amount is recovered at any time in future, it is called bad-debts recovered.
- Journal reduces the possibility of error.
- It provides an explanation to the transaction.
- It provides a chronological record of all transactions.

ANSWERS TO 'CHECK YOUR PROGRESS'

1. The Journal is called the book of original entry and the process of recording transactions in the journal is called journalising.
2. **RULES OF JOURNALISING**

   Real Accounts : "Debit what comes in and credit what goes out".
3. Sometimes, on the same date several similar dealings take place or transactions related to a single account take place. In such, cases in place

NOTES

of passing different entries, consolidated entry is passed. This is known as compound entry.

4. **Trade Discount :** The discount allowed by seller to its customer at a fixed percentage on the listed price of goods is known as Trade Discount.
5. **Cash Discount :** This discount is allowed only if the customers are ready to make prompt payment.

TEST YOURSELF

1. How does the Journal entries take place in the books ? Explain
2. What do you understand by 'Journal' ? Give rules of Journalising in connection with different types of account.
3. What are the objects and importance of Journal ?
4. What is Journal ? What are the Advantages of Journal ?
5. What is Compound Journal Entry ?
6. Write the Main advantages of Journal.

PRACTICAL QUESTIONS

1. Journalise the following transactions :

2007		Rs.
Oct 1	Commenced Business	20,000
Oct 1	Goods purchased for cash	10,000
Oct 2	Purchased goods from Ram	5,000
Oct 3	Sold goods to Ravi	3,000
Oct 5	Goods purchased from Prakash for cash	1,500
Oct 7	Paid wages	70
Oct 8	Sold goods to Brijesh	2,000
Oct 9	Received from Ravi	2,950
Oct 10	Paid to Ram	1,000
Oct 12	Rent paid	200
Oct 14	Goods purchased from Neeru	2,000
Oct 15	Goods sold to Yogendra	1,000
Oct 17	Paid for office expenses	500
Oct 20	Received payment from Yogendra	500
Oct 23	Paid for sundry expenses	50
	Paid for salary	1,000
	Donation in cash	51
	Charity in goods	100
Oct 30	Withdrew from Bank for office use	500

[Ans. : Total of Journal Rs. 51,421]

NOTES

2. Pass the Journal entries in the books of Krishna :

2007.

March 1	: Commenced business with cash Rs. 10,000 and goods Rs. 5,000.
March 8	: Sold goods for Rs. 2,000 at 10% trade discount and 5% cash discount.
March 15	: Paid to Mohan Rs. 575 in full payment of Rs. 600/-
March 20	: Purchased goods worth Rs. 1,000 from Ravi at 5% trade discount.
March 30	: Withdrew for personal use Rs. 500 cash and goods of Rs. 100

[Ans. : Total of Journal Rs. 18,950]

3. Record the following transaction in Shyam's Journal

2007			Rs.
July 1	:	Shyam commenced business	
		Cash	30,000
		Loan from 'Sanjay'	20,000
July 4	:	Purchased Furniture	2,500
		Motorcycle	12,000
July 6	:	Received order for goods from 'A'	1,400
Jyly 10	:	Sold goods to 'B'	4,500
July 11	:	Returned goods by 'B'	1,500
July 18	:	Received Cash from 'B' and	2,950
		discount allowed to 'B'	50
July 20	:	Purchased goods	8,000
		Purchased Furniture	900
July 26	:	Sold goods to 'Ram' for cash	1,300
		Sold goods to 'Ram' on credit	400
July 30	:	Paid Rent	900
		Paid Salary	750
		Paid Wages	200
July 30	:	Sent goods to 'A'	1,400

[Ans. : Total of Journal- Rs. 87,350]

Note - (i)

July 1 :	Cash A/C .....Dr.	50,000	
	To Capital A/C		30,000
	To Loan from Sanjay		20,000

(ii) Order for goods costing Rs. 1,400/- received from A on 6th July, But neither cash was paid nor goods were sent. hence the transaction is not entered in the Journal.

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FURTHER READINGS

- Accounting for Managers: Sharma and Gupta
- Management Accounting: Mr. Agrawal
- Fundamentals Accounting: Jain, Khandelwal, Pareek

4 Cash Book

NOTES

The Chapter Covers :

- INTRODUCTION
- CASH BOOK
- TYPES OF CASH BOOK
  - SINGLE-COLUMN CASH BOOK,
  - TWO-COLUMN CASH BOOK, AND
  - THREE-COLUMN CASH BOOK
- BALANCING OF CASH BOOK
- BALANCING THE THREE-COLUMN CASH BOOK
- CHEQUES RECEIVED
- PETTY CASH BOOK
- IMPREST SYSTEM OF PETTY CASH BOOK
- POSTING

Learning Objectives:

After going through this chapter, you should be able to:

- Understand cash book
- Clarify types of cash book
- Learn to balance a cash book
- Understand to balance a three column cash book
- Explain petty cash book

NOTES

INTRODUCTION

The most important aspect of accounting is cash and where we maintain receipt and payment of cash is called a cash book. This book is used to record all transactions relating to cash receipts and cash payments. The number of cash transactions is quite large in every business and it is quite unpracticable and inconvenient to record all cash transactions in the Journal. It is, therefore, necessary to keep a separate book for cash transactions known as cash book. There are a few types of cash books. This chapter promises to cover the advantages, types and maintenance Cash books.

CASH BOOK

Cash book may be defined as the record of transactions concerning cash receipts and cash payments. It is essential for a business to know the flow of cash or bank balance on hand. For this purpose and for recording the cash transactions, cash book is maintained. The number of cash transactions in a firm is generally large and, therefore, it becomes convenient to have a separate cash book, to record such transactions. Cash Book is a special journal.

Cash transactions are straightaway recorded in the cash book and, on the basis of such a record, ledger accounts are prepared. Therefore, the cash book is a subsidiary book. But, the cash book itself serves as the cash account and the bank account. As a matter of fact, the balances are entered in the Trial balance directly.

Advantages of a cash book

The cash book records all cash receipts and payments of an enterprise on daily basis. All cash received is recorded on the left-hand side or the debit side of the cash book while all cash payments are recorded on the right-hand side or the credit side of the cash book, the difference between the two totals indicates the balance of cash on hand.

Records of cash transactions normally are the largest in the business. It is by this device of passing cash transactions through the cash book that the effort of posting every item of cash transaction is recorded in the cash account.

Cash book fulfils the functions of a book of original entry as well as a ledger account. It is not necessary to have a separate cash account in the ledger because the record in the cash book takes the shape of a ledger account. In a cash book, only cash transactions are recorded in the order in which they occur. Thus, it serves the purpose of a subsidiary book and a ledger account.

Distinction between cash A/c and cash book

1. It is a separate book maintained for recording cash transactions.	1. It is account in the ledger.
2. It is a book of original entry because all cash transactions are first of all recorded in cash book and then posted from cash books to various accounts in the ledger.	2. Cash account is opened in the ledger and posting is done in this account from journal.

NOTES

3. When transactions of cash are recored in cash book, there is no necessity to open a cash A/c in the ledger.	3. When transactions of cash are recorded in Journal, it is necessary to open a cash A/c in ledger.

TYPES OF CASH BOOK

The main cash book may be of three types:

(1) Single-column cash book,

(2) Two-column cash book, and

(3) Three-column cash book

(1) Single-column cash book.

Such a cash book appears like an ordinary account, with one amount column on each side. The left-hand side records receipts of cash and the right-hand side the payments. Hence, it is called a 'single column cash book'. The ruling is as follows:

SIMPLE CASH BOOK

Dr. Cr.

Date	Particulars (Receipts)	V No.	L.F	Amount		Date	Particulars (Payments)	V No.	L.F.	Amount

In the column for:

(i) Date – the date on which transaction takes place.

(ii) **Particulars-** the name of the account in respect of which cash has been received or payment has been made is written;

(iii) **L.F.-** the page number in the ledger where the relevant account will be found is written;

(iv) **Amount-** the amount received (on the debit side) and the amount paid (on the credit side) are written.

Balancing of cash book

The receipts column will always be bigger than the payments column. The difference will be written on the credit side as "By Balance c/d". The totals are then entered in the two columns opposite one another and then on the debit side the balance is written as "To Balance b/d" to show the cash balance in hand in the beginning of the next period.

EXAMPLE 1 :

Enter the following transactions in a simple cash book:

2003			Rs.
June 1	:	Started business with cash	25,000

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June 5	:	Purchased furniture	3,000
June 7	:	Paid rent	300
June 8	:	Cash sales	3,000
June 10	:	Paid cattage	70
June 27	:	Purchased electrical equipment	2,000
June 30	:	Paid salaries	1,000

Solution :

CASH BOOK

Dr. Cr.

Date	Particulars (Receipts)	L.F.	Amount	Date	Particulars (Payments)	L.F.	Amount
2003				2003			
June 1	To Capital A/c		25,000	June 5	By Furniture		3,000
June 8	To Sales		3,000	June 7	By Rent		300
				June 10	By Cartage		70
				June 27	By Electrical Equipment		2,000
				June 30	By Salaries		1,000
				June 30	By Balance c/d		21,630
			28,000				28,000
July 1	To Balance b/d		21,630				

Note : Following conclusions can be drawn:

(1) In the simple cash book only the cash receipts and cash payments are recorded. Credit transactions are not recorded at all.

(2) The debit side will always be bigger than the credit side since the payment can never exceed the available cash.

(2) Double-Column Cash Book

If along with the columns for amounts to record cash receipts and cash payments, another column is added on each side to record the cash discount allowed or the cash discount received, it will be a double-column cash book.

This is done because cash discount received or cash discount allowed transation is not an independent transaction. It always takes place with either cash receipt or payment.

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CASH BOOK

Dr. Cr.

Date	Particulars (Receipts)	L.F.	Discount Rs.	Cash Rs.		Date	Particulars (Payments)	L.F.	Discount Rs.	Cash Rs.

Cash discount is the allowance which often accompanies on cash payments. Since cash discount will be allowed only if cash is received and the discount will be received only if cash is paid, hence, it is convenient to add a column for discount allowed on the receipts side of the cash book.

In the cash column on the debit side, actual cash received will be entered. The amount of the discount allowed, if any, to the customer concerned will be entered in the discount column. Similarly, actual cash paid will be entered in the cash column on the payments side shows total discount received and is credited to the Discount Account.

EXAMPLE 2.

Enter the following transactions in Cash Book with Discount columns.

2004		Rs.
Mar 1	Cash in hand	50,000
Mar 5	Paid to A	3,000
Mar 5	Discount allowed by him	100
Mar 8	Purchased goods	4,000
Mar 10	Received from B	800
Mar 10	Discount allowed	50
Mar 16	Cash Sales	4,000
Mar 21	Paid to C	2,950
Mar 21	Discount received	50
Mar 25	Paid wages	5,000

NOTES

Solution:

THREE-COLUMN CASH BOOK

Dr. Cr.

Date	Receipts	Discount Rs.	Cash Rs.	Bank Rs.	Date	Payments	Discount Rs.	Cash Rs.	Bank Rs.
(i)	To Capital A/c		50,000		(ii)	By Bank (C)		40,000	
					(iii)	By purchases			15,000
(ii)	To Cash (C)			40,000					
					(iv)	By Cash (C)			3,000
(iv)	To Bank (C)		3,000		(iv)	By Drawings		3,000	
(v)	To Bank (C)		1,000		(v)	By Cash(C)			1,000
						By Balance c/d		11,000	21,000
			54,000	40,000				54,000	40,000
	To Balance b/d		11,000	21,000					

Note : The discount column is not balanced. They are simply totalled as total of discount column at debit side is discount received, which is again for business and total of credit column at credit side is discount allowed, which is a loss for business.

(3) Three- columnar Cash Book (Cash Book with Cash, Bank and Discount Column)

It is the most popular form of Cash Book. Where a business enterprise has a current account in a bank, it would deposit therein most of its cash receipts and cheques received from various customers and others and would then make most of the payments by cheques drawn on such bank account.

A more elaborate cash book would have to be designed so as to serve the combined purpose of a cash account and a bank account, without in any way disturbing the double entry principles. The rulings would, in this situation, consist of discount, cash and bank columns on both sides of the cash book. The three columns provided are as follows:

- The first column is for discount, which is a nominal account
- The second column is for cash, which is a real account, and
- The third column is for bank, which is a personal account.

CASH BOOK

Dr. Cr.

Date	Receipts Particulars	L.F.	Dis.	Cash	Bank	Date	Payments Particulars	L.F.	Dis.	Cash	Bank
			N	R	P				N	R	P

N- Nominal Account R- Real Account P- Personal Account

NOTES

With addition of a bank column on both sides of the cash book, there is no need for a separate bank account in the ledger. As bank transactions are quite large in number in a business enterprise these days, this type of cash book results in a considerable amount of saving in clerical labour. Moreover, the form is able to have a rough idea about the balance position in the bank.

In three- column cash book, bank column is provided on both sides. All deposits into bank are written on the debit side while all withdrawals from bank are written on the credit side. The difference between the two sides reflects the balance at bank. Thus, this bank column serves the functions of a bank account in the ledger. Thus, the three-column cash book contains cash, bank and discount columns on both sides- debit and credit.

CONTRA ENTRY

One important feature of this cash book is that if a transaction involves both the cash and bank account, it is entered on both the sides of the cash book, one in the cash column and second in the bank column, though on opposite sides. This is called a 'Contra' entry and the letter C is indicated against that item. For example, when the firm deposits Rs. 50,000 in the bank, the journal entry will be:

Bank a/c	.....Dr. 50,000	
To Cash a/c		50,000

This is a contra entry. On the debit side of the cash book, Rs. 50,000 will be entered in the bank column (debit the receiver) and on the credit side of the cash book, Rs. 50,000 will be shown in the cash column (credit what goes out). On both the sides, the word 'C' will be mentioned to indicate that the same entry has been recorded on both sides of the cash book.

Similarly, when some money is withdrawn from bank by the firm, the firm passes the following journal entry:

Cash a/c	.....Dr.
To Bank a/c	

This is also a contra entry. On withdrawal of money from bank, entry is made on the credit (payments) side in the bank column (credit the giver). This will reduce the firm's bank balance. The firm will also write this transaction on the debit side (receipts) in the cash column (debit what comes in). This will increase the cash balance of the firm. Similarly, if cheque is deposited in Bank it is one of the Contra Entry.

Balancing the Three-Column Cash Book.

The firm will balance cash and bank column separately. Cash account will always show a debit balance, meaning thereby that cash receipts will always be more than the cash payments. The bank account generally shows a debit balance, but in some cases, it may have a credit balance, i.e., the payments from bank are more than the bank receipts. This is the case of an overdraft. This facility is provided by bank to the client only when there is a prior arrangement with the bank. The bank charges interest on overdraft. The discount columns on debit and credit sides of the cash book are not balanced. They are simply totalled. Discount account is maintained in the ledger.

Check Your Progress

1. Define cash book?
2. Describe types of cash book?

NOTES

Cheques Received

When a firm receives a cheque from a party, it is generally deposited in the bank column on the debit side of the cash book. Sometimes, this cheque is not deposited in the bank on the same day. Rather, it is deposited in the bank afterwards. In such cases, the cheque is kept in cash box and is entered in the cash book in the cash column on the debit side. When it is deposited in the bank after this date, a contra entry is made – first on the credit side in the cash column and then again on the debit side in the bank column. If nothing is mentioned in the question, we shall presume that cheque received on any day is deposited into the bank on that day itself.

It a cheque is received and deposited on the samd date, then it is directly debited to bank account. If a cheque received and deposited on different dates, the entry on receipt of cheque is 'debit cash and credit party.' When the cheque is deposited in the bank, entry- 'debit bank and credit cash' is passed.

When a cheque received from a party is endorsed in favour of a creditor of the business, the cheque received is first entered in the cash column on the debit side in the name of the party who had given this cheque. Then, it will be entered on the credit side in the cash column in the name of the party to whom it has been endorsed.

Example 3 : Enter the following transactions in a three-column cash book:

(i) Commenced business with cash amounting to Rs. 50,000.

(ii) Deposited into bank Rs. 40,000

(iii) Bought goods and paid by cheque Rs. 15,000.

(iv) Withdrawn from bank and paid for the purchase of a camera for private use Rs. 3,000.

(v) Withdrawn from bank for office use Rs. 1,000.

THREE-COLUMN CASH BOOK

Dr. Cr.

Date	Receipts	Discount Rs.	Cash Rs.	Bank Rs.	Date	Payments	Discount Rs.	Cash Rs.	Bank Rs.
(i)	To Capital A/c		50,000		(ii)	By Bank (C)		40,000	
					(iii)	By purchases			15,000
(ii)	To Cash (C)			40,000	(iv)	By Cash (C)			3,000
(iv)	To Bank (C)		3,000		(iv)	By Drawings		3,000	
(v)	To Bank (C)		1,000		(v)	By Cash(C)			1,000
			54,000	40,000		By Balance c/d		11,000	21,000
	To Balance b/d		11,000	21,000				54,000	40,000

SUBSIDIARY CASH BOOK

NOTES

As the journal is subdivided into many special journals, similarly the cash book is also subdivided into many subsidiary cash books from where the total is taken to the main cash book. Petty cash book for recording petty cash payments, cash collection book to record collections from debtors, cash book for recording payment to creditors, Remittance Cash book to record cash remittances from various branches are some of the examples of subsidiary cash book. However, out of these reffered subsidiary cash books, petty cash book is very commonly used in business enterprises.

PETTY CASH BOOK

Apart from big payments there is a number of small payments which have to be made such as for telegrams, etc. If all these payments are recorded in the cash book, it will become very cumbersome. It will overstrain the main cashier. Therefore it is usual for firms to appoint a person as 'petty cashier' and to entrust the task of making small payments to him.

Imprest system of petty cash book :

A definite sum of money is handed over to the petty cashier in the beginning of a period and he is reimbursed for the payments made at the end of the period. Thus, he will have again the fixed amount in the beginning of the new period. Petty cash book will have one column to record receipts of cash and other several columns to record payments of various types. The totals of various columns will show how much payments have been made and then the relevant accounts will be debited.

While maintaining the petty cash book the amount fixed for petty cash should be sufficient for any specified period. The petty cashier prepares a statement supported by vouchers and then he is reimbursed accordingly.

The extreme left- hand column records receipts of cash. The money columns towards the right hand show total payments for various purposes. A column is usually provided for "sundries" to record infrequent payments. The sundries column is later analysed. At the end of the period the petty cash book will be balanced. The method of balancing is the same as for the simple cash book.

On the credit side of the petty cash book, there is a column of date and next to it is the column of respective voucher number. A voucher is a statement which supports the occurance of any transaction. When the cashier pays any expense, he gets the voucher as a proof of that expense. A number is given to the voucher and the same number is written in the column of voucher. Next column is provided for particulars in which details of expenses are written. In spite of this, on the credit side of petty cash book, there are different columns adjacent to the 'totals column' to record the daily different expenses of the business. Amount of every expense is written first in 'Totals column' and thereafter that amount is written into the column related to that expense. At the end of the specified period, all the columns are totaled. The total of all the columns of expenses equals to the total of 'Total column' which is logical also. Thereafter the petty cash book is balanced.

NOTES

Advantages of petty Cash Book

There are mainly four advantages of maintaining a petty cash book:

(i) It saves time

(ii) It saves labour required for writing the cash book and posting into the ledger.

(iii) It provides control over small payments.

(iv) Preparation of ledger accounts becomes convenient.

Posting

Before posting the petty cash book in ledger a petty cash account is maintained. When an amount is given to the petty cashier, the petty cash account will be debited. After the specified time the total of payments made is credited to this account. The petty account will then show the balance in the hand of the cashier. On demand, he should be able to produce it for counting. At the end of the year, the balance is shown in the Balance Sheet as part of cash balanee.

Example 4 :

From the following transactions prepare a Petty Cash Book on the Imprest System;

2002		
Feb. 1	Received Rs. 10,000 for petty cash	
Feb. 2	Paid bus fare	25
Feb. 3	Paid for postage & Telegrams	50
Feb. 3	Paid wages	600
Feb. 4	Paid for stationery	400
Feb. 4	Paid fare charges	120
Feb. 5	Paid for furniture repair	150
Feb. 5	Paid rent	500
Feb. 6	Postage & Telegrams	270
Feb. 6	Bus fare	30
Feb. 6	Stationery	20

Check Your Progress

3. What do you mean by a single-column cash book?
4. What is a double-column cash book?
5. What is subsidiary cash book?

Solution :

Receipts Rs.	Date	V. no	Particulars	Total	Conveyance	Stationery	Postage & Telegrams	Wages
	2002							
10,000	Feb 1	1	To Cash					
	2	1	By Conveyance	25	25			

NOTES

	3	2	By Postage & Telegrams	50			50	
		3	By Wages	600				600
	4	4	By Stationery	400		400		
		5	By Conveyance	120	120			
	5	6	By repairs of furniture	150	150			
		7	By Conveyance	500	500			
	6	8	By postage & telegrams				270	
	7	9	By Conveyance	30	30			
	8	10	By Stationery	20		20		
				2,165	825	420	320	600
	6		By balance c/d	7,835				
10,000				10,000				
7,835	8		To Balance b/d					
2,165	8		To cash					

The journal entry and the relevant accounts will be shown as:

2002			
Feb 6	Conveyance A/c ....Dr.	825	
Feb 6	Stationery A/c ....Dr.	420	
Feb 6	Postage and Telegrams A/c ....Dr.	320	
Feb 6	Wages A/c ....Dr.	600	
	To Petty Cash A/c		2,165
	(being the analysis of the Petty Cash Book for the week ending Feb 6)		

Journal entry for cash handed over to the Petty Cashier passed will be as follows:

Petty Cash A/c	......Dr.	10,000	
To Cash A/c			10,000

LEDGER

NOTES

Dr. CONVEYANCE ACCOUNT Cr.

Date	Particulars	Amount		Date	Particulars	Amount
2002		Rs.				
Feb 6	To Petty Cash	825				

STATIONERY ACCOUNT

Date	Particulars	Amount		Date	Particulars	Amount
2002		Rs.				
Feb 6	To Petty Cash	420				

POSTAGE AND TELEGRAMS ACCOUNT

2002		Rs.				
Feb 6	To Petty Cash	320				

WAGES ACCOUNT

2002		Rs.				
Feb 6	To Petty Cash	600				

PETTY CASH ACCOUNT

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2002				2002			
Feb 1	To Cash		10,000	Feb 6	By conveyance		825
					By Stationery		420
					By postage and Telegrams		320
					By Wages		600
				Feb 6	By Balance c/d		7835
			10,000				10,000
Feb 8	To Balance b/d		7835				

Q)1 Enter the following transactions in the books of Shri Raj Kumar for the month of July 2011. The closing balance on hand on 30th june, 2011 was Rs. 1,000 :—

July2 received from Shyam on account Rs. 800

July4 bought goods for cash from Rakesh Rs.2000 at 10% trade discount

July5 sold goods to Ashutosh ,for cash of Rs.2000 at 10% trade discount

July9 cash sales Rs.250 and cash purchases Rs 700

July10 cash purchase of stationary Rs.150

July13 paid to Anoop Rs.250

July15 received from Kishore Rs.875

July20 paid office expenses Rs.200 and rent Rs.200

NOTES

SUMMARY

- Cash book may be defined as the record of transactions concerning cash receipts and cash payments. It is essential for a business to know the flow of cash or bank balance on hand.
- All cash received is recorded on the left-hand side or the debit side of the cash book while all cash payments are recorded on the right-hand side or the credit side of the cash book.
- Records of cash transactions normally are the largest in the business.
- Cash book fulfils the functions of a book of original entry as well as a ledger account.
- Cash book appears like an ordinary account, with one amount column on each side. The left-hand side records receipts of cash and the right-hand side the payments. Hence, it is called a 'single column cash book'.
- The receipts column will always be greater than the payments column. The difference will be written on the credit side as "By Balance c/d". The totals are then entered in the two columns opposite one another and then on the debit side the balance is written as "To Balance b/d"
- If along with the columns for amounts to record cash receipts and cash payments, another column is added on each side to record the cash discount allowed or the cash discount received, it will be a double-column cash book.
- Three – columnar Cash Book is a very popular form of Cash Book. Where a business enterprise has a current account in a bank, it would pay therein most of its cash receipts and cheques received from various customers and others and would then make most of the payments by cheques drawn on such bank account.
- A more elaborate cash book would have to be designed so as to serve the combined purpose of a cash account and a bank account, without in any way disturbing the double entry principles.
- The firm will balance cash and bank column separately. Cash account will always show a debit balance, meaning thereby that cash receipts will always be more than the cash payments. The bank account generally shows a debit balance, but in some cases, it may have a credit balance.
- When a firm receives a cheque from a party, it is generally deposited in the bank column on the debit side of the cash book. Sometimes, this cheque is not deposited in the bank on the same day. Rather, it is deposited in the bank afterwards. In such cases, the cheque is kept in cash box and is entered in the cash book in the cash column on the debit side.

NOTES

- Apart from big payments there is a number of small payments which have to be made, such as for telegrams, conveyance, stationary etc.
- A definite sum of money is handed over to the petty cashier in the beginning of a period and he is reimbursed for the payments made at the end of the period. Thus, he will have again the fixed amount in the beginning of the new period.

ANSWERS TO 'CHECK YOUR PROGRESS'

1. Cash book may be defined as the record of transactions concerning cash receipts and cash payments.
2. The main cash book may be of three types: (a) Single-column cash book, (b) Two-column cash book, and (c) Three-column cash book
3. A cash book appears like an ordinary account, with one amount column on each side. The left-hand side records receipts of cash and the right-hand side the payments. Hence, it is called a 'single column cash book'.
4. If along with the columns for amounts to record cash receipts and cash payments, another column is added on each side to record the cash discount allowed or the cash discount received, it will be a double-column cash book.
5. Petty cash book for recording petty cash payments, cash collection book to record collections from debtors, cash book for recording payment to creditors.

TEST YOURSELF

1. Explain the importance of cash book.
2. What is Cash book ? What are its different kinds ? Describe the advantage of Cash book.
3. Define Cash book. Explain in detail the various types of cash book.
4. Write the advantage of Cash book.
5. What is the Meaning of Posting ? Give its procedure with example.
6. What is Petty Cash book ? why is it prepared ?
7. What is the difference between two column cash book and three column cash book ?
8. Write the advantage of Petty Cash book.

PRACTICAL QUESTIONS

1. Enter the following transactions in a simple Cash Book :

2007		Rs.
Feb 1	Cash in hand	9,500
Feb 4	Received cash from Kharu Bros.	4,000
Feb 6	Paid Radha Book Depot	5,000

Feb 10	Cash Sales	3,200
Feb 11	Goods purchased from Murli on Credit	5,000
Feb 17	Bought Furniture	1,000
Feb 20	Cash Purchases	5,000
Feb 21	Goods sold to Hari on Credit	4,000
Feb 23	Paid wages	500
Feb 25	Cash Sales	2,500
Feb 27	Paid Salaries	1,500
Feb 28	Paid Rent	2,000

[Ans : Cash Balance Rs. 4,200]

2. Enter the following transactions of Anu Sharma in a Two-Column Cash Book.

2007		Rs.
July 1	Business started	1,00,000
July 2	Goods purchased for cash	20,000
July 3	Goods purchased on credit from Hari	40,000
July 5	Goods sold to Mohan	20,000
July 10	Goods sold for Cash	40,000
July 12	Stationery purchased	2,000
July 15	Wages paid	600
July 17	Paid to Hari	39,000
	and Discount received	1,000
July 20	Received from Mohan and	19,500
	Discount allowed	500
July 25	Rent Received	2,000
July 31	Electricity Bill Paid	3,000

[Ans : Cash Balance Rs. 96,900; Discount Rs. 500]

3. Enter the following transactions in the Three Columnar Cash Book of M/s Yeshwant General Store :

2007		Rs.
Jan 1	Cash in hand	10,020
Jan 1	Cash at Bank	50,000
Jan 2	Deposited in Bank	10,000
Jan 3	Bills Payable by cheque	2,500
	office purpose	4,000
Jan 10	Drawings in Cash	1,000
Jan 15	Received a cheque from Parul	
	and deposited in the Bank	7,000
Jan 18	Paid wages by cheque	7,000
Jan 20	Received cheque from Ram and	
	Discount allowed to him	500
Jan 24	Ram's cheque endorsed to Manu	
Jan 27	Deposited into Bank, Balance of Cash	
	in excess of Rs. 2500	

[Ans : Cash Balance – Rs, 54020, Bank Balance = Rs. 2500, Discount Dr – Rs. 500 & Cr. – NIL]

NOTES

Note –

To make balance of bank	=	Rs. 2500
10020 + 4000 + 8000	=	22020 – (10000+1000+8000+2500)
	=	22020 – 21500
	=	Rs. 20/-

FURTHER READINGS

- Accounting for Managers: Sharma and Gupta
- Management Accounting: Mr. Agrawal
- Fundamentals Accounting: Jain, Khandelwal, Pareek

5 Subsidiary Books

NOTES

The Chapter Covers :

- INTRODUCTION
- SPECIAL PURPOSE SUBSIDIARY BOOKS OR
- SPECIAL JOURNALS
- SALES BOOK
- PURCHASES BOOK
- PURCHASES RETURN BOOK
- SALES RETURN BOOK
- BILLS PAYABLE BOOK
- BILLS RECEIVABLE BOOK
- JOURNAL PROPER

Learning Objectives:

After going through this chapter, you should be able to:

- Understand what are subsidiary books
- Explain sales books
- Differentiate between purchase book and purchase return book
- Elucidate bills payable book
- Learn bill receivable book

NOTES

INTRODUCTION

We have already studied in prceeding chapters that only one journal book is maintained for all transactions. Theoretically, it may be said that all transactions can be entered in one journal book but this is not possible in practice, because in large commercial enterprises, thousands of transactions take place everyday and one person cannot write down all an a single journal simultaneously. So, we make subdivisions of journals into a number of 'Special Journals'. These are also known as 'Special Purpose Subsidiary Books' or the 'Books of Original Entry'.

The chapter on subsidiary books is an attempt to make students familiar with additional books of Accounting. This chapter delivers the information on special purpose subsidiary books, purchases books, purchases return books and sales returns book and how to do postings in these books has been explained.

SPECIAL PURPOSE SUBSIDIARY BOOKS OR

SPECIAL JOURNALS

Meaning

If the size of the business is large the system of book-keeping should be easy and simple to follow, and should be such as to allow division and sub-division of duties and speedy working. If the size of the business is a small one, then it is possible to enter each and every transaction in the journal, commonly known as books of original record or primary record. But when size of the business grows, it is no longer possible to record all the transactions in one general journal, but the main journal is split into a number of separate journals or Day Books. A separate Day Book is used for each type of transaction. These transactions are usually numerous. These journals are prepared almost everyday and are of specialized character as they include transactions relating to one type of transactions. They are, therefore, known as special journals. They may also be called **special purpose subsidiary books.**

Subsidiary Books may be defined as books where transactions are entered first for the purpose of record. In a large business, the subsidiary books generally used are:

(1) Purchase Journal or Purchases Book,

(2) Sales Journal or Sales Book,

(3) Purchase Returns Journal or Purchases Returns Book,

(4) Sales Returns Journal or Sales Returns Book.

(5) Bills Payable Book

(6) Bills Rceivable Book

(7) Journal Proper

NOTES

Advantages

1. All transactions of one nature are collected at one place. It facilitates the posting to the impersonal account with the total.
2. Special journals facilitate the division of labour. The work of posting can be entrusted to several assistants at the same time and thus the ledger of a large business can be written up in a very short time. Internal check can also be introduced.
3. When transactions of similar nature are collected at one place a careful survey of the trend and pattern of distribution and other factors can be of help in day-to-day decisions of management. For example, a careful study of sales returns journal might reveal the cause of return, loss due to such return on.
4. Division of work results in increased efficiency. Each person of accounting staff is required to write uponly one class of transactions, therefore it develop proficiency of work.
5. It results in saving of time.
6. It makes information available regarding each particular class of transactions.
7. At the time of preparing trial balance the checking is easier because books being many different persons can carry out the job.

SALES BOOK.

Sales Book is used for recording sales of goods on credit. If there are cash sales, they are recorded in cash receipts journal (cash book) and not in sales journal. Thus, it will be seen that the use of sales journal is very much limited to the recording of only credit sales of goods.

The entries in the sales book are made from the copies of the invoices which have been sent to the customers alongwith the goods. Such copies of the invoices may be termed as 'Outward Invoice'.

The format of sales journal is as follows :

SALES BOOK

Date	Particulars	Invoice No.	L.F.	Details Rs.	Amount Rs.

The particulars column is meant to record the name of the supplier, name of the articles and quantities sold. The amount in respect of each article is entered in the details column. After totalling the various amounts included in a single sale, the amount for packing, or other charges is added and the amount for trade discount is deducted. The net amount is entered in the extreme right-hand column. The total in this column will show the total credit sales for a period. The number of invoice or bill is mentioned in respective column. In L.F. column the folio number of ledger is written where the concerned account has been opened.

NOTES

EXAMPLE 1 :

The following are some of the transactions of X. Make out their Sales Book :

Sold to A on credit :	20 Tables @ Rs. 100	
	30 Chairs @ Rs. 200	
	Less: Trade Discount @ 10%	

Sold old furniture to B on credit Rs.1,000.

Sold 25 Tables on credit to C @ Rs. 100 each for cash.

Sold on credit to D:	100 Table @ Rs. 175.
	10 doors @ Rs. 500
	Less: Trade Discount @ 10%

Solution 1 : **SALES BOOK OF X**

Date	Particulars	Invoice No.	L.F.	Details Rs.	Amount Rs.
Date of Transaction	A				
	20 Tables @ Rs. 100			2,000	
	30 Chairs @ Rs. 200			6,000	
				8,000	
	Less : Trade Discount @ 10%			800	
	Sales as per invoice No...dated...				7,200
	C				
	25 Tables @ Rs. 100				
	Sales as per invoice No..dated...				2,500
	D				
	100 Tables @ Rs. 175			17,500	
	10 Doors @ Rs. 500			5,000	
				22,500	
	Less: Trade Discount @ 10%			2,250	
	Sales as per invoice No..dated...				20,250
	Sales A/c .....Cr.				29,950

Posting of Sales book. The names appearing in the sales book are of those parties which have received the goods on credit. The accounts of the parties have to be debited with the respective amounts. The total of the Sales Book shows the credit sales made during the period concerned. The amount is credited to the Sales Account.

The amount put on the credit side is equal to the total of the amounts put on the debit side. Thus, the double entry principle is followed strictly.

Ledger of X

Dr. A Cr.

Date	Particulars	Folio	Amount		Date	Particulars	Ledger	Amount
	To Sales		7,200					

B

	To Sales		7,200					

C

	To Sales		20,250					

SALES ACCOUNT

						By Sales As per SalesBook for the month of.		29,950

NOTES

To Sales

PURCHASES BOOK

Purchases journal is used for recording purchase of goods purchased on credit basis. Credit purchases of goods dealt in or materials used for production in the factory are recorded in a separate register, called the purchases book or the purchase journal. When we purchase goods on credit we receive a statement from the suppliers giving the particulars of the goods supplied by him. This statement is called an 'Inward Invoice'. The proforma of a purchase book is given below:

PURCHASES BOOK

Date	Particulars	Invoice No.	L.F.	Details Rs.	Amount Rs.

Source of Recording : The entries in the Purchases Book are made from the invoices received from the suppliers with the amounts arrived after deducting trade discount.

Cash purchases are not entered since they are entered in the cash book; only credit purchases of goods traded in or material used for production in factory should be recorded in a purchase book. Credit purchases of Asset are also not recorded in it.

In the particulars column, the name of the supplier and the name of the articles and quantities purchased are recorded. The amount in respect of each article is entered in the details column. After totalling the various amounts included in a

NOTES

single purchase, the amount for packing or other charges is added and the amount of trade discount is deducted. The net amount is entered in the extreme right-hand column. The total in this column will show the total purchases made in a period. The number of invoice or bill is mentioned in respective column.

Trade Discount. The amount of the purchase made is always arrived at after deducting the trade discount, i.e., only the net amount is considered.

Sales Tax. The amount of sales tax charged by the supplier of goods is added to the amount of purchases. If trade discount is also given, first deduct trade discount and then calculate sales tax on remaining balance.

Posting of Purchases Book. The book shows the names of the parties from whom goods have been purchased on credit. These parties are, now in accounting terminology, creditors. Their accounts have to be credited for the respective amounts shown in the total purchases made in a period. This amount is debited to the Purchases Account to indicate receipt of goods.

Example 2 : Enter the following transaction in the Purchase Book of PVR. & Co., Kota :

2007

June 2 Purchased goods from Shreekant, Gumanpura on credit :

100 Dozen Bulbs @ Rs. 50 per Dozen
25 Fans @ Rs. 200 each
10 Heaters @ Rs. 50 each
Trade Discount 15%.

June 20 Purchased goods from Ram Mohan & Co., Talwandi, on credit :

60 Dozen Bulbs @ Rs. 50 per Dozen
10 Tubelights @ Rs. 60 each
Trade Discount 10%

> ***Check Your Progress***
> 1. Define subsidiary books?
> 2. What are sales books?

Solution :

PURCHASE BOOK

Date	Particulars	Invoice No.	L.F.	Details Rs.	Amount Rs.
2007	Shreekant, Gumanpura				
June 2	100 Dozen Bulbs @ Rs. 50 per dozen			5,000	
	25 Fans @ Rs. 200 each			5,000	
	10 Heaters @ Rs. 50 each			500	
				10,500	
	Less : Trade Discount 15%			1,575	8,925
June 20	Ram Mohan & Co.; Talwandi				
	60 Dozen Bulbs @ Rs. 50 per Dozen			3,000	
	10 Tubelights @ Rs. 60 each			600	
				3600	
	Less : Trade Discount 10%			360	3,240
					12,165
June 30	Purchase A/C Dr.				

PURCHASES RETURN BOOK

NOTES

This journal is used for recording transactions relating to return of such goods as were purchased on *credit* basis. It contains details related to return of goods purchased by the firm for which no cash is paid. It is also called Returns Outward Book. It is so called because goods are returned and go out of business to the suppliers.

The form of Purchase Return Book is given below:

PURCHASE RETURN BOOK

Date	Debit Note No.	Particulars	L.F.	Details Rs.	Amount Rs.

Debit Note: It is a note made out with a carbon duplicate. The duplicate copy is for office record and the original one is sent to the party to whom the goods are returned. It is called a debit note because the party's account is debited with the amount written in this note. The same note is termed as credit note from the receiving party's point of view because he will credit the account of the party from which he has received the note together with goods. The Purchaser sends a debit note to seller and the seller sends the credit note to the purchaser.

Flow of Debit Note

Purchaser ⟶ Sends ⟶ debit Note ⟶ to Seller ↘

and

Purchaser ⟵ to ⟵ Credit Note ⟵ Sends ⟵ Saller ↙

Posting from purchase return book.

(a) Individual amounts are posted immediately on the happening of event to the debit of party's account; and

(b) Monthly total of the journal is credited to the purchases return account.

Example 3 : Enter the following transactions in the Purchase Return Book of Shri Pravin Jain :

2007	
Nov. 7	Return goods to RJ & Sons for Rs. 2,000. Trade Discount 10%.
Nov. 15	Return goods to Housefull store for Rs. 5,000 as the goods were not according to sample.
Nov. 25	Allowance claimed from Nyati Builders, on account of mistake in the invoice Rs. 3,500.

NOTES

Solution :

PURCHASE RETURN BOOK

Date	Debit Not No.	Particulars	L.F.	Details	Amount
2007					
Nov. 7		RJ & Sons		2,000	
		Less : Trade Discount 10%		200	1,800
Nov. 15		Housefull Store			5,000
Nov. 25		Nyati Builders			3,500
Nov. 30		Purchase Return A/C .....Cr.			10,300

SALES RETURN BOOK

This journal is used for recording transactions relating to return of such goods as were sold by the firm to its customers on credit basis. It contains details regarding return of goods purchased by customers for which no cash is recrived. This is also called Returns Inward Book or Sales Return Book because goods returned by customers come in the business.

The form of Sales Return Book is given below:

SALES RETURN BOOK

Date	Credit Note No.	Name of the Customer	L.F.	Details Rs.	Amount Rs.

Credit Note. It is made with a carbon duplicate- the duplicate copy being for office use. The original copy is sent to the party from which goods are received. From the point of view of business which receives goods, this note is called a credit note because the party's account is credited with the amount written in this note. The same note is called a debit note by the party who returns goods because that party uses this note for debiting the account of the party to whom goods have been returned. The Seller sends a credit note to the purchaser and the purchaser sends a debit note to the seller.

Flow of Debit Note

Seller ⟶ Sends ⟶ Credit Note ⟶ to purchaser ↘ and

Seller ⟵ Debit Note to ⟵ Sends ⟵ Purchaser ↙

Posting from Sales Return Journal.

(a) Individual amounts are posted immediately on the happening of event to the *credit* of party's account; and

(b) Monthly total of the journal is debited to sales return account.

Example 4 : Enter the following transactions in the Sales Return Book :

2007

June 7 Goods returned by M/s Brown & Co :
6 fans @ Rs. 600 each
Trade Discount 10%

June 23 M/s Carol. & Co. returned 1 lamp of Rs. 500.

NOTES

Solution :

SALES RETURN BOOK

Date	Particulars	L.F.	Details Rs.	Amount Rs.
2007				
June 7	M/s Brown & Co.			
	6 fans @ Rs. 600		3,600	
	Less : Trade Discount@ 10%		360	3,240
June 23	M/s Carol & Co.			500
	1 lamp			
June 30	Sales Return A/c .....Dr.			3,740

BILLS PAYABLE BOOK

When goods are sold on credit, a bill of exchange, payable after sometime may be drawn by a seller (creditor) on the purchaser (debtor). The bill of exchange is then, accepted by the debtor indicating that he would pay the amount written there in on the expiry of the period mentioned on the bill. After accepting the bill is returned to the creditor. To the Creditor, the bill is termed as 'Bills Receivable' since he is to receive it, while the same bill is termed as 'Bills Payable' to the Debtor since he is to pay the amount mentioned in it at a future date.

Whenever a bill of exchange is accepted its particulars are entered in a seperate book called bills payable book. Its format is given below :

Date of Acceptance	To whom given	Period of Bill	Due date	L.F.	Amount Rs.	How disposed

Posting

The periodical total of the bills payable book is posted to the credit of the bills payable account in the ledger. Each entry in the book is posted to the debit of the individual account from whom the bill is granted.

Example 5 : Record the following transactions in the Bills Payable Book :

2007

Oct 1 Accepted a bill of Rs. 20,000 for 2 months drawn by M/s Babli & Sons.

Oct 20 Gave acceptance to Mahavir & Co. for Rs. 10,000 payable 1 month after the date.

Oct 28 A bill at 45 days for Rs. 9,000 drawn by Arihant & Co. was accepted on this day.

NOTES

Solution :

BILLS PAYABLE BOOK

Date of Acceptance	To Whom Given	Period of Bill	Due Date	L.F.	Amount Rs.	How disposed
2007						
Oct 1	M/s Babli & Sons	2 Month	3 Dec.		20,000	
Oct 20	Mahavir & Co.	1 Month	3 Nov.		10,000	
Oct 28	Arihant & Co.	45 days	15 Jan.		9,000	
Oct 31	Bills Payable A/C			Cr.	39,000	

BILLS RECEIVABLE BOOK

Whenever a bill of exchange is received its particulars are entered in a separate book called Bills Receivable Book. This book is also a book of original entry. Its format is given as :

Date of Receipt	From Whom Received	Period of the Bill	Due Date	L.F.	Amount Rs.	How disposed

Posting – The periodical total of the bills receivable book is posted to the debit of the bills receivable account in the ledger. Each enter in the book is posted to the credit of the individual account from whom the bill is received.

Example 6 : Record the following transactions in the Bills Receivable Book :

2008

Jan 5 Received from Shreekant his acceptance at 3 months for Rs. 10,000

Jan 18 Acceptance received from Taranjeet for Rs. 50,000 for 60 days.

Solution :

BILLS RECEIVABLE BOOK

Date of Receipt	From Whom Received	Period of Bill	Due Date	L.F.	Amount Rs.	How disposed
2008						
Jan 5	Shreekant	35 days	Feb. 12		10,000	
Jan 18	Taranjeet	60 days	Mar. 22		50,000	
Jan 31	Bills Receivable A/C			Dr.	60,000	

JOURNAL PROPER

After the sub-division of journal into various subsidiary books, journal remains only a residuary book in which only those transactions are recorded which cannot be recorded in any other subsidiary book. In such a case, journal is called journal proper.

The following types of transactions are recorded in Journal proper.

(1) Opening Entries

(2) Closing Entrie

(3) Transfer Entri

(4) Adjustment E ries

(5) Rectifying Entries

(6) Other Entries – Purchase or sale of asset on credit, Endorsement, Cancellation & dishonour of Bill, etc.

Example 7 : Enter the following transaction of Kumar & Sons in appropriate Subsidiary Book.

2007	
Jan 1	Assets : Cash in hand Rs. 5,400, Due from Sanjay Rs. 7000/-, Due from Dheeraj Rs. 20,000; Stock Rs. 80,000; Furniture Rs. 25,000 Liabilities – Bank Overdraft Rs. 36,200. Due to Sun Rs. 9200.
Jan 3	Purchased from Laxman & Sons 10 Bags of tea @720 each less 10% trade discount.
Jan 5	Purchased from Dass 20 tins of coffee @ Rs. 480/-, less 5% trade discount. Half the payment is made in cash and half by cheque.
Jan 6.	Purchased Machinery for Rs. 10,000 from Praful on credit.
Jan 8.	Received Cash from Sanjay Rs. 6,800 in full settlement of their account.
Jan 10.	Deposited from Bank Rs. 5,000/-
Jan 12.	Sold to Sen & Co. goods as follows – 4 bags of coffee @ Rs. 950 each 12 tins of coffee @ Rs. 700 each
Jan 15.	Returned to Laxman & sons 1 bag of tea.
Jan 16.	Sold to Shankar 20 bags of tea @ Rs. 1,000 each less 5% trade discount.
Jan 17.	Shankar returned 1 bag of tea.
Jan 18.	Shankar accepted a bill for 1 month for the amount due from him.
Jan 20.	Received a cheque of Rs. 10,000 from Sen & Co. The cheque is immediately deposited into bank.
Jan 21.	Purchased from Vijay & Co. 20 bags of tea @ Rs. 800 each and 5 tins of coffee @ Rs. 500 each.
Jan 22.	2 bags of tea costing Rs. 700 each are taken by Mr. Kumar for person use.

NOTES

Check Your Progress

3. Explain purchases book?
4. What is sales tax?
5. What is a credit note?

NOTES

Jan 24. Returned to Vijay & Co. 2 bags of tea and 1 tin of coffee.

Jan 25. Acceptance given to Vijay & Co. for 2 months for the amount due to them.

Jan 27. Acceptance received from Sen. & Co. for Rs. 2,200 for 30 days.

Jan 28. Withdrew from Bank for personal use of Rs. 4,000 and for office use Rs. 6,000.

Jan 30. Paid rent by cheque Rs. 4,000.

Solution : **Purchase Book**

Date	Particulars (Name of Suppliers)	Invoice No.	L. F.	Details	Amount
2007					
Jan 3.	Laxman & Sons				
	10 bags of tea @ Rs. 720 each			7,200	
	(–) 10% Trade discount			720	6,480
Jan 21.	Vijay & Co.				
	20 bag of tea @ Rs. 800 each			16,000	
	5 tin of coffee @ Rs. 500 each			2,500	18,500
Jan 31	Purchase A/c Dr.				24,980

Sales Book

Date	Particulars (Name of Customers)	Invoice No.	L. F.	Details	Amount
2007					
Jan 12	Sen & Co.				
	4 bags of coffee @ Rs. 950 each			3,800	
	12 tins of coffee @ Rs. 700 each			8,400	12,200
Jan 16.	Shankar				
	20 bags of tea @ Rs. 1000 each			20,000	
	Less : Trade discount 5			1,000	19,000
Jan 31.	Sales A/c Cr.				31,200

Purchases Return Book

Date	Particulars (Name of Customers)	Debit Note No.	L. F.	Details	Amount
2007					
Jan 15.	Laxman & Sons				
	1 bag of tea @ 720			720	
	Less : 10% Trade Discount			72	648
Jan 24.	Vijay & Co.				
	2 bags of tea @ Rs. 800			1,600	
	1 Tin of coffee @ Rs. 500			500	2100
Jan 31.	Purchase Return A/c Cr.				2,748

NOTES

Sales Return Book

Date	Particulars	Debit Note No.	L. F.	Details	Amount
2007 Jan 17	Shankar 1 bag of tea @ Rs 1000 Less : 5% Trade Discount			1000 50	950
Jan 31	Sales Return A/C Dr.				950

Bills Payable Book

Date	To Whom Given	Period of Bill	Due Date	L. F.	Amount	How disposed
2007 Jan 25	Vijay & Co.	2 Month	March 28		16,400	
Jan 31	Bills Payable A/C Cr.				16,400	

Bills Receivable Book

Date	For Whom Given	Period of Bill	Due Date	L. F.	Amount	How disposed
2007 Jan 18 Jan 27	Shankar Sen & Co.	1 Month 30 days	Feb 21 March 1		18,050 2,200	
Jan 31	Bills Receivable A/C Cr.				20,250	

Journal Proper

Date	Particulars	L.F.	Dr.	Cr.
2007			Rs.	Rs.
Jan 1	Cash A/C ......Dr.		5,400	
	Sanjay ......Dr.		7,000	
	Dheeraj ......Dr.		20,000	
	Stock A/C ......Dr.		80,000	
	Furniture A/C ......Dr.		25,000	
	To Bank Overdrafts			36,200
	To Sun			9,200
	To Capital A/C (Balancing figure)			92,000
	(for opening balances brought forward)			
Jan 6	Machinery A/C .....Dr.		10,000	
	To Praful			10,000
	(for machinery purchased on credit)			
Jan 8	Discount A/C .....Dr.		200	
	To Sanjay			200
	(for discount allowed to Sanjay in full settlement)			
Jan 22	Drawings A/C .....Dr.		1,400	
	To purchases A/C			1,400
	(for 2 bags of tea costing Rs. 700 each taken for personal use)			

NOTES

CASE STUDY :

1. Enter the following transactions of P.C.Lal Ice cream Parlor in Sales book, Sales returns book; Purchases book and purchases returns book.

2011

July 5. Sold on credit to Sethi and co
5 units of Butter Scotch @ Rs.25 each
5 units of Vanilla @ Rs 15 each

July 8. Purchased on credit from Kwality ice-cream
25 units of Dilkush @Rs.40
100 units of strawberry @ Rs.20

July 10. Purchased for cash from Mohan and co
10 units of chocolate ice-cream at Rs.30

July 15. Sold to Gopal Bros. on credit
10 units of Dilkush @ Rs. 50
5 units of strawberry at Rs.25

July 18. Returned to Kwality ice-cream 5 units of Dilkush being spoiled.
20. Purchased from Joy ice creams
100 units Raspberry @ Rs.20
100 units Cassata @ Rs.30

July 26. Gopal Bros returned 1 unit of Dilkush as the same was spoiled.

SUMMARY

- If the size of the business is large the system of book-keeping should be easy and simple to follow so as to allow division and sub-division of duties and speedy working. If the size of the business is a small one, then it is possible to enter each and every transaction in the journal, commonly known as books of original record or primary record.
- All transactions of one nature are collected at one place.
- Special journals facilitate the division of labour.
- When transactions of similar nature are collected at one place a careful survey of the trend and pattern of distribution and other factors can be of help in day-to-day decisions by management.
- Sales journal is used for recording sales of goods on credit.
- Purchases journal is used for recording purchase of goods purchased on credit basis. Credit purchases of goods dealt in or materials used for production in the factory are recorded in a separate register, called the purchases book or the purchase journal.
- The entries in the purchases book are made from the invoices received from the suppliers with the amounts arrived at after deducting trade discount. Cash purchases are not entered since they are entered in the cash book; only credit purchases of goods traded in or material used for production in a factory should be recorded in a purchase book.
- Trade Discount is the discount which is allowed if the customer purchases goods above a certain quantity or above a certain amount.
- Posting of purchases Book shows the names of the parties from whom goods have been purchased on credit.
- Purchases Return Book is used for recording transactions relating to return of such goods as were purchased on credit basis.

NOTES

- Debit note is a note made out with a carbon duplicate. The duplicate copy is for office record and the original one is sent to the party to whom the goods are returned. It is called a debit note because the party's account is debited with the amount written in this note.
- Sales Return Book is used for recording transactions relating to return of such goods as were sold by the firm to its customers on credit basis. It contains details regarding return of goods purchased by customers for which no cash is received. This is also called Returns Inward Book or Sales Return Book because goods returned by customers come in the business.
- Credit Note is made with a carbon duplicate- the duplicate copy being for office use. The original copy is sent to the party from which goods are received. From the point of view of business which receives goods, this note is called a credit note because the party's account is credited with the amount written in this note.
- All receipts of bills are entered in the book called bills receible. The details of the bills accepted by a trader are recorded in a book known as Bills Payable Book.

ANSWERS TO 'CHECK YOUR PROGRESS'

1. Subsidiary Books may be defined as books where transactions are entered first for the purpose of record.
2. Sales Book is used for recording sales of goods on credit. If there are cash sales, they are recorded in cash receipts journal (cash book) and not in sales journal.
3. Purchases journal is used for recording purchase of goods purchased on credit basis.
4. The amount of sales tax charged by the supplier of goods is added to the amount of purchases. If trade discount is also given, first deduct trade discount and then calculate sales tax on remaining balance.
5. Credit Note. It is made with a carbon duplicate- the duplicate copy being for office use. The original copy is sent to the party from which goods are received.

TEST YOURSELF

1. What are Subsidiary Books ?
2. Write the names of Subsidiary Books of Journals.
3. What are Subsidiary Books and their advantages ?
4. Write any 3 advantages of Subsidiary Books ?
5. What is Purchase Book ?
6. What is Sales Returns Book ?
7. What is the difference between Purchases Book and Sales Return Book ?

PRACTICAL QUESTION

Q1. Following transactions were recorded in the books of Shri Kanwar :

2007

March 1 Sold to Kamal light Center :

50 Tubelights @ Rs. 60 each less 20%

20 Heaters @ Rs. 120 each less 25%

NOTES

March 5 Purchased from Ram Shyam & Co. :
25 Table Fans @ Rs. 600 each
20 Ceiling Fans @ Rs. 800 each

March 10 Goyal & Sons purchased from us :
80 dozen bulbs @ Rs. 90 per dozen

March 12 Purchases from Ram Shyam & Co.
Typewriter for Rs. 6000 on credit for office use.

March 16 Sri Ram & Sons sold us :
10 Electric Boards @ Rs. 180 less 10%

March 20 Kamal Light Center returned :
5 Tube lights sold on March 1.

March 22 Sold goods to Nirma & Co. for cash Rs. 10,000.

March 25 Returned to Sri Ram & Sons 2 Electric Boards.

You are required to prepare (i) Purchase Book (ii) Sales Book (iii) Purchase Return Book (iv) Sales Return Book

[Ans. : Total of purchase book Rs. 39, 820, Total of Sales Book Rs. 4200, Total of Purchase Return Book Rs. 324, Total of Sales Return Book Rs. 240

Purchase of Typewriter should be entered in Journal proper

FURTHER READINGS

- Accounting for Managers: Sharma and Gupta
- Management Accounting: Mr. Agrawal
- Fundamentals Accounting: Jain, Khandelwal, Pareek

6 Ledger

NOTES

The Chapter Covers :

Learning Objectives:

After going through this chapter, you should be able to:

- Explain ledger
- Difference between ledger and journal
- Understand relation between journal and ledger
- Balance an account
- Learn the rules for posting transactions

NOTES

INTRODUCTION

Business transactions are first entered in journal or, subsidiary books. The next step is to transfer the entries to respective accounts in ledger. The procedure of journalising helps us to determine which account is to be debited or credited. It is necessary to gather at one place all transactions, during the period, relating to a particular subject. It is only then that the net results can be assertained.

Ledger is supposed to be a permanent and organized book for all the transactions occured in a company. This chapter serves you a lot of information on Ledger. The chapter introduces you to the meaning of ledger and posting. It enables you to compare between ledgers and journals. In addition, you will know about the rules for posting transactions. By the end of the chapter, we will likely to be in position to get a detailed knowledge of Ledger.

LEDGER

Meaning of Ledger. Ledger is a set of account. It is a book which contains accounts is known as the ledger. It is defined as a "book or register which contains, in a summarized and classified form, a permanent record of all the transactions." It is the most important book of accounts, since final position pertaining to the financial status of a business emerges only from them. Hence, the ledger is called the Principal Book.

Its sources of information are the books of original entry, called journals. When a customer purchases goods from a firm on different dates, his transactions are recorded on different pages in the journal. It is not possible to know at a glance what amount is owed by a customer unless all the entries relating to his account are brought together in the form of an account. Ledger is kept keeping in view of this objective.

A General Ledger is just a formal set of T-Accounts. Each account that is to be tracked and kept up has a separate page or pages maintained in a record book called the General Ledger. The general ledger's major sections are Assets, Liabilities, Owner's Equity, Revenues, Expenses, and Drawings.

For each item (account) in General Ledger, the increases and decreases for a period (usually a month) are measured and its ending balance is calculated. The ending balance of the account is easily determined by adding the increases and substracting the decreases from the account's beginning period balance.

Ending Account Balance = Beginning Balance + Increases - Decreases

Simply stated a General Ledger is just a book containing the summarized financial transactions and balances of the accounts for all assets, liabilities, equity, revenue, and expense accounts of business.

Objectives :

1. To ascertain how much amount is due from each customer or how much amount the firm has to pay to each supplier.
2. To ascertain how much is the amount of purchase or sale during a particular period.

3. To ascertain how much amount has been spent on each head of expenses and amount has been earned on account.

Importance of ledger :

NOTES

1. It helps in preparation of final account of organisation.
2. It helps to find true position of debtors & creditors.
3. It saves time.
4. It act as a proof in case of any dispute.
5. It show the ultimate position of assets and liabilities.
6. In ledger all transactions pertaining to a person or thing will be parted at one place which will provide a complete picture of all transactions relating to them at a glance.

***Form of ledger*.** The accounts in the ledger are kept in specific form is given below:

Dr. **Name of account** Cr.

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

There are two sides of a ledger account. The left-hand side is known as debit side while the right –hand side is known as credit side. The words 'Dr.' and 'Cr.' are used to denote Debit and Credit.

The name of the account is written in the middle of the account. On each side, there are columns for date, particulars, journal folio and amount. 'J.F.' denotes folio or page number on which the journal entry may be found.

What is posting?

Posting is the process of entering in the ledger the information given in the journals. Posting from the journal or book is done periodically, may be weekly or fortnightly or monthly as per the convenience of the business. The posting of a journal entry to the general ledger accounts is a purely mechanical process using information already in the journal entry and requiring no additional analysis.

RELATION BETWEEN JOURNAL AND LEDGER

The journal and the ledger are the most important books of the double entry system of accounting and are indispensable for a proper system. Following are the points of comparison between these two types of books:

(i) The Journal is the book of original entry and the ledger is the book of second entry.

(ii) The Journal is the book for chronological record and the ledger is the book for analytical record.

(iii) The Journal, as a book of source entry, has greater weight as legal evidence than the ledger.

(iv) The unit of classification of data within the ledger is the account; the unit of classification of data within the Journal is the transaction.

RULES FOR POSTING TRANSACTIONS

NOTES

(a) The debit side of the journal entry is posted to the debit side of the account and on that side the reference is given of that fact which is put on the credit side of the journal entry.

(b) The credit side of journal entry is posted on the credit side of the account and on that side the reference is given of that fact which is put on the debit side of the journal entry.

The journal entry needs two accounts to post it fully; one account is debited and the other is credited.

(c) On the debit side, posting begins with 'To' and on the credit side with 'By'.

(d) In the 'folio' column, the page number of the journal from where the entry is transferred to ledger account is written.

EXAMPLE :

Mar 6	Machinery A/c	.....Dr. 25,000	
	To Amron A/c		25,000

The amount of Rs. 25,000 will be debited to the Machinery Account and credited to Amron. The manner will be: in the Machinery Account in the particulars column we shall write "To Amron". In the account of Amron "By Machinery Account" will be written. The two accounts will thus appear as:

Dr. MACHINERY ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
March 6	To Amron	35	25,000				

J.F.

Dr. AMRON ACCOUNT Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
				March 6	By Machinery A/c	35	25,000

BALANCING THE ACCOUNT

After completion of posting of all transactions, accounts are balanced every year or after a certain period. Balancing of account means the total of both the sides of an account are equal and to write the difference in the side whose total is short. For example, if total of credit side is more than the debit side of any account the difference of amount will be recorded as Balance c/d on debit side and vice versa on the credit side. If the total of debit side of any account is greater, that account will reveal a debit balance and if total of credit side of any account is more it will show credit balance. The total of debit side and credit side of some accounts may be equal, those accounts will not display any balance.

Check Your Progress

1. Define a ledger?
2. How many sides are there in a ledger account?
3. What is posting?

NOTES

Balancing a ledger account involves the following important steps:

- The first step is to total the debit and credit entries.
- If the totals of both the sides are equal then the account is considered to be balanced or closed.
- If the debit total is greater than the credit total or the credit total is greater than the debit total, then the balance or difference is placed on the shorter side, so that total of both the sides are equal.
- If the difference is placed on the debit side, then 'To Balance c/d' is written. The word c/d refers to carried down to next period. Similarly, if difference is placed on the credit side, 'By Balance c/d' is written.
- The totals of both the sides, which are equal, are placed at the bottom of both the sides.
- At the beginning of the next period, the closing balance will appear as the opening balance in the opposite side as 'To balance b/d.' or 'By Balance b/d'. The word b/d refers to 'brought down from the previous period'.

The balance thus obtained can be of two types:

- *Opening balance.* The balance can be opening debit balance or opening credit balance. These balances are shown as debit balance on the debit and credit balance on the credit side.
- *Closing balance.* There are two closing balances- closing debit balance and closing credit balance. These balances can be shown as debit balance on the credit side and credit balance on the debit side.
- *Significance of variance balances to Accounts.* Ledger provides necessary information regarding various accounts. Personal accounts in ledger show how much money the firm owes to his creditors and the amounts it can recover from its debtors. The real accounts show the values of properties and also the value of stock. Nominal accounts reflect the sources of income and also the amount spent on various items. The financial position of the business concern can be ascertained easily at any time with the help of ledger.

EXAMPLE 1: Journalise the following transactions and post them to ledger, also balance the accounts.

2007		
Dec	11	Ram commences business with Rs. 2,00,000 in cash.
	12	He buys goods of Rs. 1,50,000 from Darshan on credit.
	15	He buys machinery for Rs. 50,000 from Nathan on credit.
	18	He pays Nathan Rs. 25,000
	20	He pays Darshan Rs. 50,000.
	22	Cash sales Rs. 1,00,000.
	31	He sells goods to Rakesh on credit Rs. 7,000.

Check Your Progress

4. What do you mean by opening balance?
5. What do you understand form closing balance?

NOTES

Solution:

Ram
JOURNAL

Date	Particulars	L.F.	Cr. Amount	Cr. Amount
2007 Dec. 11	Cash a/c .....Dr.		2,00,000	
	To Ram's capital account			2,00,000
	(Being the capital invested in cash)			
Dec. 12	Purchases account .....Dr.		1,50,000	
	To Darshan			1,50,000
	(Being goods purchased on credit)			
Dec. 15	Machinery account .....Dr.		50,000	
	To Nathan			50,000
	(Being machinery purchased on credit)			
Dec. 18	Nathan .....Dr.		25,000	
	To Cash a/c			25,000
	(Being cash paid to Nathan)			
Dec. 20	Darshan .....Dr.		20,00,000	
	To Cash a/c			20,00,000
	(Being cash paid to Darshan)			
Dec. 22	Cash a/c .....Dr.		50,000	
	To Sales account			50,000
	(Being goods sold for cash)			
Dec. 31	Rakesh .....Dr.		7,000	
	To Sales account			7,000
	(Being goods sold on credit to Rakesh)			

LEDGER
CASH ACCOUNT

Dr. Cr.

Date	V. No.	Particulars	L.F.	Amount	Date	V. No.	Particulars	L.F.	Amount
2007 Dec 11		To Ram's Capital		2,00,000	2007 Dec 18		By Nathan		25,000
Dec 22		To Sales Account		1,00,000	Dec 20		By Darshan		50,000
					Dec 31		By Balance c/d		2,25,000
				3,00,000					3,00,000
2008 Jan 1		To Balance b/d		2,25,000					

NOTES

RAM'S CAPITAL ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 31	To Balance c/d		2,00,000	2007 Dec 11	By Cash		2,00,000
			2,00,000				2,00,000
				2008 Jan 1	By Balance b/d		2,00,000

PURCHASES ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 12	To Darshan		1,50,000	2007 Dec 31	By Balance c/d		1,50,000
			1,50,000				1,50,000
2008 Jan 1	To Balance b/d		1,50,000				

MACHINERY ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 15	To Nathan		50,000	2007 Dec 31	By balance c/d		50,000
			50,000				50,000
2008 Jan 1	To Balance b/d		50,000				

NATHAN A/C

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 18	To Cash		25,000	2007 Dec 15	By Machinery A/c		50,000
Dec 31	To Balance c/d		25,000				
			50,000				50,000
				2008 Jan 1	By Balance b/d		25,000

DARSHAN A/C

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 20	To Cash		50,000	2007 Dec 12	By Purchases A/c		1,50,000
Dec 31	To Balance c/d		1,00,000				
			1,50,000				1,50,000
				2008 Jan 1	By Balance b/d		1,00,000

RAKESH A/C

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 31	To Sales A/c		7,000	2007 Dec 31	By Balance c/d		7,000
			7,000				7,000
2008 Jan 1	To Balance b/d		7,000				

NOTES

SALES ACCOUNT

Dr. Cr.

Date	Particulars	L.F	Amount	Date	Particulars	L.F.	Amount
2007 Dec 31	To Balance c/d		1,07,000	2007 Dec 22	By Cash		1,00,000
				Dec 31	By Rakesh		7,000
			1,07,000				1,07,000
				2008 Jan 1	By Balance b/d		1,07,000

CASE STUDY :

Q) Farid had the following balances on 31st ,December, 2011

Rs

Rs

Capital 20,000 cash

300

Due to:- bank

6,700

Ershad 500 stock

12,000

Gobind 600 Due from:-

Harish 700 Inderjeet

1,200

Jitender

800

Furniture

1,000

22,000

22,000

Pass the necessary opening entry in his book as on January 1, 1991 and post the same ledger.

SUMMARY

- Ledger is defined as a "book or register which contains, in a summarized and classified form, a permanent record of all the transactions." It is the most important book of accounts, as final position pertaining to the financial status of a business emerges only from them. Hence, the ledger is called the Principal Book.
- Its sources of information are the books of original entry, called journals. When a customer purchases goods from a firm on different dates, his transactions are recorded on different pages in the journal. It is not possible to know at a glance what amount is owed by a customer unless all the entries relating to his account are brought together in the form of an account. Ledger is kept keeping in view of this objective.
- A General Ledger is just a formal set of T-Accounts. Each account that is to be tracked and kept up has a separate page or pages maintained in a record book called the General Ledger. The general ledger's major

sections are Assets, Liabilities, Owner's Equity, Revenues, Expenses, and Drawings.

- Ledger is the most important book of account. It is the principal book of account which contains all the information regarding business.
- Posting is the process of entering in the ledger the information given in the journals. Posting from the journal or book is done periodically, may be weekly or fortnightly or monthly as per the convenience of the business.
- After completion of posting of all transactions, accounts are balanced every year or after a certain period. Balancing of account means the total of both the sides of an account are equal and to write the difference in the side whose total is short.
- Opening balance can be opening debit balance and opening credit balance. These balances are shown as debit balance on the debit side and credit balance on the credit side.
- Closing balances could be of two types : closing debit balance and closing credit balance. These balances can be shown as debit balance on the credit side and credit balance on the debit side.

ANSWERS TO 'CHECK YOUR PROGRESS'

1. LEDGER book or register which contains, in a summarized and classified form, a permanent record of all the transactions.
2. There are two sides of a ledger account. The left-hand side is known as debit side while the right -hand side is known as credit side. The words 'Dr.' and 'Cr.' are used to denote Debit and Credit.
3. Posting is the process of entering in the ledger the information given in the journals.
4. Opening balance. The balance can be opening debit balance or opening credit balance. These balances are shown as debit balance on the debit and credit balance on the credit side.
5. Closing balance. There are two closing balances- closing debit balance and closing credit balance. These balances can be shown as debit balance on the credit side and credit balance on the debit side.

TEST YOURSELF

1. Write the rules of Posting in Ledger.
2. Write the need and importance of Ledger.
3. What is the difference between Ledger and Posting ?
4. What is Posting ?
5. What is the relation between Journal and Ledger ?
6. What are the rules for Posting a Transaction ?

NOTES

PRACTICAL QUESTIONS

Q1. Record the following transactions of M/S Mahipal Bros. into the Ledger :

2007

Nov 1	Commenced business with cash Rs.2,00,000
Nov 2	Deposited into Bank Rs. 1,75,000
Nov 4	Purchased goods from Mr. D for Rs. 40,000 at Trade discount 20%
Nov 6	Gave a cheque to Mr. D for Rs. 16,800 and cash discount allowed by him Rs. 200
Nov 8	Goods bought from Nilesh for cash Rs. 14,000
Nov 10	Accepted a bill at 2 months for Rs. 15,000 drawn by Dilip.
Nov 11	Bought goods from Suresh Rs. 75,000
Nov 13	Paid to Suresh a cheque of Rs. 58,800 after receiving discount of 2%
Nov 15	Cash Sales made to Jyoti Rs. 8,000
Nov 16	Sold goods to Mohinder for Rs. 20,000
Nov 17	Goods returned by Mohinder for Rs 1,500
Nov 18	Received from Mohinder Rs. 7,900 after allowing a discount of 1.25%
Nov 20	Goods sold to Banerjee Rs. 50,000
Nov 21	Deposited into Bank Rs. 20,000
Nov 25	Drawings (Goods) - Rs. 2,000
	Purchased furniture - Rs. 40,000, Typewriter Rs. 10,000 and paid by cheque.
	Sold goods to Anu Rs. 30,000
Nov 27	Received full payment from Banerjee by cheque, sent it to Bank, Discount allowed 2%.
Nov 28	Acceptance received from Anu at 30 days for the amount due from him.
Nov 29	Paid for stationery Rs. 400 and for postage Rs. 200
Nov 30	Rent of proprietor's house paid by cheque Rs. 2,500.

[Ans. : Dr. Balances : Cash Rs. 58,600; Bank Rs. 1,15,900; Purchases Rs. 1,05,000;
Mohinder Rs 10,500; Sales Return Rs 1,500;
Discount Rs 1,100;

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Drawings Rs. 4,500; B/R Rs. 30,000; Furniture Rs. 40,000;
Typewriter Rs 10,000; Stationery Rs. 400; Postage Rs. 200

Cr. Balances : Capital Rs 2,00,000; Discount Received Rs. 1,400, B/P Rs. 15,000; Suresh Rs. 15,000; Sales Rs. 1,17,000]

Q2. Journalise the following transaction, Post them into ledger, balance the accounts and prepare a Trial Balance :

2007			Rs.
Dec 1	Abhinav Jain commenced business with cash		80,000
Dec 2	Purchased goods for cash		36,000
Dec 4	Machinery purchased for cash		4,000
Dec 5	Purchased goods from :	Mr. R	22,000
		Mr. D	30,000
Dec 6	Returned goods to Mr. R		4,000
Dec 8	Paid to Mr. R, in full settlement of his account		17,500
Dec 10	Sold goods to Mohan & Co. for Rs. 32,000 at 5% trade discount.		32,800
Dec 13	Received cash from Mohan & Co.		19,800
	Discount allowed		200
Dec 15	Paid cash to Mr. D		14,850
	Discount received		150
Dec 20	Sold goods for cash		25,000
Dec 24	Sold goods for cash to Sudhir Ltd.		18,000
Dec 25	Paid for rent		1500
Dec 26	Received for commission		2,000
Dec 28	Withdrew cash by Abhinav for his personal use		5,000
Dec 28	Purchased a fan for Abhinav's house		1,200

[Ans. : Total of Trial Balance Rs. 1,74,850

Dr. Balances : Cash Rs. 6,250; Purchases Rs. 106,000; Machinery Rs. 4000;

Mohan & Co. Rs. 10,400; Rent Rs. 1,500 and Drawings Rs. 6,200.

Cr. Balances : Capital Rs. 80,000; Mr. D. Rs. 15,000, Purchases Returns Rs. 4,000; Discount (Received), Rs. 450; Sales, Rs. 55,400 and commission Rs. 2,000

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FURTHER READINGS

- Accounting for Managers: Sharma and Gupta
- Management Accounting: Mr. Agrawal
- Fundamentals Accounting: Jain, Khandelwal, Pareek

7 Trial Balance - Errors and Their Rectifications

The Chapter Covers :

Learning Objectives:

After going through this chapter, you should be able to:

- Learn trial balance
- Discuss on various characteristics, uses, functions and limitations of a trail balance
- Locate error and types of errors
- Rectify errors
- Explain suspense account

NOTES

INTRODUCTION

Books of accounts are often closed at the end of the year, but they may be closed at any time according to the requirement of the businessman, wherever books are closed, balances are found out in various accounts and then these balances are recorded in a statement called trial balance.

The chapter on Trial Balance serves detailed information on Trial Balance and its associated facts. By the end of this chapter you will know many crucial points related with trial balance. You will know the importance of trial balance, errors in trial balance and most importantly how to locate errors and rectify them.

TRIAL BALANCE, ERROR AND THEIR RECTIFICATION

Meaning : A basic rule of double–entry accounting is that for every credit there must be an equal debit amount. Trial Balance is a statement of accounts which appeared in the ledger showing either the balances or total amounts of debit and credit items. The trial balance is prepared after posting the journal entries into the ledger and balancing the accounts. All the debit entries are written on one side and all the credit entries on the other side. The total of the debit side of trial balance must be equal to that of the credit side. If debits do not equal credits, then it reflects that an error has occured. The Trial Balance is a tool for detecting such errors.

The trial balance is prepared by putting the balances of all the ledger accounts in a list. The account balances are used because the balance summarizes the net effect of all of the debits and credits in an account.

The preparation of a Trial balance is an essential part of the process because if totals of both the sides are the same then it is proved that books are at least arithmetically correct.

The trial balance is a worksheet where all general ledger accounts and their debit or credit balance appear. It is a tool that is used to detect errors in the books. The total debits must equal the total credits. At the end of the accounting period three trial balances are prepared:

- A preliminary trial balance is prepared using general ledger account balances before making adjusting entries.
- An adjusted trial balance is prepared after passing adjustment entries and posting them to general ledger. This will ensure that the books used to prepare financial statements are in balance.
- A post-closing trial balance is prepared after posting closing entries. This trial balance, which contains only balance sheet accounts, will guarantees that the books are in balance for the beginning of the new accounting period.

Main characteristics and uses of a trial balance

Following are the main characteristics of a trial balance –

1. It is a statement prepared in a tabular form. It has two columns – one for debit balances and another for credit balances.
2. Closing balances, are the balances at the end of the period as shown by ledger accounts.
3. Trial balance is only a statement of balances.
4. It can be prepared on any date provided accounts are balanced.
5. It is a consolidated list of all ledger balances at the end of a period at one place.
6. It is a method of verifying the arithmetical accuracy of entries made in the ledger.

The agreement of the trial balance means that the total of the debit column agrees with the total of the credit column of the trial balance.

7. It is a big help in preparation of Trading A/c, Profit and Loss A/c and the Balance Sheet at the end of the period which exhibit the financial position of the firm.

Functions of a Trial Balance.

The functions of a Trial Balance are:

1. To ascertain arithmetical accuracy by checking that both the sides are in balance.
2. It provides a summarized version of the position of each account and enables one to know the asset and liability of a firm.
3. Preparation of financial statements and various adjustments can be made on the basis of trial balance.
4. Error in journals, posting to ledger accounts and balancing the ledger accounts can be detected easily.
5. Enables the auditor to check whether any corrections were made after the accounts were checked.

Limitations of a Trial Balance.

If the trial balance agrees, it does not mean that now there are absolutely no errors in the books. Even if trial balance agrees, some errors may remain undetected and may not be disclosed by the trial balance. This is the major limitation of a trial balance. The errors which are not disclosed by a trial balance are as under:

(i) *Omission of an entry in the original book* : If an entry has not been recorded in the original or subsidiary book at all, then both the aspects of the transaction will be omitted and the trial balance will not be affected.

(ii) *Wrong recording in original books* : If wrong entry for any trasaction has been passed into the original books, the trial balance will agree because both the sides will be affected equally.

(iii) *Posting an item on the correct side but to the wrong account* : If, suppose, cash has been received on account from A, but this transaction has been credited to B's A/c, the amount being correct, the trial balance will agree and it will not reveal this error.

(iv) *Compensating errors* : These are errors arising from the excess- debits or under- debits of accounts being neutralized by the excess- credit or under-credit to the same extent of some other accounts. It is very rare that such errors of equal amounts arise on the debit as well as on the credit sides of the ledger accounts. Such errors do not affect the agreement of a trial balance.

(v) *Error of principle* : Whenever any amount is not properly allocated between capital and revenue or some double entry principles are violated the error so made is known as error of principle. If wages paid for erection of machinery are debited to wages account, then this is an error of principle.

When a trial balance disagrees and the difference between debit and credit balances is quite large, it would never be safe to allow these errors to remain undetected. All possible efforts should be made to localize the cause of the difference. Final accounts must not be prepared unless and until trial balance agrees, otherwise final accounts will not present true picture of final state of affairs. In very exceptional circumstances, if the preparation of final accounts cannot be further delayed due to requirements of law, then after due careful effort to locate errors, the difference may be temporarily transferred to a

NOTES

Suspense Account and shown accordingly in the Balance Sheet. If it has a debit balance, it will be shown on assets side, otherwise on liabilities side.

Reasons for disagreement of a Trial Balance.

The reasons for disagreement of a trial balance may be enumerated as under:

- Error in bringing forward proper or correct balances from the previous year's books.
- Errors in additions of items in accounts and carry forwards of total to next page.
- Cash balance or bank balance may be omitted to be recorded in trial balance.
- Posting of entries to wrong sides of accounts.
- Balance of personal accounts placed on wrong sides in trial balance.
- Omission of any monthly totals of the Purchases Journal, Sales Journal, Returns Journal, Bills journal to be posted in the ledger.
- Omission of any balance from the nominal accounts, e.g., salary, rent, etc. in the trial balance.
- Wrong posting of the totals of discount columns from the cash book to the trial balance.

All possible steps must be taken to locate the errors and then to rectify them before proceeding to prepare final accounts.

Errors disclosed by Trial Balance.

Trial Balance, in general, discloses any error which affects one side of the account. Some of the examples are as follows:

(i) An item omitted to be posted from subsidiary records.
(ii) Error in casting the books of subsidiary records.
(iii) Error in balancing an account.
(iv) A wrong amount posted to the correct account.
(v) Error in additions of ledger accounts, unless they are of compensating nature.
(vi) Forgetting to take the balance of an account in the trial balance.
(vii) Error in preparing the list of Debtor's and Creditor's balances.

PREPARATION OF A TRIAL BALANCE

There are two methods of preparing the Trial Balance:

Total Method :

1. The first method is known as the 'totals' method. In this method, the totals of debit and credit sides of the ledger accounts are shown in the trial balance. Balance of ledger accounts is not taken. The sum totals of debit and credit columns of the trial balance must be equal. Then the trial balance is said to agree.

Ram's Books

TRIAL BALANCE as on March 31, 2007

S.No.	Title of accounts	L.F.	Debit total Rs.	Credit total Rs.
1.	Cash account		3,00,000	75,000
2.	Ram's capital account			2,00,000
3.	Purchases account		1,50,000	
4.	Machinery account		50,000	

5.	Nathan		25,000	50,000
6.	Darshan		50,000	1,50,000
7.	Rakesh		7,000	
8.	Sales account			1,07,000
	Total		5,82,000	5,82,000

Balance Method :

2. The second method is known as 'Balances' method. In this method, the balances of ledger accounts are taken to respective debit and credit columns of the trial balance and then grand total is taken out. The total of balances in the debit column must be equal to the total of balances in the credit column of the trial balance. Then only, the trial balance is said to agree.

TRIAL BALANCE as on March 31, 2007

S.No.	Title of accounts	L.F.	Debit total Rs.	Credit total Rs.
1.	Cash account		2,25,000	
2.	Ram's capital account			2,00,000
3.	Purchases account		1,50,000	
4.	Furniture account		50,000	
5.	Nathan			1,00,000
6.	Darshan			25,000
7.	Rakesh		7,000	
8.	Sales account			1,07,000
	Total		4,32,000	4,32,000

The agreement of a trial balance provides a very useful check upon the posting into the ledger. It is thus ascertained that both the aspects of each transaction, debit and credit, have been recorded and that the books are arithmetically accurate. But it is not a conclusive proof. Thus, a trial balance may agree arithmetically yet there may be a number of errors in book-keeping.

Reasons for Disagreement in Trial Balance:

The debit total of trial balance should be equal to credit total. Sometimes, they are not equal and it is assumed that there are some errors in books of account. Some of the reasons of errors may be as follows:

1) Trial balance will disagree if a transaction is posted in one side of an account and omitted to post it in the another side of another account.
2) If wrong amount is posted in ledger accounts, the trial balance will not agree.
3) When an amount is posted wrong side say in debit side instead of credit side, the trial balance will not agree.
4) Sometime, a transaction may be posted twice in the ledger accounts. As a result, the total of a trial balance will not be equal.
5) Disagreement of a trial balance may be caused by the wrong totaling or balancing of ledger accounts.
6) While totaling the figure of subsidiary books there may arise some errors that will cause disagreement of trial balance.

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7) Omission to post a ledger balance also causes the disagreement of a trial balance.
8) If there is wrong in totaling of trial balance, a trial balance will disagree.
9) Another cause of disagreement of a trial balance may be the error made in carrying forward the total from one page to another.

Errors Disclosed by Trial Balance:

If the Trial Balance does not tally, it will indicate that certain errors have been committed which have affected the agreement of the Trial Balance. The accountant will then proceed to find out the errors and ultimately the errors will be located. Such errors are called 'Errors Disclosed by Trial Balance or Errors which affect the agreement of Trial Balance. Until such errors are rectified, the Trial Balance will not agree. Some of these types of errors are as follows:

1) **Wrong Casting:** If the total of the Cash Book or some other Subsidiary Book is wrong, the Trial Balance will not tally. For example, the total of the Purchase book has been added Rs. 2000 in excess. When this total will be posted to the debit side of the purchase account, it will also show an excess debit of Rs. 2000 and hence, the Trial Balance will not tally.
2) **Posting to the Wrong Side:** If instead of posting an amount on the debit side of an account, it is posted on the credit side, or vice versa, the Trial balance will not tally. For example, goods for Rs. 2000 from Gopal. If instead of posting the amount on the credit side of Gopal's account it is posted to his debit, the debit side of the Trial Balance will exceed the credit by Rs. 4,000.
3) **Posting of Wrong Amount:** The Trial Balance will not tally if the posting in an account is made with an incorrect amount. For example, goods for Rs. 600 have been purchased from Mahendra. If, it has been correctly entered in the Purchase Book or purchase account, but while posting to Mehendra's account, in credit side (correct side) the amount posted is Rs. 60 instead of Rs. 600, the Trial Balance will not tally.
4) **Omission of Posting of One Side of an Entry:** For example if Rs. 500 have been received from Ram and correctly entered in the Cash Book or Cash Account but if it is omitted to be posted on the credit side of Ram's Account, the Trial Balance will not tally.
5) **Double posting in a Single Account:** For example if Rs. 500 has been received from Shyam Lal and correctly entered in the Cash Account, but if it is posted twice on the credit side of Shyam Lal's account, the Trial Balance will not tally.
6) **Errors of Totaling and Balancing of Accounts in the Ledger:** Errors may occur in the totaling of debit or credit sides of accounts in the Ledger or in the balancing of accounts in the Ledger. Because the balances of accounts are transferred to the Trial Balance, Then the Trial balance will not tally.

TYPES OF ERRORS

Errors can broadly be divided into the following categories:

(a) Errors of Principle

(b) Errors of Omission

- Errors of complete omission
- Errors of partial omission

(c) Errors of Commission

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(d) Compensating errors

Errors (b), (c) and (d) can also be termed as clerical error.

Errors of Principle

An error of principle is one where a transaction is not recorded as per the accounting rules of debit and credit or in violation of some other basic principle. Error of principle is involved whenever the amount received or spent is not properly allocated between revenue and capital. This distinction between capital and revenue is of great importance because any incorrect adjustment or allocation in this respect would alter the final result.

Examples of such errors are:

1. Furniture purchased on credit wrongly recorded in Purchases Journal instead of Journal Proper. This means that Purchases account has been wrongly debited instead of Furniture account. This is an error of principle because the item of capital expenditure (i.e. furniture) has been treated as revenue expenditure (i.e., purchase of goods.)
2. Sale of a fixed asset has been passed through the Sales Journal. This way, the Sales account has wrongly been credited instead of the fixed asset account.
3. Commission paid for purchase of land is debited to commission account instead of land account.

Errors of omission

When a transaction has been omitted to be recorded in the books of account-either wholly or partially. Thus, it is of the following two types:

(a) ***Complete omission***. Here the transaction is completely omitted from the books. If a transaction is not recorded in the books of account or a transaction recorded in the journal is not posted in the ledger such error arises. Such errors do not affect the trial balance.

Example:

Failure to record credit sales transaction in Sales Journal.

(b) ***Partial omission***. This means that the transaction is entered in the subsidiary books but it is not posted in the ledger. This can happen in relation to any subsidiary book. Such errors result in trial balance being not tallied. Example: A credit purchase is entered in the Purchase Journal but not posted to the credit of the supplier's or creditor's account.

Such errors do affect the agreement of trial balance. Trial balance would not agree due to such errors, there would be either short debit or short credit.

Errors of Commission

These are the most common type of errors. Here the error is the result of commission, i.e., something being done which ought not to be done. Amounts wrongly written in the subsidiary book or in the ledger or posting into wrong account or wrong balancing are the cases of errors of commission. These mistakes are committed because of ignorance, lack of proper accounting knowledge, and carelessness of the ledger clerks. These are committed while recording transactions.

Examples of such errors are:

- Wrong amount entered in subsidiary books, e.g., a purchase of Rs. 7,500 entered in the Purchases Journal as Rs. 5,700.
- Entering the transaction in a wrong subsidiary book, e.g., a purchase transaction entered in the Sales Journal and a sales transaction entered in Purchases Journal.

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Compensating Errors

These are the errors those cancel out the impact of each other, and thus, these types of error are the most difficult errors to detect. They may be dissimilar in nature, but are of a similar amount.

Example:

Underposting of the Purchases Journal may be compensated or cancelled out with the undercasting of the Sales Journal by a similar amount.

STEPS TO LOCATE THE ERRORS

Even if there is only a small difference in the Trial balance, the errors leading to it must be located and rectified as a small difference may be the result of a number of errors. The following steps will be useful in locating errors:

1. The two columns of the Trial balance should be totalled again. If in the place of a number of accounts, only one amount has been written in the Trial Balance, the list of such accounts should be checked and totalled again, for example, the list of sundry debtors.
2. It should be seen that the cash and bank balances have also been written in the Trial Balance.
3. The exact difference in the Trial Balance should be established. The ledger should be gone through; it is possible that a balance equal to the difference has been omitted from the Trial Balance. The difference should also be halved; it is possible that a balance equal to half the difference has been written in the wrong column.
4. The ledger accounts should be balanced again.
5. The casting of subsidiary books should be checked again
6. Check the totals, specially if the difference is of 1, 10, 100 and so on.
7. If the difference is divisible by 9, it is possible that some figures have been transposed.
8. If the difference is big, the balance in the various accounts should be compared with the corresponding accounts in the previous period. If the figures differ materially, the causes should be seen; it is possible that an error has been committed.
9. Posting of the amounts equal to the difference or half of the difference should be checked. It is possible that an amount has been omitted to be posted or has been posted on the wrong side.
10. If there is still a difference in the Trial Balance, a complete checking will be necessary. The posting of all the entries including the opening entry should be checked. It may be better to begin with the nominal accounts.

Example 1 : The following is the Trial Balance prepared by an inexperienced accountant. Redraft it in a correct form and give necessary notes.

TRIAL BALANCE
For the year ending 30th June 2007

Name of Accounts	Balance Dr.	Balance Cr.
Debtors	12,200	
Creditors		9,200
Stock (1-7-2006)	15,600	

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Purchase	53,500	
Purchases Returns	2,100	
Cash	11,000	
Machinery	40,200	
Goodwill		10,000
Sales		86,200
Sales Returns		7,800
Loan from Raman	20,000	
Interest on Raman's Loan	3,000	
Bills Receivable		6,400
Capital		57,000
Life Insurance Premium	5,000	
Carriage	600	
Advertisement	2,500	
Discount received	1,500	
Investments	8,000	
Interest on Investments	800	
	1,76,000	1,76,000

Solution :

Trial Balance
(As on 30th June, 2007)

Name of Accounts	Balance Dr.	Balance Cr.
Debtors	12,200	
Creditors		9,200
Opening Stock	15,600	
Purchase &	53,500	
Purchases Returns		2,100
Cash	11,000	
Machinery	40,200	
Goodwill	10,000	
Sales		86,200
Sales Returns	7,800	
Loan from Raman		20,000
Interest on Raman's Loan	3,000	
Bills Receivable	6,400	
Capital		57,000
Life Insurance Premium	5,000	
Carriage	600	
Advertisement	2,500	
Discount received		1,500
Investments	8,000	
Interest on Investments		800
Suspense A/C	1,000	
	1,76,800	1,76,800

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EFFECT OF ERRORS ON TRIAL BALANCE

All possible errors in accounting based on their effect on trial balance, can be categarized in two parts :

A. **Errors which affect the trial balance.** The following are the errors due to which the trial balance does not agree. These are the errors which are disclosed by the trial balance. Trial balance, in general, discloses any error which affects one side of the account. Examples are:

- **(a)** Error in casting the books of subsidiary records.
- **(b)** Error in carrying forward the total of one page to another page.
- **(c)** Error in posting from the books of subsidiary record to ledger.
- **(d)** Error in balancing the account.
- **(e)** Error in preparation of debtors schedule and creditors schedule.
- **(f)** Forgetting to carry forward a balance of an account to the trial balance.
- **(g)** Omission of casting.
- **(h)** Error in totalling the trial balance.
- **(i)** Forgetting to write cash book balance in the trial balance.

B. **Errors which do not affect the trial balance**. Following are some of the errors which will not affect the agreement of the trial balance. These are the errors which are not disclosed by the trial balance:

(a) Omission in recording the transaction in the books of original entry. If a transaction is not recorded, then both debit and credit effects of that transaction will be omitted and trial balance will not be affected.

(b) Wrong recording in the original books. Trial balance will not be affected because the same amount will be shown on both sides of the trial balance.

(c) Posting to wrong account with correct amount and on correct side. If credit of Rs. 6,000 to Ram is wrongly posted to the credit (side is correct) of Ram's account Rs. 6,000(amount is correct), trial balance will remain unaffected.

(d) Compensating errors. Such errors also do not affect the agreement of a trial balance. Forgetting to post Rs. 350 on the credit side of a certain account may be compensated by overposting of Rs. 350 on the credit side in some other account.

RECTIFICATION OF ERRORS

Amount are considered to be authentic proof of true financial position of a concern. But inspite of best efforts there are certain transactions which are omitted to be recorded or entered wrongly in the books 'Such error affect the financial accounts. An accountant should therefore try to locate such errors and rectify them before the preparation of final accounts.

Error should never be converted by overwriting or erasing because it reduces the authenting of accounting record. So, error should be corrected by passing a suitable journal entry, called rectifying entry.

Stages of rectification of errors. Rectification of errors can be carried out through the following three stages:

(a) Before the preparation of trial balance. Errors are normally corrected before the preparation of final trial balance. If it is done then the correction is carried out without the help of Suspense Account.

(b) Before the preparation of final accounts. If correction is carried out at this stage then Suspense Account is required.

(c) *After the preparation of final accounts.* Errors which affect the trading and profit and loss account are corrected with the help of Profit and Loss adjustment account or capital account. Suspense account is also used wherever necessary.

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Classification of errors from rectification point of view.

Errors can be classified into two broad categories:

(1) Errors which affect one account / One Sided Errors; and

(2) Errors which affect two or more accounts / Two Sided Errors

Errors which affect one account : Errors which affect one account can be errors of:

(a) Casting,

(b) Carry forwarding

(c) Posting,

(d) Balancing,

(e) Forgetting to show in the trial balance.

Such errors should first be located and then rectified by giving an explanatory note or by giving a journal entry with the help of a suspense account.

Rectification of errors of casting and carry forwarding : The process of totalling the transaction at the end of the period is called casting. Error of casting means mistake in getting the total.

Errors of casting are of two types. i.e., undercasting and overcasting. In the case of undercasting, the correction is carried out by putting the amount on that side of the account on which usual posting is made. But in the case of overcasting the amount in excess is put on the opposite side. In order to rectify the error of casting an explanatory note is given.

Rectification of errors of posting : Error of posting can be recognized by setting any of the three key words:

• Posted • Credited • Debited

In case the word *posted* is used then the side of the account on which the amount is to be posted is always taken as *correct.* What is correct side is determined by the merit of the case. Word '*debited*' and '*credited*' stand for debit side and credit of the account respectively.

Rectification of errors of balancing. When a mistake occurs in calculating the balance of a ledger account it leads to wrong copying of the balance in the trial balance. Correction is carried out by means of an explanatory note either on the debit or credit side of the account wherever necessary.

Example 2 :

Rectify the following errors:

(a) Sales to Ram Rs. 4,000 Debited to his account as Rs. 400.

(b) Sales to Rajesh Rs. 3,400 posted to his account as Rs. 4,300.

Solution : These errors will be rectified as follows :

(a) There is a short debit to Ram's account of Rs. 3,600. This error will be rectified by giving a note on the debit side of Ram's account;

"To short debit for sales (error rectified) Rs. 3,600."

(b) More debit has been given to Rajesh's account by Rs. 900. Rs. 900 (4,300-3,400) will be written on the credit side by giving a note.

" By excess debit on account of sales (now rectified) Rs. 900."

Check Your Progress

1. When trial balance is prepared?
2. Explain total method of preparing trial balance?

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Errors affecting two or more accounts.

- Error of omission
- Error of recording
- Error of posting to wrong account
- Error of principle

Error of Omission; Error of omission stands for omission of recording the transaction in the books of subsidiary records. Omission of a transaction from a subsidiary record affects two accounts. Because of omission the transaction does not appear in the book and monthly casting of the books becomes wrong, which in turn, affects that account where the total of the book is taken. The omission also affects the individual account because in the absence of any record in the book posting to that account is done. For example, if a Sale to Ajit of Rs. 5,000 is not recorded then the monthly total of the Sale book will be short of Rs. 5,000 and thus purchases account will be affected. Ajit's account will also be wrong because no posting will be made to this account. Rectification of such omission is done by making a journal entry.

Example 3 : Following errors were committed. Rectify them.

(1) Sales to Mohan of Rs. 6,000 were not recorded.
(2) Purchases from Rajesh of Rs. 1,500 were omitted from the books.

Solution:

			Rs.	Rs.
1.	Mohan	.....Dr.	6,000	
	To Sales			6,000
2.	Purchases	.....Dr.	1,500	
	To Rajesh			1,500

Error of recording : Recording is the first stage of book-keeping and any mistake at this stage means an error in the subsidiary book. This error also affects two accounts. First, wrong recording affects the casting of the book which, in turn affects the impersonal account where the total is posted, and secondly, the individual account is incorrectly posted.

If recording is done with the less amount, then the original entry is passed with the difference amount and reverse entry is passed in case of recording with excess amount.

Example 4 : Rectify the following errors:

1. Sales to Harsh of Rs. 5,500 were recorded as Rs. 5,050.
2. Sales to Harsh of Rs. 5,050 were recorded as Rs. 5,500.

Solution :

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1.	Harsh .....Dr.		500	
	To Sales A/c			500
	(Being entry passed with the difference because the amount recorded is less than the correct amount)			
2.	Sale A/c .....Dr.		450	
	To Harsh			450
	Being reverse entry passed with the difference because the recording has been done with the excess amount			

NOTES

Error of posting to wrong account. This error is committed when the posting is done to wrong account. It can be in any one of the following ways:

- wrong account, but correct side and correct amount,
- wrong account, correct side but wrong amount,
- wrong account, wrong side and wrong amount.
- wrong account, wrong side but correct amount.

In order to rectify such errors, it is not always possible to pass a journal entry. Under such circumstances an explanatory note can be given.

Example 5 : Rectify the following errors:

1. Sales to A of Rs. 5,000 posted to B's account.
2. Sales to A of Rs. 5,000 debited to B's account.
3. Sales to A of Rs. 5,000 credited to B's account.

Solution :

1. A	....Dr.	Rs. 5,000	
To B			Rs. 5,000
(Being the cancellation of wrong debit to B's account)			
2. A	....Dr.	Rs. 5,000	
To B			Rs. 5,000
(Being cancellation of wrong debit to B's account and installation of correct debit to A's account)			

3. A's account will be debited by Rs. 5,000 and B's account will also be debited by Rs. 5,000.

Error of principle : It involves incorrect allocation of expenditure or receipt between capital and revenue. For rectification of such errors, some important cases are given below in the form of rules.

When asset is purchased :

1. When asset is purchased- debit asset account and not purchases account.
2. When asset is purchased and any expense is incurred in purchasing that asset, the asset account is debited and not the expense account.
3. When a second-hand asset is purchased and is repaired before bringing it in use then the repair charges are debited to the asset account and not to repairs account.

When asset is sold :

1. When asset is sold, credit asset account and not sales account. If by mistake sales account has been credited then debit the sales account (to cancel the wrong credit) and credit the asset account.
2. When asset is sold and some expenses are incurred, debit asset account and cash account or party's account. In no case expense account is debited.

Example 6 : Rectify the following errors :

1. Paid cartage for the newly purchased machinery Rs. 500, posted to cartage account.
2. Sold old furniture for Rs. 5,000 passed through the sales book.

NOTES

Solution :

RECTIFYING JOURNAL ENTRIES.

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1.	Machinery A/c .....Dr. To Cartage A/c (Being cartage paid for newly purchased machinery wrongly posted to cartage account, now rectified)		500	500
2.	Sale A/c .....Dr. To Furniture A/c Being sale of old furniture wrongly passed through the Sales book, now rectified)		5,000	5,000

SUSPENSE ACCOUNT

Meaning : All the errors which affect one account, affect the agreement of trial balance at the end of the year, and ultimately delay the preparation of final accounts. In order to avoid the delay in the preparation of final accounts, the difference in the trial balance is put to suspense account. For Example, if the debit side of trial balance exceeds the credit side, then difference is put on the credit side and suspense account shows a credit balance. When errors are located entries are passed with the help of suspense account and thus when all errors affecting the trial balance are located suspense account stands closed. If suspense account still shows a balance, then it is taken to the balance sheet.

The suspense account will appear as an asset on the assets side of the balance sheet if it has a debit balance. Debit balance in the suspense account means that the credit side of the trial balance total is more than the debit side total. It will appear as a liability on the liabilities side of the balance sheet if it has a credit balance. Credit balance in the suspense account means that the debit side of the trial balance total is more than the credit side total. Efforts are made early in the next period to detect the errors. When the errors are detected, they will be duly corrected and the suspense account will be closed. The debit or credit balance in suspense account indicates the net effect of all the errors having effect on the trial balance. That is why, when correction of errors is done, the suspense account stands closed. Whenever any error is rectified, some part of suspense account is reduced (or may increase also). If the rectification needs debiting or crediting an account, the credit or debit goes to suspense account. If an error requires rectification by means of a journal entry, it does not affect suspense account. The reason is that such an error did not cause disagreement of the trial balance and hence did not contribute to the suspense figure.

Check Your Progress

3. What is balance method of preparing trial balance?
4. Define errors of principle?
5. What is a suspense account?

Example 7 :

Write out the journal entries to rectify the following errors using a Suspense Account:

1. A sum of Rs. 850 received from A was posted to his debit as Rs. 580.
2. The total of the Sales Return Book has been added Ten Rupees short.
3. A discount of Rs. 350 allowed to a customer has been credited to his account as Rs. 300.

Solution :

RECTIFYING JOURNAL ENTRIES

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1.	Suspense A/c .....Dr. To A A/c (Being amount Rs. 850 received from 'A' posted to his debit as Rs. 580, now rectified)		1,430	1,430
2.	Returns Inward A/c .....Dr. To Suspense A/c Being the undercasting of Sales Returns Book rectified)		10	10
3.	Suspense A/c .....Dr. To Customer's A/c Being the short posting in Customer's A/c rectified)		50	50

NOTES

Difference in Trial Balance :

Trial balance is affected only by those errors which are rectified with the help of suspense account. Therefore, in order to calculate the difference of suspense account, a table is prepared and if suspense account is debited in the rectification entry, the amount is put on the debit side, and if suspense account is credited, the amount is put on the credit side of the table. The balance is calculated and is reversed for suspense account, that is, if credit side exceeds, difference is put on the debit side of suspense account (not on the credit side) and vice versa.

SUSPENSE ACCOUNT

Dr. Cr.

Particulars	L.F.	Amount Rs.	Particulars	L.F.	Amount Rs.
To A's A/c		1,430	By Return Inward A/c		1,470
			By Balance, difference in the trial balance		10
To Customer's A/c		50			
		1,480			1,480

Effect on Net Profit :

In order to calculate the effect of errors on net profit, it is essential to understand that only those accounts which are taken to trading account or profit and loss account affects profits. For example, purchases account, wages, salaries, etc., affect the net profit because they are shown either in trading account or profit and loss account. If any one of these accounts is debited in the rectification entry, it reduces the profit and if any of these accounts is credited then it increases the profit. Accounts which are shown in the balance sheet do not affect net profit.

Correction in the Next Accounting Period :

Since it is desirable to ascertain profit or less of each accounting period separately, it becomes necessery to rectify errors in such a way that they do not affect the

NOTES

current period's incomes, expenses, profit or losses. For this objective, a separate account namely 'Profit & Loss Adjustment Account' is opened and all debits and credit in respect of nominal accounts for errors committed in the previous accounting period are passed through that account. The balance of this account is finaly transferred to the capital account.

This method is used only in respect of nominal accounts and that too in case when rectifications are carried out in the next accounting period.

CASE STUDY:

1. Pass necessary journal entries to rectify the following errors :
   - (i) Sale of an old machine for Rs.4500 was posted to Sales account
   - (ii) Rent of proprietors residence of Rs.12000 was posted to Rent Account.
   - (iii) A credit to Brij Mohan of Rs.6750 was posted to his account as Rs.4750
   - (iv) Furniture purchased from M/s Decorates for Rs.22500 was entered in the Purchases Book
   - (v) Salary paid to the accountant Sushil Gupta of Rs.6500 was debited to his personal Account
2. The Book keeper of a firm found that his trial balance did not agree. Its credit total exceeded the debit total by Rs.2850. He placed the amount in Suspense A/c and subsequently found the following errors.
   - (i) A credit item of Rs.3490 has been debited to his personal Account as Rs.4390.
   - (ii) A sum of Rs.2650 written off as depreciation on machine has not been posted to Depreciation A/c.
   - (iii) Goods of Rs.5300 sold were returned by the customer and were taken into stock before closing the books but were not entered in the books.
   - (iv) Rs.4800 due from Lakhan Pal which had been written off as bad debt in a previous year was unexpected recorded and had been posted to the personal account of Lakhan Pal.
   - (v) Sales Book is undercast by Rs.1500.
   - (vi) Rs.4000 withdrawn for domestic use by the proprietor was debited to General Expenses A/c.
   - (vii) Machine Purchased from Machine Mart for Rs.18000 were entered in the Purchases Book.
   - (viii) Cash paid Rs.1200 to Lakshman was credited to Ram as Rs.2100.

SUMMARY

- A basic rule of double–entry accounting is that for every credit there must be an equal debit amount. Trial Balance is a statement of accounts which appeared in the ledger showing either the balances or total amounts of debit and credit items. All the debit entries are written on one side and all the credit entries on the other side.
- The trial balance is also by putting the balances of all the ledger accounts. The account balances are used because the balance summarizes the net effect of all of the debits and credits in an account.

- A post-closing trial balance is prepared after posting closing entries. This trial balance, which contains only balance sheet accounts, guarantees that the books are in balance for the beginning of the new accounting period.
- It is a method of verifying the arithmetical accuracy of entries made in the ledger. The agreement of the trial balance means that the total of the debit column agrees with the total of the credit column of the trial balance.
- If an entry has not been recorded in the original or subsidiary book at all, then both the aspects of the transaction will be omitted and the trial balance will not be affected.
- Compensating errors are errors arising from the excess- debits or under-debits of accounts being neutralized by the excess- credit or under- credit to the same extent of some other accounts.
- An error of principle is one where a transaction is not recorded as per the accounting rule of debit and credit or in violation of some other basic principle. Error of principle is involved whenever the amount received or spent is not properly allocated between revenue and capital.
- Sale of a fixed asset has been passed through the Sales Journal. This way, the Sales account has wrongly been credited instead of the fixed assets account.
- If a transaction is not recorded in the books of account or a transaction recorded in the journal is not posted in the ledger such an error is called complete omission error.
- Partial omission infers that transaction is entered in the subsidiary books but it is not posted in the ledger.
- Compensating Errors : These are the errors those cancel each other impact, and because of this they are rather not simple to discover. They may be dissimilar in nature, but are of a similar amount.
- Trial balance is affected only by those errors which are rectified with the help of suspense account. Therefore, in order to calculate the difference of suspense account, a table is prepared and if suspense account is debited in the rectification entry, the amount is put on the debit side, and if suspense account is credited, the amount is put on the credit side of the table. The balance is calculated and is reversed for suspense account, that is, if credit side exceeds, difference is put on the debit side of suspense account (not on the credit side) and vice versa.
- In order to calculate the effect of errors on net profit, it is essential to understand that only those accounts which are taken to trading account or profit and loss account affects profits. For example, purchases account, wages, salaries, etc., affect the net profit because they are shown either in trading account or profit and loss account. If any one of these accounts is debited in the rectification entry, it reduces the profit and if any of these accounts is credited then it increases the profit. Amounts which are shown in the balance sheet do not affect net profit.

ANSWERS TO 'CHECK YOUR PROGRESS'

1. The trial balance is prepared after posting the journal entries into the ledger and balancing the accounts.
2. The first method is known as the 'totals' method. In this method, the totals of debit and credit sides of the ledger accounts are shown in the trial balance.

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3. Balance Method : the balances of ledger accounts are taken to respective debit and credit columns of the trial balance and then grand total is taken out.

4. An error of principle is one where a transaction is not recorded as per the accounting rules of debit and credit or in violation of some other basic principle.

5. The suspense account will appear as an asset on the assets side of the balance sheet if it has a debit balance.

TEST YOURSELF

1. What is Trial Balance ? Why is it prepared ? Describe the importance of Trial Balance.
2. What is Trial Balance ? Why is it prepared ?
3. What is the main characteristics and uses of a Trial Balance ?
4. What are the Limitations of Trial Balance ?
5. What are the functions of Trial Balance ?
6. What is Suspense Account ?
7. What is the method of preparation of Trial Balance ?
8. What are the types of errors in Trial Balance ?

PRACTICAL QUESTIONS

Q1. Classify the under-mentioned errors into :

(a) Error of Omission, (b) Error of Commision, (c) Compensating Error, and (d) Error of Principle :

(1) Purchased goods from Bhardwaj on credit for Rs. 6,000 but were recorded in purchase Book as Rs. 60,000.

(2) Amount paid for the proprietor life Insurance premium of Rs. 5,000 was debited to 'General Expenses Account'.

(3) Goods amounting to Rs. 20,000 have been returned to Chetan, but no entry has been made in the books.

(4) Goods sold to Suresh for Rs. 650 were recorded as Rs. 560 in the Sales Book.

(5) Goods for Rs. 500 have been taken by the proprietor for his personal use, for which no entry has been passed in the books.

[Ans. Error of Commision - 1, 4 Error of Principle - 2 Error of Omission - 3,5]

Q.2 Prepare a Trial Balance from the following balances as on 31st March, 2007.

	Rs.		Rs.
Stock (1-4-2006)	28,800	Sales Return	7,500
Purchases	82,000	Purchase Return	5,600
Sales	1,60,000	Carriage Inwards	1,640

Wages	16,160	Carriage Outwards	3,200
Salaries	6,400	Furniture	12,000
Repairs	500	Motor Car	80,000
Commission received	800	Cash	4,700
Sundry debtors	24,200	Bank Overdraft	25,400
Sundry Creditors	7,300	Investment	20,000
Capital	90,000	Interest on	2,400
Drawings	4,400	Investment (Cr.)	

[Ans. : Total of Trial Balance - Rs. 2,91,500]

Q.3. Rectify the following errors :

(1) The Purchase Book was undercast by Rs. 100.

(2) The Sales Book was overcast by Rs. 10.

(3) Rs. 540 received from M. Chawhan were posted to the debit of his a/c.

(4) The total of the credit of Bhim's a/c has been over added by Rs. 200.

(5) A discount of Rs. 92.75 allowed to a customer has been credited to his account as Rs. 29.57.

(6) Goods of Rs. 270 returned to Mr. Singh entered in the return book has not been posted to his accounts.

[Ans. (1) Purchase a/c = Dr., Suspense a/c = Cr.

(2) Sales a/c = Dr., Suspense a/c = Cr.

(3) Suspense a/c = Dr., M Chawhan a/c = Cr.

(4) Bhim a/c = Dr., Suspense a/c = Cr.

(5) Suspense a/c = Dr., Customer's a/c = Cr. by Rs. 63.18 (92.75 – 29.57)

(6) Singh a/c = Dr., Suspense a/c = Cr.]

Q.4. A book keeper finds the difference in the Trial Balance amounting to Rs. 70 and puts it in the Suspense Account. Rectify these and prepare the Suspense Account.

(1) Purchased goods from Lala Rs. 3000 passed through Sales Book.

(2) Received one bill from Arjun Rs. 5000, passed through Bills Payable Book.

(3) An item of Rs. 250 relating to prepaid rent was omitted to be brought forward.

(4) Rs. 500 paid to Harish Brothers against our acceptance were debited to Rammohan Account

NOTES

(5) An item of Rs. 90 in respect purchase returns, instead of being debited to personal account from Return onward Book, had been wrongly entered in the Purchase Book and posted there from wrongly to the debit of personal account.

Ans. : ***SUSPENSE ACCOUNT***

To difference in T.B.	***70***	***By Prepaid Rent***	***250***
To Purchase a/c	***90***		
To Purchase return a/c	***90***		
	250		***250***

FURTHER READINGS

- Accounting for Managers: Sharma and Gupta
- Management Accounting: Mr. Agrawal
- Fundamentals Accounting: Jain, Khandelwal, Pareek

8 Time Value of Money

NOTES

The Chapter Covers :

- AN INTRODUCTION
- PRESENT VALUE BASICS (SINGLE CASH FLOW)
- FUTURE VALUE & PRESENT VALUE OF AN ANNUITY

Learning Objectives:

After going through this chapter, you should be able to:

- Understand time value of money
- Identify future and present value of money
- Decide the worth of a product or service in future

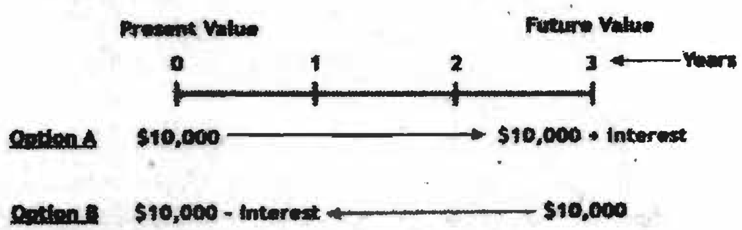
AN INTRODUCTION

NOTES

Money has time value. A rupee today is more valuable than a rupee a year.

In the previous chapter we have gone through various topics like financial decisions, financial functions & other important issues related to finance. We know that procurement of funds & its utilization are major concerns where a finance manager concentrates. Now while taking the decisions related to the above matter the time & risk are very important. Let us understand with the following examples:

1. If a company XYZ has to purchase machinery or any other fixed asset it will require an immediate cash outlay while it will generate cash inflow in the future periods of time. Similarly if it borrows fund from bank or any other source, it will receive cash in present & repay cash (interest+ principal) in future. Here it is important that inflows & outflows should be matched with the perspective of time. It means that the company should analyze whether in the future course of time the appropriate amount can be generated for repayment. Also during investment opportunity cost should be kept in mind.
2. You have won a cash prize of $10,000. You have 2 payment options. 1st Receive $10,000 now & 2nd receive $10,000 in 3 years. Now which option will you choose? If you're like most people, you would choose to receive the $10,000 now. After all, three years is a long time to wait. Why would any rational person defer payment into the future when he or she could have the same amount of money now? For most of us, taking the money in the present is just plain instinctive. So at the most basic level, the **time value of money** demonstrates that, all things being equal, it is better to have money now rather than later. Now the question arises that why it is so because the amount is same after 3 years as it is now? Actually, although the amount is same, you can do much more with the money if you have it now because over time you can earn more interest on your money. Back to our example: by receiving $10,000 today, you are on the edge to increase the future value of your money by investing and gaining interest over a period of time. For Option B, you don't have time on your side, and the payment received in three years would be your future value. Look at the following diagram:



So we can say that Time value of Money is can individual's preference for possession of given amount of money now rather than the same at some future time. There are 3 reasons behind it:

- Risk in future cash receipts
- Preference for present consumption over future consumption
- Investment opportunities

Future Value of Money (Single Cash Flow)

Now we shall understand the **future value of money** by Continuing with the example described earlier. If you choose Option A and invest the total amount at a simple annual rate of 4.5%, the future value of your investment at the end of the first year is $10,450, which of course is calculated by multiplying the principal amount of

$10,000 by the interest rate of 4.5% and then adding the interest gained to the principal amount:

Future value of investment at end of 1^{st} year = ($10,000 x 0.045) + $10,000

= $10,450

NOTES

If the $10,450 left in your investment account at the end of the first year is left untouched and you invested it at 4.5% for another year, how much would you have? To calculate this, you would take 4.5% of the $10,450 and add it with $10,450. At the end of two years, you would have $10920.The above calculation, then, is equivalent to the following equation:

Future value of investment at end of 2^{nd} year :

$$= \$10{,}000 \times (1+0.045) \times (1+0.045)$$
$$= \$10{,}450 \times (1+0.045)$$
$$= \$10{,}920.25$$

Recall your math's classes of your school and the rule of exponents, which states that the multiplication of like terms is equivalent to adding their exponents. In the above equation, the two like terms are (1+0.045), and the exponent on each is equal to 1. Therefore, the equation can be represented as following:

Future Value

$$= \$10{,}000 \times (1+0.045)^{1+1}$$
$$= \$10{,}000 \times (1+0.045)^{2}$$
$$= \$10{,}920.25$$

This calculation shows us that we don't need to calculate the future value after the first year, then the second year, then the third year, and so on. If you know how many years you would like to hold a present amount of money in an investment, the future value of that amount is calculated by the following equation:

Future Value = Original Amount x (1+ interest rate per period) $^{\text{Number of Periods}}$

$$= P\,(1+i)^{n}$$

Now when we have to calculate the future value of any amount for more number of years, say 10 years or 15 years, the process will be very lengthy & time taking. To make it simple, the concept of compound value factor (CVF) is applied. For e.g.:- if we have to calculate the future value of Rs 10000 for 5 years @10% p.a., we shall multiply 10000 with $(1.1)^5$ or 1.611. This value is known as CVF of Re 1 @ 10% for 5 years.

Present Value Basics (Single Cash Flow)

If you received $10,000 today, the present value would of course be $10,000 because present value is what your investment gives you now if you were to spend it today. If $10,000 were to be received in a year, the present value of the amount would not be $10,000 because you do not have it in your hand now, in the present. To find the present value of the $10,000 you will receive in the future, you need to pretend that the $10,000 is the total future value of an amount that you invested today. In other words, to find the present value of the future $10,000, we need to find out how much we would have to invest today in order to receive that $10,000 in the future.

> ***Check Your Progress***
> i. What is annuity?
> ii. How to find Present Value of Annuity?

To calculate present value, or the amount that we would have to invest today, you must subtract the (hypothetical) accumulated interest from the $10,000. To achieve this, we can discount the future payment amount ($10,000) by the interest rate for the period. In essence, all you are doing is rearranging the future value equation above so that you may solve for P. The above future value equation can be rewritten by replacing the P variable with present value (PV) as follows:

NOTES

*$PV = FV/(1+i)^n$

Let's walk backwards from the $10,000 offered in Option B. Remember; the $10,000 to be received in three years is really the same as the future value of an investment. If today we were at the two-year mark, we would discount the payment back one year. At the two-year mark, the present value of the $10,000 to be received in one year is represented as the following:

PV of \$ 10000 in 1 year = \$10000 x $(1+0.045)^{-1}$

= \$ 9569.38

Similarly for 2 years & 3 years the PV will be \$ 9157.30 & \$ 8762.97.

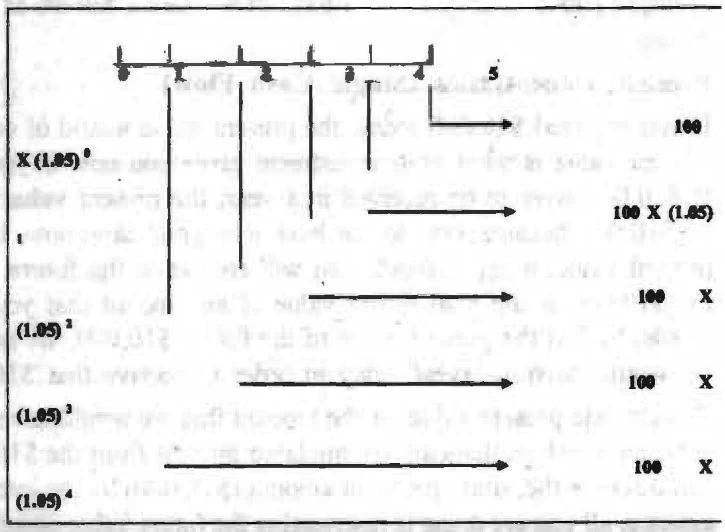
So the present value of a future payment of \$10,000 is worth \$8,762.97 today if interest rates are 4.5% per year. In other words, choosing Option B is like taking \$8,762.97 now and then investing it for three years. The equations above illustrate that Option A is better not only because it offers you money right now but because it offers you \$1,237.03 (\$10,000 - \$8,762.97) more in cash! Furthermore, if you invest the \$10,000 that you receive from Option A, your choice gives you a future value that is \$1,411.66 (\$11,411.66 - \$10,000) greater than the future value of option B.

Now, when we have to calculate the Present value of any amount for more number of years, say 10 years or 15 years, the process will be very complex. To make it simple, the concept of Present Value Factor/Discount Factor ($PVF_{n,i}$) is applied where n is no of years & I is rate of interest. For e.g.:- If we have to calculate the Present value of Rs 50000 for 15 years @ 9% p.a., we shall multiply 50000 with $(1.09)^{-15}$ or 0.275. This value is known as PVF of Re 1 @ 9% for 15 years.

Future Value & Present Value of an Annuity

First of all we have to understand the meaning of annuity & how it is different from previous cash flow we have described. An annuity is a series of equal payments or receipts that occur at evenly spaced intervals. Leases and rental payments are examples. The payments or receipts occur at the end of each period for an ordinary annuity while they occur at the beginning of each period for an annuity due. Bond is a case of annuity due.

The question is how it is different from previous cash flows & what is the need to study annuity separately? To understand this, let us go through an example. Mr. Sharma deposits Rs 100/year @ 5% p.a. in a saving deposit account for 5 years. The interest earned by him after 5 years will be as following:-



This implies that Rs 100 deposited at the end of 1st year will grow for 4 years; Rs 100 deposited at the end of 2nd year will grow for 3 years& so on. So it is clear that in annuity the cash flows at different periods have different maturity periods. Due to this basic difference between single cash flow & annuity, the need for their separate study arises.

If we have to calculate the future value in the above case by using the previous method then the value will be as following:

$$FV = 100 \times (1.05)^0 + 100 \times (1.05)^1 + 100 \times (1.05)^2 + 100 \times (1.05)^3 + 100 \times (1.05)^4$$

$$= 100 \times (1.05^0 + 1.05^1 + 1.05^2 + 1.05^3 + 1.05^4)$$

$$= 100 \times (1 + 1.05 + 1.05^2 + 1.05^3 + 1.05^4)$$

Now it is in the form of **Geometric Progression.** So by applying the rule of G.P, we can write

$$FV = 100 \times \frac{(1.05^4 - 1)}{.05}$$

By observing the above calculation, we can write the formula for Future value of an annuity as following:

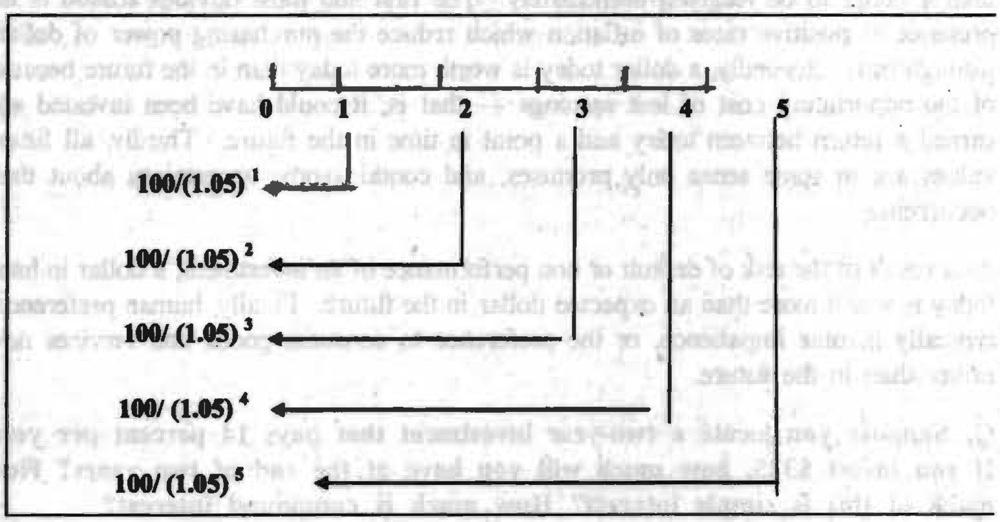
$$\text{FV of Annuity} = A \times \frac{[(1+i)^n - 1]}{i}$$

Where A=Value of Annuity, i= Rate of interest, n=Time Period

If it is the case of annuity due, then

$$\text{FV of Annuity Due} = A \times \frac{[(1+i)^n - 1]\,(1+i)}{i}$$

If you would like to determine Present (today's) value of a series of future payments, you need to use the formula that calculates the present value of an ordinary annuity. The PV of ordinary annuity calculates the present value of the payments that you will receive in the future. Considering the above example, If Mr. Sharma will receive Rs 100/year @ 5% p.a. in coming 5 years, the PV of his receipts will be as following:-



$$PV = 100/(1.05)^1 + 100/(1.05)^2 + 100/(1.05)^3 + 100/(1.05)^4 + 100/(1.05)^5$$

$$= 100[1/(1.05)^1 + 1/(1.05)^2 + 1/(1.05)^3 + 1/(1.05)^4 + 1/(1.05)^5]$$

$$= 100 \frac{[(1.05)^4 + (1.05)^3 + (1.05)^2 + (1.05)^1 + 1]}{(1.05)^5}$$

Applying the concept of **Geometric Progression,**

$$= 100 \times \frac{(1.05^4 - 1)}{0.05(1.05)^5}$$

NOTES

So a common formula for the PV of annuity will be

$$\text{PV of Annuity} = \frac{A \times (1+i)^n - 1}{i(1+i)^n}$$

Similarly present value of an annuity due will be

PV of Annuity Due= PV of Annuity x (1+i)

CASE STUDY:

This case study contains explanations and illustrations of common Time Value of Money problems facing agricultural and agribusiness firms.

Time Value of Money problems refer to situations involving the exchange of something of value (money) at different points in time. In a basic sense, all investments involve the exchange of money at one point in time for the rights to the future cash flows associated with that investment. Expressing all of the values that are exchanged in terms of a common medium of exchange, or money, allows different sets of products or services to be compared in terms of a single standard of value.

However, the passage of time between the outflows and inflows in a typical investment situation results in different current values associated with cash flows that occur at different points in time. Thus, it is not possible to assess an investment simply by adding up the total cash inflows and outflows and determining if they are positive or negative without first considering when the cash flows occur.

There are four primary reasons why a dollar to be received in the future is worth less than a dollar to be received immediately. The first and most obvious reason is the presence of positive rates of inflation which reduce the purchasing power of dollars through time. Secondly, a dollar today is worth more today than in the future because of the opportunity cost of lost earnings — that is, it could have been invested and earned a return between today and a point in time in the future. Thirdly, all future values are in some sense only promises, and contain some uncertainty about their occurrence.

As a result of the risk of default or non performance of an investment, a dollar in hand today is worth more than an expected dollar in the future. Finally, human preferences typically involve impatience, or the preference to consume goods and services now rather than in the future.

Q. Suppose you locate a two-year investment that pays 14 percent per year. If you invest \$325, how much will you have at the end of two years? How much of this is simple interest? How much is compound interest?

At the end of the first year, you will have *\$325* x *(1 + .14)* = *\$370.50*. If you reinvested this entire amount, and thereby compound the interest, you will have *\$370.50* x *1.14* = *\$422.37* at the end of the second year. The total interest you earn is thus *\$422.37* — *325* = *\$97.37*. Your \$325 original principal earns *\$325* x*.14* = *\$45.50* in interest each year, for a two-year total of \$91 in simple interest. The remaining *\$97.37* — *91* = *\$6.37* results from compounding. How much will you have in the third year?

SUMMARY

NOTES

- Money has time value. A rupee today is more valuable than a rupee a year.
- When cash flow occur at different points in time, it is easier to deal with them using a time line. A time line shows the timing and the amount of each cash flow in an acsh flow stream.
- The process of investing money as well as reinvesting the interest earned thereon is called compounding. The future or compounded value of an investment after n years when the interest rate is r percent is:

  Future value = present value $(1 + i)^n$

- If no interest is earned on interest the investment earns only simple interest. In such a case the investment grows as follows: Future value = present value $[1 + Ni]$
- According to the ruler of 72, the doubling period under compounding is obtained by dividing 72 by the interest rate.
- The process of discounting, used for calculating the present value, is simple the inverse of compounding. the present value formula is : $PV = FV_n [1/(1 + r)^n]$
- The present value of a cash plow is equal to:

$$PV_n = \sum_{t=1}^{n} \frac{At}{(1+i)^t}$$

- An annuity is a stream of constant cash flow (payment or receipt)occurring at regular intervals of time when the cash flows occur at the end of each period the annuity is called a regular annuity or deferred annuity. When the cash flow occurs at the beginning of each period, the annuity is called an annuity due.
- The future value of an annuity is given by the formula :

  $FVA_n = A\ [(1+i)^n - 1]/i$

- The present value of an annuity is given by an formula :

  $PVA_n = A\ [\{1-(1/1+i)^n]\}/i]$

ANSWERS TO 'CHECK YOUR PROGRESS'

1. An annuity is a series of equal payments or receipts that occur at evenly spaced intervals. Leases and rental payments are examples.
2. PV of Annuity= $\dfrac{A\,x(1+i)^n - 1}{i(1+i)^n}$
3. The process of discounting, used for calculating the present value, is simple the inverse of compounding. the present value formula is:

   $PV = FV_n[1/(1 + r)^n]$

4. The process of investing money as well as reinvesting the interest earned thereon is called compounding.
5. A time line shows the timing and the amount of each cash flow in a cash flow stream.

NOTES

TEST YOURSELF

1) What is the Time Value of Money?
2) Explain future value & present value of an Annuity.
3) A company may issue a pure discount bond of Rs 1,000 face value for Rs 520 today for a period of five years. Calculate the rate of interest?
4) A firm borrows Rs.1, 000 by issuing a bond with coupon rate of 10% and promises to pay back the principal in 20 years. If the Current market interest rate on a similar bond is 10%, what is the value of this bond?
5) Find the price of a share of preferred stock given that the par value is Rs.100 per share, the preferred dividend rate is 8%, and the required return is 10%?
6) State the formula for future value of an annuity?

FURTHER READINGS

- Accounting for Managers: Sharma and Gupta
- Management Accounting: Mr. Agrawal
- Fundamentals Accounting: Jain, Khandelwal, Pareek

9 Financial Statements

NOTES

The Chapter Covers :

- INTRODUCTION
- USERS OF FINANCIAL STATEMENT
- INCOME STATEMENT
  - TRADING ACCOUNT
  - PROFIT & LOSS ACCOUNT
- PREPARATION OF TRADING ACCOUNT
- PREPARATION OF PROFIT & LOSS ACCOUNT
- STATEMENT OF FINANCIAL STATUS (BALANCE SHEET)
- POINTS TO BE NOTED FOR PREPARATION OF FINAL ACCOUNTS
- LIMITATION OF FINAL STATEMENTS/FINAL ACCOUNTS
- ADJUSTMENTS

Learning Objectives:

After going through this chapter, you should be able to:

- Understand financial statement
- Explain income statement
- Prepare trading account
- Prepare P/L account
- Adjustments

NOTES

INTRODUCTION

Financial statements refer to such statements which reports the profitability and the financial position of business at the end of accounting period. The term financial statements includes at least two basic statements which are as under :

(i) Income Statements (Trading and Profit & Loss Account)

(ii) Statement of Financial Position (Balance Sheet)

These two financial statements are also termed as 'Final Accounts'.

In the words of John. N. Myer- "The financial statements provide a summary of the accounts of a business enterprise, 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."

USERS OF FINANCIAL STATEMENTS

(1) **Management :** It helps the management in assessing the profitability of various activities and departments. Management can review the progress of the business and take decisions for controlling the non-profitable activities.

(2) **Employees :** They can judge as to how much bonus and increase in their wages are possible from the profits of the enterprise.

(3) **Investors :** They can assess the short term & long term soundness by studying the future growth of enterprise.

(4) **Government :** To study the profit marging of various industries to introduce or withdraw various concessions and to increase or decrease the excise duty.

(5) **Taxation Authorities :** They use the financial statements for the purpose of assessment of income tax, sales tax etc.

(6) **Other Users :** Such as creditors, researchers, trade associations, consumer agencies etc.

INCOME STATEMENT

It is divided into two parts :

(i) Trading Account (ii) Profit & Loss Account

The fundamental principle of preparing the Trading and profit & loss A/c is that the expenses and incomes for the full trading period, byt only ofr the trading period, are taken to there account.

(i) **Trading Account** : Trading Account is prepared for calculating the gross profit or gross loss arising or incurred as a result of the trading activities of a business. In other words, it records the amount of purchases of goods and also the expenses which are incurred in bringing that commodity to a saleable state. All expenses related to purchase of material or manufacturing of goods (Direct Expenses) are recorded in the Trading Account.

According to Carter "Trading Account is the account which is prepared to determine gross profit or gross loss."

According to J.R. Batliboi - "The Trading Account shows the results of buying and selling of goods. In preparing the accounts, the general charges are ignored and only the transactions in goods are included."

Objects / Importance of Trading Account :

(1) To find out Gross Profit or Gross Loss.

(2) To compare last year's items with that of convert year

(3) To scrutinise the reasons for increase or decrease in sales.

(4) To find out the percentage of Gross Profit or Gross Loss on sales.

(5) To find out the expenses incurred on purchase of goods.

(6) To simplify the method of valuation of closing stock.

NOTES

PREPARATION OF TRADING ACCOUNT

Trading Account is a Nominal Account and all expenses which relate to either purchase or manufacturing of goods are written on the Dr. side of the Trading Account.

Items written on the Dr. side

(1) Opening Stock : The stock of goods remaining unsold at the end of the last year is termed as the opening stock of the current year. Opening stock includes Raw Material, Work-in-progress and Finished goods.

(2) Net Purchases – Net purchases refers to the net amount of purchases after dudecting purchase returns out of ie.

(3) Direct Expenses - All expenses related to purchase of goods, bringing them to godowns and manufacturing of goods are called direct expenses. For example- Wages, Freight, Carriage Inwards, Factory expenses, Insurance of purchase, Direct Taxes on Purchase.

Items written on the Cr. side

(1) **Net Sales** – Net sales refers to gross sales less sales returns.

(2) **Closing Stock** - The goods remaining unsold at the end of the current 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, work-in-progress and finished.

Normally, the closing stock is given outside the Trial Balance. But if it is given inside the Trial Balance, it will not be shown in the Trading Account but on the Asset side of the Balance-sheet only.

SPECIMEN OF TRADING ACCOUNT

(for the year ending ....)

Dr. Cr.

Particulars		Amt.	Particulars		Amt.
To Opening Stock		....	By Sales		....
To Purchases	....		Less : Sales Return or	....	....
Less : Purchase Return or			Return Inward		
Return outward	....	....	By Closing stock		....
To wages		....	By Gross Loss		....
To wages & Salaries		....	(if any) transferred to		
To carriage	or	....	Profit and Loss A/c		
To carriage Inward	or	....	(Balancing figure)		
To carriage on purchase		....			
To Direct Expenses		....			
To Freight, Octroi and cartage		....			

NOTES

To Gas, Fuels & Power	....		
To Manufacturing Expenses or productive Expenses	....		
To Factory Expenses, such as Factory lighting Factory Rent etc.	....		
To Dock charges and clearing charges	....		
To Import Duty or Custom Duty	....		
To Excise Duty	....		
To Royalty	....		
To Gross Profit	....		
transferred to P&L A/c (Balancing figure)	....		
	....		....

CLOSING ENTRIES RELATING TO TRADING ACCOUNT

(1) For the items of Dr. side of Trading Account

Trading A/c Dr.

To Opening Stock A/c
To Purchases A/c
To Sales Return A/c
To Wages A/c
To Direct Expenses A/c
To Carriage A/c
To Gas, Fuel & Power A/c
To Manufacturing Expenses A/c
To Factory Rent & Lighting A/c
To Custom Duty A/c
To Royalty A/c

(For the transfer of above accounts to the Dr. side of Trading A/c)

(2) For the items of Cr. side of Trading account

Sales A/c Dr.
Closing stock A/c Dr.
Purchase Return A/c Dr.
To Trading A/c

(For the transfer of above accounts to the cr. side of Trading A/c)

(3) For Gross Profit

Trading A/c Dr.
To Profit & Loss A/c

(For the transfer of Gross Profit to the Cr. side of P&L A/c)

(4) For Gross Loss

Profit & Loss A/c Dr.
To Trading A/c

(For the transfer of gross loss to the Debit side of P&L A/c)

(ii) Profit & Loss Account

A business incurs a number of expenses which are directly not related to buying and salling goods and thoutore, they are not taken to trading account. Hence a business man is more interested in knowing the profit earned or net loss incurred during the year. As such, a Profit & Loss Account prepared which contains all the items of losses and gains pertaining to the accounting period. This account is prepared from Nominal accounts and its balance is transferred to capital account.

NOTES

According to Prof. Carter – "A Profit & Loss Account is an account into which all gains and losses are collected, in order to ascertain the excess of gains over the losses or vice-versa."

Objects/Importance of Profit & Loss Account

(1) To ascertain the Net Profit or Net Loss

(2) To Compare current year and previous year profits

(3) To ascertain whether business is being conducted efficiently or not.

(4) Helps in taking concrete steps for controlling expenses.

(5) Helpful in the preparation of Balance-sheet

PREPARATION OF PROFIT & LOSS ACCOUNT

Profit & Loss account is a Nominal Account and all the expenses and losses are shown on its debit side and all the incomes and gains are shown on its credit side. These expenses include administrative expenses, selling expenses, distribution expenses etc. These are called indirect expenses.

Items written on the Dr. side :

(i) **Gross Loss** – Gross Loss brought down from the Trading account.

(ii) **Office and Administrative Expenses** – Such as salary, office expenses, office rent, lighting and electricity, Rates & Taxes, Insurance, Telephone, Postage, Stationery, Legal expenses, Trade Expenses, Repairs, audit fees etc.

(iii) **Selling & Distribution, Carriage Outward, Bad-debts, Delievery van expenses etc.**

(iv) **Miscellaneous Expenses :** Such as Discount, Depreciation, Charity, Interest on Loan, Interest on capital, donation etc.

Items written on the Cr. Side :

(1) **Gross Profit** – Gross profit brought down from the Trading Account.

(2) **Other Incomes & gains** – Income from Investment, Interest on drawings, Rent received, Discount received, Commission received etc.

Specimen of Profit & Loss Account
(for the year, ending ....)

Particulars	Amount	Particulars	Amount
To Gross Loss b/d	....	By Gross Profit b/d	....
To Salaries	....	By Rent (Cr.)	....
To Salaries & wages	....	By Discount (Cr.)	....
To Rent, Rates & taxes	....	By Commission received	....
To Printing & Stationery	....	By interest on investments	....
To Postage & Telegram	....		....
To Insurance Premium	....	By Bad-debts Recovered	....

NOTES

To Telephone Charges	....	By Apprentice Premium	....
To Legal Charges	....	By Profit on sale of Assets	....
To Audit fees	....		....
To Travelling expenses	....	By Discount on purchases	....
To Establishment Expenses	....	By Rent of subletting	....
To Trade Expenses	....	By income from	....
To General Expenses	....	other sources	....
To Carriage outward or	....	By Net loss (if any)	....
Carriage on sale	....	transferred to	....
To Unproductive wages	....	capital A/c	....
To Advertisement	....		
To Commission	....		
To Brokerage	....		
To Bad-debts	....		
To Packing charges	....		
To Delivery van expenses	....		
To Stable Expenses	....		
To Discount	....		
To Sales tax			
To Repairs			
To Depreciation			
To Interest (Dr.)			
To Bank Charges			
To charity & Donation			
To entertainment Expenses			
To Conveyance Expenses			
To Loss on sale of Asset			
To Net Profit			
transferred to Capital A/c			
	....		....

Note : Domestic and household expenses of the proprietor, Income-tax and life Insurance premium etc. are known as drawings deducted from capital at the Liabilities side of the Balance-sheet.

Closing entries relating to Profits & Loss A/c

(1) Transfer of expenses and losses

Profit & Loss A/c Dr.

To Salaries A/c

To Rent, Rates Taxes A/c

To General Expenses A/c

(For the transfer of Indirect Expenses to Profit & Loss A/c)

(2) Transfer of Incomes and Gains

Interest Received A/c Dr.

Commission Received A/c Dr.

To Profit & Loss A/c

(For transfer of income & gains to Profit & Loss A/c)

NOTES

(3) Transfer of profit balance.

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

(4) Transfer of Loss balance
Capital A/c Dr.
To Profit & Loss A/c

(For the transfer of net Loss to Capital A/c)

Distinction between Trading and Profit & Loss A/C

S. No.	Trading A/C	Profit & Loss A/C
1	It is prepared as part of P&L A/c	It is prepared as an independent and principal account.
2.	Direct expenses are recorded in it.	Indirect expenses are recorded in it.
3.	This account gives the amount of Gross Profit/Loss.	This shows the amount of Net Profit/Loss.
4.	Balance of this account is transferred to Profit & Loss A/c	Balance of this account is transferred to Balance Sheet
5.	The number of items to be recorded in the Trading Account are generally very less.	The number of items to be recorded in this account are generally quite large.
6.	Prepared before Profit & Loss Account.	Prepared after Trading Account.

Example 2 : From the following particulars of Shri Kanha Traders in respect of the year ending 31st March 2007, prepare Trading and Profit & Loss A/c.

Opening Stock	16,000	
Purchases	1,00,000	
Purchases Returns		600
Return Inwards	1200	
Sales		1,64,000
Carriage Inward	400	
Wages	1,000	
Rent & Taxes	600	
Trade Expenses	1,200	
Discount	80	
Discount on Purchases		100
Commission	20	

NOTES

Salaries	4,000	
Legal Expenses	100	
Audit fees	120	
Bank charges	80	
Sales Tax	100	
Interest on Drawing		120
Interest from Investments		400
Repairs & Renewals	520	

Closing Stock Rs. 2,000/-

Solutions :

Trading and Profit & Loss Account
(For the year ending on 31 March 2007)

Particulars		Amount	Particulars	Amount
To opening stock		16,000	By Sales	1,64,000
To Purchases	1,00,000		Less : Returns 1,200	1,62,800
Less : Return	600	99,400	By Closing Stock	2,000
To wages	1,000			
To Carriage inward		400		
To Gross Profit c/d		48,000		
		1,64,800		1,64,800
To Salaries		4,000	By Gross profit b/d	48,000
To Discount		80	By Discount on Purchases	100
To Commission		20	By Interest on Investment	400
To Legal Expenses		100	By Interest on Drawings	120
To Audit fees		120		
To Bank charges		80		
To Sales tax		100		
To Repairs and Renewals		520		
To Rent and Rates		600		
To Trade expenses		1,200		
To Net Profit transferred to Capital A/c		41,800		
		48,620		48,620

MANUFACTURING ACCOUNT

The business concerns those manufacture goods would like to ascertain or may like to ascertain the cost of producing the total output. The ordinary Trading and Profit & Loss Account are not capable of providing the same. Some concerns, engaged in manufacturing, prepare separate 'Manufacturing Account' to which all expenses incurred in the factory as the production of goods are debited. The total of such expenses after adjustments of value of stocks of raw materials and work in progress shown the total cost of the output during the accounting period. This figure is then, transferred to the debit of the Trading Account which reflects the gross profit made by the concen. Trading and Profit & Loss Accounts are prepared as usual leaving the items taken into Manufacturing account : Opening balance of raw materials and work in progress are shown on the debit side of the account and closing balances on the credit side. Raw material consumed during the accounting period is written on debit side of the account, which is ascertained as fallows :

NOTES

	Openint stock	***
Add :	Purchases	***
Less :	Cosing stock	***
	Raw Material consumed	***

Example – 1

Following are the balances as on March 31, 2007 taken from the books of Velocin Brothers. You are required to prepare (a) Manufacturing Account, (b) Trading Account, and (c) Profit & Loss account

Sales	2,40,000
Opening stock :	
Raw material	8,000
Work in Progress	12,000
Finished goods	18,000
Closing stock :	
Raw Material	6,000
Work in Prgress	16,000
Finished goods	12,000
Raw Material Purchases	60,000
Factory Expenses :	
Wages	48,000
Carriage Inwards	2,000
Rent	6,400
Factory Repairs	8,400
Plat Repairs	15,600
Supervisor's Remuneration	20,000
Work manager's salary	5,600
Administration Overheads :	
Salaries	8,000
Other expenses	12,000

NOTES

Salling Overheads :

salaries	4,000
Commision	16,000
Advertising	10,000
Other Expenses	3,200

Distribution Overheads :

Van expenses	3,600
Wages	2,000

Solution

Manufacturing Account
(For the year ended March 31, 2007)

Particulars		Rs.	Particulars	Rs.
Direct Material :			Net works cost of production (transfered to Trading A/c)	1,64,000
Opening stock	8000			
Purchases	60,000			
	68000			
less: Closing stock	6,000			
Raw Material consumed		62,000		
Direct wages :				
Factory wages		48,000		
Direct Expenses :				
Carriage Inwards		2,000		
Prime cost		1,12,000		
Factory Overheads :				
Factory Rent	6,400			
Factory Repairs	8,400			
Plant Repairs	15,600			
Supervisor's wages	20,000			
Work manager's salery	5,600	56,000		
Works cost		1,68,000		
Add : Opening work in progess		12,000		
Less : Closing work in progress		16,000		
		1,64,000		1,64,000

Trading and Profits & Loss Account
(for the year ended March 31, 2007)

Opening stock of finished goods		18,000	Sales	2,40,000
Net cost of production		1,64,000		
		1,82,000		
Less: Closing stock of finished goods		12,000		
Cost of goods sold		1,70,000		
Gross profit c/d		70,000		
		2,40,000		2,40,000
Administration overheads :			Gross profit	70,000
Salaries	8,000			
Other expenses	12,000	20,000		

Selling overheads :				
Salaries	4,000			
Commission	16,000			
Advertising	10,000			
Other expenses	3200	33200		
Distribution Overheads :				
Van expenses	3,600			
Wages	2,000	5,600		
Net Profit		11,200		
		70,000		70,000

NOTES

STATEMENT OF FINANCIAL STATUS OR BALANCE-SHEET

The Trading and Profit & Loss account show only the net profit or net Loss of a business for a certain trading period. But the businessman may also like to know the financial position of the business at the end of the trading period. For this purpose, he prepares a statement of his assets and liabilities as on the closing date of the trading period. This statement is known as Balance-sheet. A Balance-Sheet is a sheet containing the balances of real and personal accounts of a business. The name, balance-sheet is derived from the fact that these accounts must always be in balance i.e. Assets must equal the sum of liabilities, internal and external as well.

According to J.R. Batliboi – "A Balance-sheet is a statement that measures the exact financial position of a business on a certain fixed date."

Need and Importance of Balance-Sheet

(1) To ascertain the true financial position of the business at a particular point of time.

(2) To ascertain the nature and cost of various assets of the business.

(3) To determine the nature and amount of various liabilities of business.

(4) To provide information about the exact amount of capital at the end of year and the addition/deduction in the current year.

(5) To find out whether the firm is solvent or not.

(6) To help in preparing the opening entries at the beginning of the next year.

Marshalling of Assets & Liabilities

Marshalling is the arrangement of various assets and liabilities in a proper order. Though the order is not fixed, still to create uniformity in the Balance-Sheets following two methods are used :

(1) Liquidity method

(2) Fixity or Permanence method

(1) In order of Liquidity :

An asset which is most easily convertible into cash is written first and then will follow those assets which are comparatively less easily convertible. In the same way, those liabilities which are to be paid early are written first and then the fixed and long term liabilities.

NOTES

BALANCE-SHEET
(As on ....)

Liabilities	Amount	Assets	Amount
Current Liabilities		Current Assets	
Bank Overdraft	....	Cash in hand	....
Bills Payable	....	Cash at Bank	....
Sundry Creditors	....	Bills Receivable	....
Outstanding Expenses	....	Short term Inverstment	....
Bank Loan (Short-term)	....	Sundry Debtors	....
Unearned Income	....	Closing Stock	....
Fixed Liabilities	....	Prepaid Expenses	....
Long term loan	....	Accrued Income	....
Reserves	....	Fixed Assets -	....
Capital	....	Furniture	....
(+) Net Profit	....	Motor Vehicles	....
(–) Net Loss		Long term Investment	....
(–) Drawings	....	Plant & Machinery	....
(–) Income Tax & LIP....		Land & Building	....
		Patents	....
		Goodwill	....
	....		....

Suitability –

Sole Proprietors and partnership firms prepare their Balance-sheet in the order of liquidity.

(2) In order of Fixity or Permanence –

Assets which are most difficult to be converted into cash (Goodwill) are written first and the assets which are most liquid (cash) are written last. Liabilities which are to be paid last (capital) are written first and current liabilities in last.

BALANCE-SHEET
(As On ....)

Liabilities	Amount	Assets	Amount
Capital		Fixed Asset -	....
(+) Net Profit		Good will	....
(–) Net Loss		Patents	....
(–) Drawings		Lands & Building	....
(–) Income tax & LIP		Plants & Machinery	....
Fixed Liabilities -		Long term Investment	....
Long term loans	....	Motor Vehicles	....
Reserves	....	Loose Tools	....
Current Liabilities -		Furniture	....
Unearned Income	....	Current Assets -	
Outstanding expenses	....	Accrued Income	....
Bank loan (short-term)	....	Prepaid expenses	....
Sundry Creditors	....	Closing Stock	....

Bills Payable	....	Sundry debtors	....
Bank overdraft	....	Short term Investments	....
		Bills Receivable	....
		Cash at Bank	....
		Cash in hand	....
	....		....

NOTES

Suitability – Joint stock companies are required to prepare their Balance-sheet in the order of permanence.

Resemblance in Trial Balance and Balance-sheet :

(1) Both Trial Balance and Balance sheet are statements.

(2) Both of these statements are prepared on the basis of ledger.

(3) Both of these statements reflects the balances of accounts an a certain date.

(4) Balances of cash book are written in both of these statements.

(5) The accounts which have been closed are not mentioned in either of the statments.

(6) Preparation of these statements doesn't require journal entries.

Distinction between Trial Balance & Balance-Sheet

Basis of Difference	Trial Balance	Balance sheet
1. Object	To check arithmetical accuracy of the books of accounts.	To know the true financial position of the firm.
2. Necessity	Not necessary	Necessary to prepare.
3. Heading	Headings of its column - Debit & Credit	Headings of its columns - Liabilities & Assets.
4. Period	Normally prepared every month or when ever needed.	Normally prepared half-yearly or at the end of accounting period.
5. Types of accounts	Personal, real or nominal-all types of accounts must be written in it.	Only personal and real accounts are included in it.
6. Closing Stock	Normally, it does not contain closing stock.	It contains the items of closing stock.
7. Adjustments	It can be prepared without adjustment.	It cannot be prepared without making adjust-ments.
8. Evidence	It is not accepted by the court as documentary evidence.	It is accepted by court as documentary evidence.

Work sheet : It is a summarised way of working out final accounts. It has a number of columns, a set of two for trial balance figures, another set ofr adjustments, a third set to show adjusted trial balance, fourth for the Trading Account, fifth for the profit & loss Account and the last set for Balance sheet items. A format of such work sheet is given below :

Check Your Progress

1. What is a trading account?
2. What are net purchases?

NOTES

Work sheet of .... on March 31, 2007

Particulars	Trail Balance		Adjustment		Adjested Trail Balance		Trading A/C		P&L A/C		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Total												

POINTS SHOULD BE NOTED FOR PREPARING FINAL ACCOUNTS

1. If a trial balance is not given in the question, it is better to prepare a Trial Balance first of all. If there is a difference in the Trial Balance, the difference is placed to a 'Suspense A/c' and shown in the Balance Sheet.
2. Items which appear in the Trial Balance should be shown only once.
3. Items which appear outside the Trial Balance known as Adjustments, have to be shown at two places.
4. Items appearing on debit side of Trial Balance should be shown at Dr. side of Trading and profit & loss A/c or Assets side of Balance-sheet.
5. Items appearing on the credit side of Trial Balance should be shown at Cr. side of Trading and Profit & Loss A/c or Liabilities side of Balance-Sheet.
6. All accounts relating to goods are written in the Trading Account where as all the remaining expenses or the balances are shown in the Profit & Loss Account.
7. The balances of Personal and Real Accounts are always shown in the Balance-sheet and balances of Nominal Accounts in the Trading and Profit & Loss A/c.
8. The totals of both sides of the Balance sheet will always be equal.
9. If the expenses are in respect of factory they will be shown in the Trading Account else they will be shown in Profit & Loss Account.
10. If a Trial Balance is not given in the question, and if it is not clearly stated whether a particular items is expense or income, it will be treated as expense such as Discount, Commission, Brokerage or Rent etc.

LIMITATION OF FINANCIAL STATEMENTS/ FINAL ACCOUNTS

1. They are mainly statements of historical costs and do not show the current worth.
2. Most of the times, costs are allocated on arbitrary and subjective basis.
3. Assets show cost of acquisition less depreciation and do not show current value.

4. They reflect a composite of historical costs, current costs and estimates.
5. They do not reflect certain important qualitative elements like competency and reputation of the management, morale an defficiency of employees etc.
6. They also show certain deferred charges to future income which have no real value as assets.

NOTES

Example 3 : From the following Trial Balance of Mahavir & Co, prepare a Trading and Profit & Loss A/c and Balance-Sheet for the year ending. 31 Dec., 2006.

Trial Balance
(As on 31.12.2006)

Particulars	Amount	Particulars	Amount
Opening Stock	3,800	Sales	14,000
Purchases	7,200	Creditors	2,000
Sales return	120	Purchase Returns	80
Wages	1400	Capital	4320
Salaries	600		
Rent	200		
Discount	200		
Tax	120		
Drawing	1,600		
Debtors	2,240		
Cash in Hand	200		
Cash at Bank	2,320		
Furniture	400		
	20,400		20,400

Stock on 31st Dec., 2006 was valued at Rs. 2,000.

Solutions :

Mahavir & Co.
Trading and Profit & Loss Account
for the year ending 31st Dec. 2006

Dr. **Cr.**

Particulars		Amount Rs.	Particulars		Amount Rs.
To opening stock		3,800	By Sales	14,000	13,880
To purchases	7,200		Less : Return	120	
Less : Returns	80	7120	By Closing stock		2,000
To wages		1400			
To Gross Profit c/d		3,560			
(Transferred to P&L A/c)					
		15880			15,880

NOTES

To Salaries	600	By Gross Profit b/d	3,560
To Rent	200		
To Discount	200		
To Tax	120		
To Net profit	2,440		
[Transferred to Capital A/c]	3,560		3,560

Balance-Sheet
(As on 31st Dec. 2006)

Liabilities		Amount	Assets	Amount
Capital	4,320		Furniture	400
(+) Net profit	2,440		Debtors	2,240
			Closing Stock	2,000
(–) Drawings	1,600	5,160	Cash at Bank	2,320
Creditors		2,000	Cash in Hand	200
		7,160		7,160

Example 4 : From the following Balances, prepare a Trading, Profit & Loss Account and Balance sheet.

Dr.			Cr.
Carriage on purchase	8,000	Supplier's A/c	61,000
Carriage on sales	3,500	Banker's	30,000
Manufacturing Expenses	42,000	Interest on Investment	4,500
Advertisement	7,000	Capital A/c	1,00,000
Excise Duty	4,400	Sales less Return	5,20,000
Lighting	6,000	Discount on Purchase	3,400
Customer's A/c	80,000		
Duty & Clearing Charges	5,200		
Postage & Telegram	800		
Fire Insurance premium	3,600		
Patent	12000		
Income Tax	10,000		
Life Insurance Premium	14,000		
Office Exp.	7,200		
Commission on Purchase	2,000		
Purchase less Return	1,60,000		
Cash in Hand	2,500		
Motor Car	60,000		

NOTES

Drawings	8,000		
Audit fees	2,700		
Repairs	2,200		
Closing stock	76,000		
Trade Exp.	3,200		
Investment	30,000		
Sales tax	12,000		
Discount	2,700		
Plant	1,53,900		
	7,18,900		7,18,900

Solutions :

Trading and Profit & Loss Account
(for the year ending ....)

Dr. **Cr.**

Particulars	**Amount**	**Particulars**	**Amount**
To Purchase less Return	1,60,000	By Sales less Return	5,20,000
To Carriage on purchase	8,000		
To Commission on Purchase	2,000		
To Manufacturing Exp.	42,000		
To Excise Duty	4,400		
To Duty & Cleaning Charges	5,200		
To Gross Profit c/d transferred To P&L A/c	2,98,400		
	5,20,000		5,20,000
To Carriage on sale	3,500	By Gross Profit b/d Transffered from trading A/c	2,98,400
To Advertisement	7,000		
To Lighting	6,000	By Interest on Investments	4,500
To Postage & Telegram	800	By Discount on Purchases	3,400
To Fire Insurance Premium	36,600		
To office Expenses	7,200		
To Audit fees	2,700		
To Repairs	2,200		
To Trade Expenses	3,200		
To Sales Tax	12,000		
To Discount paid	2,700		
To Net Profit Transferred to capital A/c	2,55,400		
	3,06,300		3,06,300

NOTES

BALANCE-SHEET
as on ....

Liabilities		Amount	Assets	Amount
Banker's		30,000	Cash in hand	2,500
Supplier's A/c		61,000	Customer's A/c	80,000
Capital	1,00,000		Closing Stock	76,000
(+) Net Profit	2,55,400		Investments	30,000
	3,55,400		Motor Car	60,000
Less : Drawings	8,000		Plant	1,53,900
	3,47,400			
Less : Income Tax	10,000		Patents	12,000
	3,37,400			
Less : Life Insurance Premium	14,000	3,23,400		
		4,14,400		4,14,400

Note : If closing stock appears inside the trial-balance, it will be shown only at one place, i.e. only on the assets side of the Balance sheet.

ADJUSTMENTS

While preparing final accounts it must be detected whether there is a transaction :

(1) which has been omitted to be recorded in the books, or

(2) which has wrongly been recorded in the books, or

(3) of which only one aspect has been recorded in the books. Entries passed for such transactions are called **'adjustment entries'.**

(1) Closing stock – The amount of goods unsold at the end of the year is called closing stock. It is valued at cost price or market price, whichever is less. The entry will be :

Closing stock A/c .....Dr.
To Trading A/c
(For closing stock transferred to Trading A/c)

Effect – It will be shown at two places, i.e., on the credit side of the Trading A/c and on the Assets side of the Balance-sheet.

(2) Outstanding expenses or expenses due but not paid – These are the expenses which have been incurred during the year but have been left unpaid on the date of preparation of final accounts. For example, a firm pays rent@ 5000 per month. If during the accounting year ending on 31 Dec., only 11 months rent amounting to Rs. 55,000 has been paid, rent for one month of Rs. 5,000 will remain outstanding at the end of the year. The entry will be :

Rent A/c .....Dr. 5,000
To Outstanding Rent A/c 5,000
(For outstanding rent of one month)

Effect : Added to the concerned expenses on the debit side of Trading or Profit & Loss. Account and on the other hand, will also be shown on the Liabilities side of the Balance-Sheet.

NOTES

(3) **Prepaid Expenses or Unexpired Expenses or Expenses paid in advance** – These are the expenses which have been paid in advance for the next year during the current year itself. In other words, the benefit of such payments will be available in the next accounting year. Prepaid insurance amounted to Rs. 1000.

Prepaid Insurance A/c	.....Dr.	1,000	
To Insurance A/c			1,000
(For Prepaid Insurance is to Insurance A/C)			

Effect : It will be deducted from the concerned expenses on the debit side of Trading or Profit and Loss Account and on the other hand, will also be shown on the Asset side of the Balance-sheet.

(4) **Depreciation** – Depreciation is the loss or fall in value of fixed assets due to their constant use and expiry of time. For example : Machinery of Rs. 60,000 is to be depreciated @ 10% p.a. Entry will be :

Depreciation A/c	....Dr.	6,000	
To Machinery A/c			6,000
(For Depreciation charged)			

Effect : It will be shown on the debit side of the Profit & Loss A/C and will be deducted from the value of the concerned asset on the Asset side of Balance Sheet.

(5) **Accrued Income or Income Receivable** – Income earned during the current year but have not been actually received by the end of the current year. Such incomes are known as 'Accrued Incomes' or 'Earned Incomes'. For example, commission earned in December (at the end of year) and received in January of Rs. 300 then commission accrued is Rs. 300.

Accrued commission A/c	.....Dr.	300	
To Commission A/c			300
(For commission receivable)			

Effect : Such incomes will be added in the concern in income on the credit side of the Profit & Loss Account and on the other hand, will be shown on the Asset side of the Balance-sheet.

(6) **Unearned Income or Income Received in Advance** – Certain Income is received in the current year but the whole amount of it does not belong to the current year. Such Income is known as 'Unearned Income' or 'Income Receivable'. For e.g. – Rent received on 1st April, 2006 Rs. 28,000 @ Rs. 2,000 P.M. This rent is from 1st April 2006 to 30 May 2007. Accounting year is from 1st April, 2006 to 31st march, 2007. In such case, 2 month rent (April 07 & May 07) is advance income, entry will be.

Rent a/c	.....Dr.	4,000	
To Rent received in Advance a/c			4,000
(For adjustment of unearned Rent)			

Effect : It will be deducted from the concerned income on the credit side of Profit & Loss Account and also be shown on the liabilities side of the Balance-sheet.

(7) **Interest on Capital** – Capital invested by the proprietor is treated as a loan to the business earning interest at a fixed rate. If this amount had not been invested in the capital, it would even then have earned some interest outside.

NOTES

As such the proprietor wants interest for his capital and profit for the risk undertaken by him, for example, if 5% interest is to be allowed on the capital of Rs. 1,00,000, the entry will be :

Interest on capital A/c	.....Dr.	5,000	
To Capital A/c			5,000
(For Interest allowed on capital)			

Effect : Interest on capital is shown on the debit side of Profit & Loss Account and added to capital in Balance-sheet.

(8) **Interest on Drawings** – The proprietor draws cash or goods for his personal use. Such with-drawals are termed as Drawings. If the firm pays interest on Capital, it is fully justified that it should also charge interest on drawings. For example : Proprietor has drawn 10,000 for personal use and interest is @ 3%. Its entry will be :

Drawings A/c	.....Dr.	300	
To Interest on Drawings			300
(For Interest charged on Drawings)			

Effects : Interest on drawing is shown on the credit side of Profit & Loss Account & deducted from capital in Balance-Sheet.

(9) **Interest on Loan** – Loan is a liability of the firm and interest on such loan will be an expense. If up-to-date interest has not been paid on the loan, the unpaid interest will have to be calculated and will be treated just like outstanding expenses i.e. For example, Interest on loan is charged @ 10% & the amount of loan is 2,00,000.

Interest on Loan A/c	.....Dr.	20,000	
To Outstanding Interest A/c			20,000
(For interest charged on loan)			

Effect : Unpaid interest on loan is added in the Intrest on loan written on debit side of P&L a/c and on the other hand added to the loan from Bank in liabilities side or the Balance Sheet.

(10) **Bad Debts** – When it becomes certain that a particular amount will not be recovered from debtors, it is known as Bad debts. For example : written off Bad debts of Rs. 1,000. Entry will be

Bad debts A/c	.....Dr.	1,000	
To Debtors A/c			1,000
(for Bad debts deducted from debtors)			

Effect : It will come in debit side of the P&L a/c and the amount will be deducted from Debtors on the Asset side of the Balance-sheet.

(11) **Provision for Bad and Doubtful Debts** – As the amount of actual loss on account of current year bad-debts would be known only in the next year when the amount is realised from Debtors, a provision is created to cover any possible loss on account of bad-debts likely to occur in future. Such a provision is created at a fixed percentage on Debtors every year and is called 'Provision for Bad & Douhtful Debit' For example : Debtors are of Rs. 60,000 and provision is made on it @ 5%. Its entry:

Profit & Loss A/c	.....Dr.	3,000	
To Provision for Bad and Doubtful Debts			3,000
(for creation of reserve @ 5% on Debtors)			

Effect : It will come on debit side of P&L a/c and amount is deducted from Debtors on the Asset side of Balance-Sheet.

NOTES

(12) Provision for discount on Creditors – Many a time discount is received from the creditors. A reserve is created for possible discount in the future. For example, Creditors are of Rs. 20,000 and created provision@ 2%, its entry will be :

Provision for discount from creditors A/c	.....Dr.	400	
To Profit & Loss A/c			400

Effect : It will come towards the credit side of Profit & Loss A/c and will be deducted from creditors in Balance-Sheet.

Example 5 : From the following Trial balance of Salman & sons, prepare Trading A/c, and Profit & Loss A/c for the year ending 31st March, 2007 and a Balance-sheet as on that date.

Trial Balance
(As on 31-3-2007)

Dr. **Cr.**

Particulars	Amount	Particulars	Amount
Opening stock	5,200	Capital	16,000
Purchases	15,500	Creditors	2,000
Sales Return	300	Sales	20,000
Debtors	4,000	Commission	3,140
Building	5,000	Rent	2,000
Furniture	1,600		
Machinery	4,000		
Bills Receivable	2,000		
Salaries	1,600		
Tax	200		
Insurance	300		
Carriage on purchases	900		
Trade Expenses	300		
Travelling Expenses	440		
Wages	1000		
Cash	800		
	43,140		43,140

Adjustment :

(1) Closing stock Rs. 12,000, (2) Accrued Rent Rs. 500, (3) Unearned commission of Rs. 140, (4) Depreciation@10% p.a. on Machinery & Furniture.

Solution : **Trading and Profit & Loss Account**
(for the year ended 31st March, 2007)

Dr. **Cr.**

Particulars	Amt.	Particulars		Amt.
To Opening Stock	5,200	By Sales		20,000
To Purchases	15,500	Less : Return	300	19,700

NOTES

To Carriage	900	By Closing Stock		12,000
To Wages	1,000			
To Gross Profit c/d	9,100			
Transferred to P&L A/c	31,700			31,700
To Salaries	1,600	By Gross Profit b/d transfers A/c		9,100
To Tax	200	By Commission	3,140	
To Insurance	300	Less : Unearned	140	3,000
To Trade Expenses	300			
To Travelling Expenses	440	By Rent	2,000	
To Dep. on Machinery *1	400	(+) Accrued	500	2,500
To Dep. on Furniture *2	160			
To Net profit				
Transferred to capital a/c	11,200			
	14,600			14,600

*1 $4{,}000 \times \frac{10}{100} = 400$ *2 $1{,}600 \times \frac{10}{100} = 160$

Balance-Sheet
(As on 31st March, 2007)

Liabilities		Amount	Assets		Amount
Creditors		2,000	Cash		800
Unearned Commission		140	B/R		2,000
Capital	16,000		Debtors		4,000
Add : Net profit	11,200	27,200	Closing stock		12,000
			Accured Rent		500
			Furniture	1600	
			Less : Dep	160	1,440
			Machinery	4000	
			Less : Dep	400	3,600
			Building		5,000
		29,340			29,340

Example 6 : From the following Trial balance of Mr. Jain, prepare Trading, Profit & Loss A/c and Balance sheet for the year ending 31st Dec., 2007.

NOTES

Trial Balance
(As on 31st Dec., 2007)

Dr. Cr.

Particulars	Amount	Particulars	Amount
Opening stock	1,60,000	Bank loan	44,000
Building	2,40,000	Creditors	1,16,000
Debtors	1,70,000	Capital	3,20,000
Machinery	1,00,000	Sales	13,00,000
Drawings	40,000	Discount	4,000
Purchases	9,00,000	Purchase Returns	8,000
Insurance and Tax	15,000	Commission	7,500
Trade Expenses	36,000	Bad Debts Reserve	4,000
Sales Return	6,000	Bills Payable	20,000
Salaries	82,000		
Carriage inwards	12,500		
Bad debts	3,000		
Bills Receivable	45,000		
Cash	14,000		
	18,23,500		18,23,500

Adjustments :

(1) Stock on 31 Dec., 2007 is Rs. 1,20,000

(2) 5% Interest is to be charged on capital.

(3) Outstanding salary is Rs. 8000

(4) Prepaid Insurance Premium is Rs. 1500.

(5) Depreciate Building by 2% and Machinery by 10%.

(6) The Bad Debts Reserve is to be maintained at 5% on debtors.

(7) The accrued commission is amounted to Rs. 2000.

Check Your Progress

3. Explain closing stocks?
4. What is a balance sheet?
5. What do you mean by depreciation?

Trading and Profit & Loss Account
(for the year ending 31st Dec., 2007)

Dr. Cr.

Particulars		Amt.	Particulars		Amt.
To Opening stock		1,60,000	By Sales	13,00,000	
To Purchase	9,00,000		Less : Sales Return	6,000	12,94,000
Less : Purchase Return	8,000	8,92,000	By closing stock		1,20,000
To Carriage Inwards		12,500			
To Gross Profit c/d					
(Transferred to P&L A/c)		3,49,500			
		1,41,4000			14,14,000
To Salaries	82,000		By Gross Profit b/d		3,49,500
Add : Outstanding	8,000	90,000	By Discount		4,000
To Insurance	15,000		By Commission	7,500	
Less : Prepaid	1,500	13,500	Add : Accrued	2,000	9,500

NOTES

To Trade Expenses		36,000		
To Bad debts	3,000			
Add : New Provision *1	8,500			
	11,500			
Less : Old Provision	4,000	7,500		
To Interest on capital *2		16,000		
To Depreciation on				
Machinery *3	10,000			
Building *4	4,800	14,800		
To Net Profit				
(Transferred to Capital A/c)		1,85,200		
		3,63,000		3,63,000

*1 $1,70,000 \times \frac{5}{100} = 8,500$ *2 $3,20,000 \times \frac{5}{100} = 16,000$

*3 $1,00,000 \times \frac{10}{100} = 10,000$ *4 $2,400,000 \times \frac{2}{100} = 4,800$

Balance-Sheet
(As on 31st March, 2007)

Liabilities		Amount	Assets		Amount
Capital		3,20,000	Building		2,40,000
Add : Interest	16,000		Less : Dep	4,800	2,35,200
Add : Net Profit	1,85,200		Machinery	1,00,000	
	5,21,200		Less : Dep	10,000	90,000
Less : Drawings	4,000	4,81,200	Closing Stock		1,20,000
Outstanding Salaries		8,000	Debtor	1,70,000	
Bank Loan		44,000	(–) Provision for		1,61,500
Bills Payable		20,000	Bad debts	8,500	
Creditors		1,16,000	Accrued Commission		2,000
			Prepaid Insurance		1,500
			Bills Receivable		45,000
			Cash		14,000
		6,69,200			6,69,200

Example 7 : From the following Trial Balance extracted at the end of a trading year ended on 31st March, 2007. Prepare Trading and Profit & Loss A/c as well as Balance-Sheet on the date and also show the necessary journal entries to give effect to the adjustment.

Trial Balance (As on ....)

Particulars	Dr. Amount	Cr. Amount
Capital A/c	—	5,00,000
Stock (1st April, 2006)	80,000	—
Purchases	2,00,000	—
Sales	—	8,00,000

Sales Return	15,000	
Purchase Return	—	4,000
Carriage Inwards	12,000	
Carriage outwards	25,000	
Wages		33,000
Salaries		55,000
Rent		11,000
Freight & dock Charges	24,000	
Fire Insurance Premium	9,000	
Bad Debts	21,000	
Discount	5,000	
Apprenticeship Premium		15,000
Printing & Stationery	2,500	
Taxes & Rates	3,500	
Travelling Expenses	1,500	
Trading Expenses	2,000	
Premises	5,50,000	
Furniture	25,000	
Bills Receivable	35,000	
Bills Payable		25,000
Debtors	2,00,000	
Creditors		1,58,000
Packing Machinery	45,000	
Smith's Loan A/c	50,000	
Investment	30,000	
Cash in Hand	2,500	
Cash at Bank	35,000	
Drawings	30,000	
	15,02,000	**15,02,000**

NOTES

Adjustment :

(1) Stock on 31st March, 2007 is Rs. 70,000.

(2) Outstanding wages – Rs. 3000, Outstanding salaries – Rs. 5,000, Rent – Rs. 1,000 and Stationery– Rs. 300

(3) Fire Insurance Premium of Rs. 6,000 is related to the period upto 31st March, 2007.

(4) Apprenticeship Premium is for three years, paid in advance on 1st April, 2006.

(5) Depreciate : Premises by 5%, Furniture by 10% and Packing Machinery by 10%

(6) Create a Reserve on Debtors for doubtful debts @ 5% and for discount @ 3%

NOTES

(7) Create a Reserve on creditors for discount@3%

(8) Interest on Smith's loan for one year has accrued@7%

(9) Interest on Investment @5% for the half year has accrued.

(10) Interest on capital to be allowed @5% for the year.

(11) Interest on Drawings is Rs. 800 for the year.

Solution :

Trading and Profit & Loss Account
(for the year ending 31st March, 2007)

Dr. **Cr.**

Particulars		**Amount**	**Particulars**		**Amount**
To Opening stock		80,000	By Sales	8,00,000	
To Purchase	2,00,000		(–) Return	15,000	7,85,000
(–) Return	4,000	1,96,000	By Closing stock		70,000
To Carriage Inwards		12,000			
To Freight and Dock					
Charges		24,000			
To wages	33,000				
Add: Outstanding wages	3,000	36,000			
To Gross Profit c/d					
(Transferred to P&L A/c)		5,07,000			
		8,55,000			8,55,000
To Salaries	55,000		By Gross Profit b/d		5,07,000
Add: outstanding	5,000	60,000	By Reserves for		
To Rent	11,000		discount on creditors		4,740
Add: Outstanding	1000	12,000	By Interest		
To Fire Insurance:			accrued on loan *6		3,500
Premium	9000		By Interest accrued		
Less: Prepaid Premium	3000	6,000	on Investment *7		750
To Carriage outward		25,000	By Interest on		
To Bad debts	21,000		Drawings *8		800
Add: Reserve *4	10,000	31,000	By Apprenticeship		
To Discount		5,000	Premium	15,000	
To Printings:			Less: Advance-		
Stationery	2,500		premium	10,000	5,000
Add: Outstanding	300	2,800			
To Rent & Taxes		3,500			
To Travelling Expenses		1,500			
To Trading Expenses		2,000			
To Dep on:					
Premises *1	27,500				
Furniture *2	2,500				
Packing Machine *3	4,500	34,500			

To Reserve for discount :			
on debtors *9	5,700		
To Interest on Capital *5	25,000		
To Net Profit			
(Transferred to	3,07,790		
Capital A/c)			
	5,21,790		**521790**

*1 $5,50,000 \times \frac{5}{100} = 27,500$ *2 $20,000 \times \frac{10}{100} = 2,500$

*3 $45,000 \times \frac{10}{100} = 4,500$ *4 $2,00,000 \times \frac{5}{100} = 10,000$

*5 $5,00,000 \times \frac{5}{100} = 25,000$ *6 $50,000 \times \frac{7}{100} = 3,500$

*7 $30,000 \times \frac{5}{100} \times \frac{6}{12} = 750$ *8 Given in adjustment

*9 $2,00,000 - 10,000 = 1,90,000 \times \frac{3}{100} \times = 5,700$

Balance-Sheet
(As on 31st March, 2007)

Liabilities		Amount	Assets		Amount
Sundry Creditors	1,58,000		Cash in hand		2,500
Less : Provision for			Cash at Bank		35,000
discount	4,740	1,53,260	Bills Receivable		35,000
Outstanding Expenses			Investment	30,000	
Wages	3,000		Add : Int. Accrued	750	30,750
Salaries	5,000		Debtors	2,00,000	
Rent	1,000		Less : Reserve	10,000	
Stationery	300	9,300	for Douhtful		
			Debts	1,90,000	
			Less : Reserve for-		
Bills Payable		25,000	discount	5,700	1,84,300
Advance paid			Smith's Loan	50,000	
Apprenticeship Premium		10,000	Add : Interest-		
Prepaid Insurance premium		3,000	accrued	3,500	53,500
Capital	5,00,000		Closing stock		70,000
(+) Interest	25,000		Furniture	25,000	
(+) N.P.	3,07,790		Less : Dep.	2,500	22,500
	8,32,790		Packing Mach.	45,000	
			Less : Dep.	4,500	40,500
(–) Drawings	30,000		Premises	5,50,000	
(+) Interest on	800 (–) 30,800	8,01,990	Less : Dep.	27,500	5,22,500
Drawings					
		9,99,550			**9,99,550**

NOTES

Necessary Adjustment Entries

Date	Particulars	L.F.	Amount Rs.	Amount Rs.
2007				
Mar. 31	Closing Stock A/c .....Dr.		70,000	
	To Trading A/c			70,000
	(Closing stock taken into account)			
	Wages A/c .....Dr.		3,000	
	Salaries A/c .....Dr.		5,000	
	Rent A/c .....Dr.		1,000	
	Stationery A/c .....Dr.		300	
	To outstanding Liabilities for expenses A/c			9,300
	(Adjustment of outstanding expense)			
	Prepaid Insurance A/c .....Dr.		3,000	
	To Fire Insurance A/c			3,000
	(Adjustment of Prepaid Insurance)			
	Apprenticeship Premium A/c .....Dr.		10,000	
	To Apprenticeship Premium received in advance		10,000	
	(Adjustment of prepaid Premium)			
	Depreciation A/c .....Dr.		34,500	
	To Furniture A/c			2,500
	To Premises A/c			27,500
	To Packing Machine A/c			4,500
	(Depreciation of assets)			
	Profit & Loss A/c .....Dr.		15,700	
	To Reserve for DoubtfulDebts			10,000
	To Reserve for discount for Debtors A/c			5,700
	(Adjustment of reserves for debtors)			
	Reserve for discount on creditors A/c .....Dr.		4,740	
	To Profit & Loss A/c			4,740
	(Adjustment of Reserve for discount on creditors)			
	Accrued Interest A/c .....Dr.		3,500	
	To Interest A/c			3,500
	(Adjustment of Accrued Interest)			
	Interest A/c .....Dr.		25,000	
	To Capital A/c			25,000
	(Adjustment of Interest on capital A/c)			
	Drawings A/c .....Dr.		800	
	To Interest A/c			800
	(Adjustment of Interest on Drawings A/c)			

CASE STUDY:

Systex ltd financial statement contain following information.

NOTES

	31.3.2007	31.03.2008
Cash	200000	160000
Sundry Debtors	320000	400000
Temporary Investments	200000	320000
Stock	18400000	2160000
Prepaid exp	28000	12000
Total current assets	2588000	3052000
Total assets	5600000	6400000
Current liabilities	640000	800000
10% debenture	1600000	1600000
Equity share capital	2000000	2000000
Retained earnings	468000	812000

Statement of profit for the year ended 31march 2008

	Rs.
Sales	4000000
Less:-	
Cost of goods sold	- 2800000
Interest	- 160000
Net profit	1040000
LessTaxes @ 50%	- 520000
Profit After taxes	520000
Dividend declared on equity Share	220000

For above appraise the financial position of the company from the point of view of:

1) Liquidity 2) solvency 3) profitablitiy and 4) activity?

SUMMARY

- Financial statements provide a concise picture of profitability and financial position of the business.
- The interested parties are management, shareholders, creditors, government, employees customers etc.
- Financial statement includes Trading, Profit & Loss A/c as well as Balance-sheet.

NOTES

- Trading Account is a Nominal Account and all expenses related to either purchase, sales or manufacturing of goods are written in it. Dr. side of trading account includes opening stock, purchases & purchase return, Direct expenses where as Cr. side includes sales & sales return, closing stock etc. If total of Cr. side is more than that of Dr. side, the balancing figure will be Gross profit and if total of Dr. side is more than that of Cr. side, the balancing figure is Gross Loss.
- Profits & Loss Account shows the net profit or net loss of a business for a particular trading period. It takes all expenses, selling & distribution, administrative, financial expenses etc.
- The Balance sheet is a statement at a particular date showing on one side the trader's asset (property & possessions) and on the other side the liabilities (loan & credits). Balance sheet is Marshalled in order of Liquidity (for sole proprietors and partnership firm) and Permanace (for Joint stock companies.)
- Unrecorded transaction, not entered while preparing Balance sheet, are known as adjustment Entries.

	Entry	Final Accounts
1) Outstanding expenses	Salary A/c .....Dr. To Outstanding Salary A/c	P&L A/c (+) Debit side B/S – Liabilities
2) Accrued Incomes	Accrued Rent A/c .....Dr. To Rent A/c	P&L A/c (+) Debit side B/S – Asset
3) Prepaid Expenses	Prepaid Wages A/c .....Dr. To Wages A/c	Trading A/c – (–) Debit side B/S – Asset
4) Unearned Income	Income Ac .....Dr. To Unearned Income A/c	P&L A/c (–) Credit side B/S – Liabilities
5) Closing Stock	Closing Stock A/c .....Dr.. To Trading A/c	Trading A/c – Credit side B/S – Asset
6) Depreciation	Depreciation A/c .....Dr.. To Asset A/c	P &L – Debit side B/S – Deduct from Particular Asset
7) Interest on capital	Interest on capital A/c .....Dr. To Capital A/c	P & L – Debit side B/S – Deduct out of Capital in Liabilities side
8) Interest	Drawings A/c .....Dr. To Interest on Drawings A/c	P&L – Credit side B/S – Add in Capital in Liabilities side
9) Interest on Loan	Interest on Loan A/c .....Dr. To Outstanding Interest A/c	P & L – (+) Debit side B/S – Add in Loan in Liabiliteis side
10) Bad debts	Bad debts A/c .....Dr. To Debtors	P & L – Debit side B/S – Deduct from Debtors in Assets side

11) Provision for Bad & Doubtful Debts	Profit & Loss A/c .....Dr. To Provision for Bad & Doubtful Debts	P & L – Debit side B/S – Deduct from debtors in Assets side
12) Provision for Discount on creditors	Provision for Discount .....Dr. on Creditors A/c To Profits Loss A/c	P & L – Credit side B/S – Deduct from Creditors in Liabilities side

NOTES

ANSWERS TO 'CHECK YOUR PROGRESS'

1. Trading Account : records the amount of purchases of goods and also the expenses which are incurred in bringing that commodity to a saleable state.
2. Net Purchases - Net purchases refers to the net amount of purchases after dudecting purchase returns out of ie.
3. Closing Stock - The goods remaining unsold at the end of the current year is known as closing stock.
4. A Balance-Sheet is a sheet containing the balances of real and personal accounts of a business.
5. Depreciation - Depreciation is the loss or fall in value of fixed assets due to their constant use and expiry of time.

TEST YOURSELF

1. What do you understand by Final Accounts ?
2. Distinguish between –
   (a) Trading Account and Profit & Loss Account
   (b) Trial Balance and Balance-sheet
3. What important points are kept in mind while preparing Final Accounts ?
4. What do you understand by 'Adjustment' Entries ? Why are they necessary for preparing Final Account.
5. Write short notes on :
   (a) Interest on Capital
   (b) Interest on Drawings
   (c) Accrued Income
   (d) Unearned Income
   (e) Bad debts
   (f) Outstanding Expenses

NOTES

NUMERICALS

1. **Following is the Trial Balance of Bharat on 31.12.2006, prepare Trading, Profit & Loss A/c and Balance sheet.**

Trial Balance
As on 31.12.2006

	Dr. (Rs.)	Cr. (Rs.)
Capital A/c		20,000
Plant & Machinery	10,000	
Fixture & Fittings	450	
Manufacturing expenses	1,000	
Carriage Inwards	150	
Salaries	200	
Opening Stock	5,720	
Bills Receivable	5,000	
Cash in hand	120	
Cash at Bank	450	
Debtors	6,000	
Purchases	9,500	
Petty wages	160	
Rent and Taxes	350	
Drawings	1,400	
Sales		16,000
Creditors		4,500
Total	40,500	40,500

Adjustments :

(i) Closing stock is Rs. 3,200

(ii) Depreciate Plant & Machinery by 5% and Fixtures and Fittings by 10%.

(iii) Create 5% Reserve for Bad and Doubtful debts on debtors.

(iv) Rent and Taxes amounting to Rs. 80 were outstanding, salaries & wages amounting to Rs. 150 and Rs. 60 respectively are yet to be paid

[Ans. Gross profit– Rs. 2,610/-,
Net Profit Rs. 985/-
Total of Balance-sheet – Rs. 24,375]

NOTES

2. **From the following balance, prepare Final Accounts of the books of Mr. A for the year ending 31st March, 2007.**

	Rs.		Rs.
Capital	24,500	Loan	7,880
Drawings	2,000	Sales	65,360
General Expenses	2,500	Purchases	47,000
Building	11,000	Motorcar	2,000
Plant	9,340	Bad Debts Reserve	900
Opening stock	16,200	Commission (Cr.)	1,320
Coal & Power	2,240	Car's Expenses	1,800
Taxes & Insurance	1,315	Bills Payable	3,850
Wages	7,200	Cash in hand	80
Debtors	6,280	Bank Overdraft	3,300
Creditors	2,500	Donation	105
Discount (Dr.)	550		

Adjustments :

(i) Stock on 31 March, 2007 is valued for Rs. 23,500.

(ii) Write off Rs. 160 for Bad Debts and make a reserve of 5% for bad and doubtful debts on debtors.

(iii) Depreciation on Plant by 10% and Motor Car by 12%.

(iv) The motor car is partly used for business and partly for private use of the proprietor. Hence 1/3 of the depreciation, and car expenses are to be charged to the proprietors.

(v) Interest of Rs. 750 was outstanding on Bank overdraft.

(vi) It is decided that Rs. 250 be transferred every year to create donation reserve.

[Ans. : Gross Profit – Rs. 16,220; Net Profit – Rs. 10,210 and B/s – Rs. 50,560]

[Note : Treat 1/3 of depreciation and car expenses as Drawings]

3. **From the following Trial Balance extracted from the books of A, prepare Trading & Profit & Loss A/c for the year ending 31st December, 2007 and a Balance-sheet on that date.**

	Dr. (Rs.)	Cr. (Rs.)
Furniture	6,400	
Loose Tools	62,500	
Building	75,000	

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Capital Account		1,25,000
Bad debts	1,250	
Sundry Debtors and Creditors	38,000	25000
Stock (1.1.2007)	34,600	
Purchases and Sales	54,750	1,54,500
Bank Overdraft		28,500
Sales and Purchase Return	2,000	1,250
Stationery	4,500	
Interest Account	1,180	
Commission		3,750
Cash in hand	6,500	
Taxes and Insurance	12,500	
General Expenses	7,820	
Salaries	33,000	
Provision for Bad debts		2,000
	3,40,000	3,40,000

Adjustments :

(1) Stock on 31 December 2007 was Rs. 32,500

(2) Depreciate Building to 5% and Furniture at 10%. Loose Tools are revalued at Rs. 50,000 at the end of the year.

(3) It was decided at place Rs. 1,000 to Bonus fund for staff.

(4) Salaries of Rs. 3,000 and taxes of Rs. 1,200 are outstanding.

(5) Insurance amounting to Rs. 1,000 is prepaid.

(6) Written off a further Rs. 1000 as Bad-Debts and Provision for Doubtful Debts is to be made equal to 5% on Sundry Debtors.

(7) Half of the stationery was used by the Proprietor for his personal purposes
[Ans – Gross Profit – Rs. 96,900; Net Profit Rs. 11,710 and B/S Total – Rs. 2,02,160]

[**Note :** (1) Depeciation on loose tools will be Rs. 6,250 – Rs. 50,000 = Rs. 12,500

(2) Bonus payable to staff will be treated as outstanding expenses]

FURTHER READINGS

- Accounting for Managers: Sharma and Gupta
- Management Accounting: Mr. Agrawal
- Fundamentals Accounting: Jain, Khandelwal, Pareek

10 Introduction of Financial Management

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The Chapter Covers :

- AN OVERVIEW
- INTRODUCTION TO FINANCE & FINANCIAL MANAGEMENT
- OBJECTIVES OF FINANCIAL MANAGEMENT
- NATURE OF FINANCIAL MANAGEMENT
- FUNCTIONS OF FINANCIAL MANAGEMENT/FINANCIAL MANAGER:
- SCOPE OF FINANCIAL MANAGEMENT
- THE FUNDAMENTAL PRINCIPLE OF FINANCE
- EMERGING ROLE OF THE FINANCIAL MANAGERS IN INDIA
- FUNCTIONS OF FINANCIAL MANAGER
- FUNCTIONS OF TREASURER
- FUNCTIONS OF CONTROLLER
- FINANCIAL DECISIONS
- NATURE OF FINANCIAL DECISIONS
- FINANCIAL INSTRUMENTS / ASSETS
- SOURCES OF FINANCE

Learning Objectives:

After going through this chapter, you should be able to:

- Understand finance & financial management
- Explain objectives, functions, scope and nature of financial management
- Describe sources of finance
- Learn fundamental principle of finance
- Functions of financial manager and role of financial management in India

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AN OVERVIEW

Suppose you are planning to start your own business. No matter what the nature of your proposed business is and how it is organized, you will have to address the following questions:

1 What capital investment should you make? That is what kind of real estate, machineries, R&D programmers', IT infrastructure; and so on should you invest in?

2 How will you raise money to pay for the proposed capital investments? That is, what will be the mix of equity and debt in your financing plan?

3 How will you handle the day-to-day financial activities like collecting your receivables and paying your suppliers?

While these are not the only concerns of financial management, they are certainly the central ones.

This book discusses the theories, analytical methods, and practical considerations that are helpful in addressing various issues in financial management, a discipline that has assumed great significance in recent times.

Before we begin our odyssey, let us get a bird's eye view of financial management, also referred to as corporate finance or managerial finance. This chapter provides such an overview.

INTRODUCTION TO FINANCE & FINANCIAL MANAGEMENT

The term finance is concerned with resource allocation as well as resource management, acquisition & investment. Finance is the life blood of business. Without finance, the heart & brain of business can't function implying thereby its natural death. Actually it is not the inadequate finance that causes the failure of a business but the mismanagement of resources is ultimately responsible for it. **Collin Brooks** has rightly remarked in this context that "bad production management, bad sales management has slain their hundreds but faulty finance has slain its thousands." Therefore efficient management of funds enables the firms to prosper & grow. Earlier **before 80's** it was considered as branch of economics but now it is a separate branch of study. It refers to how resources are obtained, the way they are invested & the way they draw/lose value. In this complex dynamic environment & especially in this era of globalization, where sources of fund are numerous, it is very difficult to decide which source should be adopted or which should be left. Finance concentrates on this particular issue.

The term financial management can be defined as the management of flow of funds and it deals with the financial decision making. It encompasses the procurement of funds in the most economic and prudent manner and employment of these funds in the most optimum way to maximize the return for the owner. Since raising of funds and their best utilization is the key to the success of any business organization, the financial management as a functional area has got a place of prime relevance in every firm. Financial management includes any decision made by a business that affects its finances.

In simple terms, Financial Management is a managerial activity of planning & controlling the firm's financial resources. Let us see some of the important definitions of financial management.

According to **Howard & Upton**- "Financial Management is the application of the planning & control functions to the finance function."

According to **Weston & Brigam** – "Financial management is an area of financial decisions harmonizing individual motives & enterprise goals."

According to **Joseph & Massie** - "Financial Management is the operational activity of a business that is responsible for obtaining & effectively utilizing the funds necessary for efficient operations."

Before 50's FM was only confined with the allocation of funds. It had very little role to play in financial decision making. But in 50's the emphasis was laid on not only judicious allocation but also on judicious utilization of funds. Now, in the current scenario financial managers not play the traditional role of recording financial data and arranging funds as per the needs of the organization. Now they are on the key positions & shape the fortune of the organizations. The FM has basically two important aspects through which we can understand its relevancy. These two aspects are as below:

(i) **Procurement of funds**- There are multiple sources from where funds can be raised. It can be either in the form of debt or equity shares or any other (will be described later).the Company can decide to go in domestic market or global market according to its need & circumstances. Funds obtained from different sources have different characteristics in terms of risk, cost & control. For example- equity is less risky than debt because there question of repayment, until the company is being liquidated but in terms of cost it is more costly because the shareholders have more expectation of dividend than the prevailing interest rate in the market. The situation is different for the debt part. So the funds should be raised by balancing all these situations.

(ii) **Utilization of funds**- The proper utilization of funds is as necessary as its procurement because if the funds procured are kept idle, it may create question mark on the existence of the organization. The very latest & practical example of mismatch of the above two can be observed during the recession period due to which various organizations got collapsed globally.

So we can say that FM deals with the above two steps & it is a basic responsibility towards the organization.

OBJECTIVES OF FINANCIAL MANAGEMENT:

It is the duty of the top management to lay down the objectives or goals which are to be achieved by the business. The main objectives are:

1. **Profit Maximization:**

According to this approach, all activities which increase profits should be undertaken and which decrease profits should be avoided. Profit maximization implies that the financial decision making should be guided by only one test, which is, select those assets, projects and decisions which are profitable and reject those which are not.

Arguments are in favor of Profit Maximization Approach:

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i) **Best Criterion on Decision-Making:** The goal of profit maximization is regarded as the best criterion of decision-making as it provides a yardstick to judge the economic performance of the enterprises.

ii) **Efficient Allocation of Resources:** It leads to efficient allocation of scare resources as they tend to be diverted to those uses which, in terms of profitability, are the most desirable.

iii) **Optimum Utilization:** Optimum utilization of available resources is possible.

iv) **Maximum Social Welfare:** It ensures maximum social welfare in the form of maximum dividend to shareholder, timely payment to creditors, higher wages, better quality and lower prices, more employment opportunities to the society and maximization of capital to the owners.

Criticism of Profit Maximization Approach:

i) **Ambiguous:** One practical difficulty with this approach is that the term profit is ambiguous. Different people take different meaning of term profit. For example:

1 Profit may be short-term or long-term.
2 Profit may be before tax or after tax
3 Profit may be total profit or rate of profit.
4 Profit may be return on total capital employed or total assets or shareholders funds.

ii) **Ignores the Time Value of Money:** This approach ignores the time value of money. It does not make a distinction between profits earned over the different years. It ignores the fact that the value of one rupee at present is greater than the value of same rupee received after one year.

iii) **Ignores Risk Factor:** This approach ignores the risk associated with the earnings. If the two fu-ms have the total expected earnings, but if earnings of one firm fluctuate considerably as compared to the other, it will be more risky. It is, thus clear that profit maximization criterion is inappropriate and unsuitable. It is not only ambiguous but fails to solve the problems of time value of money and the risk. An alternative to profit maximization, which solves these problems, is the criterion of wealth maximization.

2. **Wealth Maximization:**

Second objective of financial management is value maximization or Net Present worth maximization. This approach is now universally accepted as an appropriate criterion for making financial decision as it removes all the limitations of profit maximization approach. It is also known as net present value (NPV) maximization approach. According to this approach the worth of an asset is measured in terms of benefits received from its use less the cost of its acquisition. Benefits are measured in terms of cash flows received from its use rather than accounting profit which was the basis of measurement of benefits in profit maximization approach.

Another important feature of this approach is that it also incorporates the time value of money. While measuring the value of future cash flows an allowance is made for time and risk factors by discounting or reducing the cash flows by a certain percentage. This percentage is known as discount rate.

The difference between the present value of future cash inflows generated by an asset and its cost is known as net present value.

i) A financial asset or a project which has a positive NPV creates wealth for shareholders and, therefore is undertaken.

ii) On the other hand, a financial asset or a project resulting in negative NPV should be rejected since it would reduce shareholder's wealth.

iii) If one out of various projects is to be chosen, the one with the highest NPV is adopted.

Merits of Wealth Maximization Approach:

The wealth maximization approach is superior to the profit maximization approach because:

1. Wealth maximization approach uses cash flows instead of accounting profits which avoids the ambiguity regarding the exact meaning of the term profit.
2. Wealth maximization approach gives due importance to the time value of money by reducing the future cash flows by an appropriate discount or interest rate.

Other Basic Objectives of Financial Management:

Financial management is defined as a management task which deals with effective utilization of the procured finance to meet organizational objectives. It plans, controls, organizes, directs the activities related to finance in an organization. The FM is generally concerned with the procurement, allocation & control of funds. The following are the objectives of Financial Management:

1) **To confirm adequate supply of funds:** Adequate supply of funds to an organization should be ensured so as to meet its daily production requirements so that organizational goals and objectives are met in time. Failure of adequate supply of funds curtails the production which adversely effects the organization by making delays in several inter-departmental functions.

2) **To warrant fair return for the share holders:** Finance management should make a fair return on share holders' investment, which makes the organization stronger in terms of further procurement of funds through various procurement methods of finance from internal and external sources.

3) **To help in enhancing the market price of share:** It should help in increasing the market price of share through standardized financial practices, increasing organizational assets or decreasing the debts, through increasing a company's potential to be taken over by other companies, through increasing public image and through improving credit worthiness.

4) **To plan optimum funds utilization:** Financial Management should deal effectively in utilizing the funds at its optimum level. It should plan proper inflow and outflow of funds and utilization should be done in such a way where the wastage on the funds utilization is seen at negligible levels.

5) **To establish safety on investment:** It should safely invest the funds in risk free or high returns offering shares or other financial instruments, which proves the organizational investment pattern to be hassle-free for the investors through adding credit worthiness and making wise investment decisions.

6) **To assure a sound capital structure:** Financial management in an organization should be sound by ensuring proper inflow and outflow of funds and financial stability. The plan for expenditure and its working capital structure

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pattern should positively affect an organization in the long run by maintaining the organizations credit with its customers, creditors, shareholders, and society.

NATURE OF FINANCIAL MANAGEMENT:

(1) **Financial Management is an essential part of Top Management:** In the modern business management the financial manager is one of the active members of top management team and day-by-day his role is becoming more significant in solving the complex management problems. This is because almost all kinds of business activities such as production, marketing etc. directly or indirectly involve the acquisition and use of finance.

(2) **Less Descriptive and More Analytical:** Financial management is less descriptive and more analytical. Due to the development of new statistical and accounting techniques of financial analysis, the financial management chooses the best alternative out of the many possible alternatives.

(3) **Continuous Function:** Financing is a continuous function. In addition to the raising of finance, there is a continuous need for planning and controlling the finances of an enterprise. A firm performs finance functions continuously in the normal course of the business.

(4) **Different from Accounting Function:** There are key difference between the accounting and finance function. Accounting generates information or data whereas in the finance function the data are analyzed and used for the purpose of decision making.

(5) **Wide Scope:** There is wide scope of financial management. It is concerned not only with the raising of finance but also with the allocation and efficient use of such finance.

(6) **Centralized Nature:** Financial management is centralized in nature. It is neither, possible nor desirable to decentralize the financial responsibilities.

(7) **Measurement of Performance:** Financial management is concerned with the wise use of finance. It fixes certain norms and standards against which the benefits of an investment decisions are matched.

(8) **Inseparable Relationship between Finance and other Activities:** There exists an inseparable relationship between finance on the one hand and production, marketing and other activities on the other. All other activities are related to finance.

(9) **Applicable to All Types of Organizations:** It is applicable to all forms of organization whether corporate or non-corporate such as sole proprietorship and partnership firms etc.

FUNCTIONS OF FINANCIAL MANAGEMENT/FINANCIAL MANAGER:

The functions of Financial Management can be outlined as below:

i) **Estimation of capital requirement-** A finance manager has to make estimation regarding capital requirement of the company. This estimation will be based on expected cost & profits and future programmers' & policies of the concern (organization). This estimation will be based on extensive analysis using the different techniques of cost accounting & financial accounting.

ii) **Determination of the capital composition-** As we have discussed earlier in this unit that capital composition is very crucial to the company.

This is known as capital structure of the company & depends on various factors like companies' mission & vision, the way companies' are risk averse to the market etc.

iii) **Choice of sources of funds-** For additional funds, the company can go for the following options:-

a) Issue of shares & debentures

b) Raising of loans through banks & other financial institutions

c) Raising of public deposit through bonds

The choice will depend upon the company policy & strategy & other factors.

iv) **Investment of funds-** The finance manager has to decide, where to invest the funds so that return can be assured with minimizing the risk factor.

v) **Disposal of surplus-** Regarding this function the finance manager can go for two options. He can dispose the surplus by declaring dividends to the shareholders or it can be retained in the form of retained earnings for company's growth & development.

vi) **Management of cash-** Cash management is one of the important functions of the finance manager. The cash is required for payment of wages & salary, electricity bills, creditors, meeting current liabilities, purchase of raw materials etc.

vii) **Financial control-** The finance manager has not only to plan, procure, & utilize the funds but he has to also make control over the finance by various controlling techniques like ratio analysis, financial forecasting etc.

SCOPE OF FINANCIAL MANAGEMENT:

The term financial management means managing the financial ventures for a firm or a company. The whole financial sector of the company is dependent upon the financial manager and it is according to his decisions that would decide whether the company would make profit or it will run under a loss in the near future. The main role of a financial manager is to analyze the financial flow of the company and then take efficient decision regarding the ways to earn profit in the near future.

The scope of financial management is huge. The financial manager makes short-term plans and takes every step necessary to fulfill the goal and implement the plan so that the company is benefited. The flow of the assets and the funds of the company are being observed by the financial manager and he also looks after the inflow of funds and assets of the company.

The scope of financial management also includes decision-making activities. The main role of the financial manager is to take decisions, which would make other companies invest in the firm for increasing its profitability.

At the same time, a financial manager also looks after the income and expenditure of the company and he has to manage the company's financial accounting books. In case of undertaking a particular venture, it is the financial manager, who first analyzes the benefit and the cost of the project by using the cost benefit analysis. If the cost is more than the benefit then the project is abandoned. However, if the return from the project, that is, the return from the investment is high enough and the company would be earning more benefits than the cost incurred on the venture

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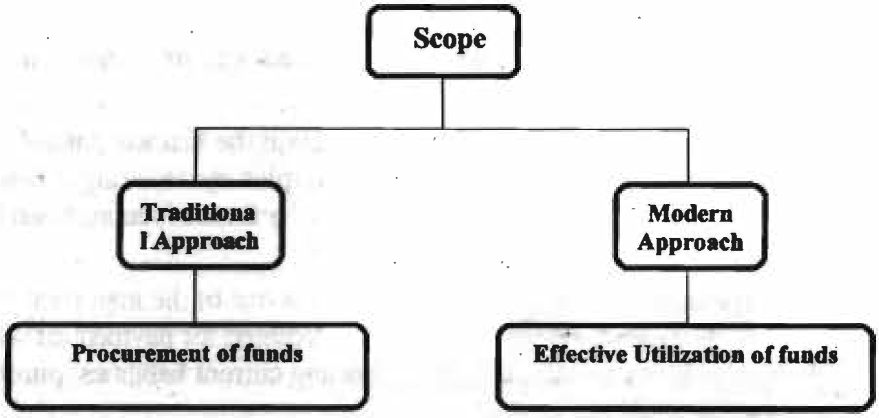
or the project, then the financial manager sanctions the project and the company makes the investment for the project.

Financial management as an academic discipline has undergone notable changes over the years, with regard to its scope of functions. At the same time, the financial manager's role also has undergone fundamental changes over the years. Study of the changes that have taken place over the years is known as "Scope of Financial Management". In order to have an easy understanding and better exposition to the changes, it is necessary to divide the scope into two approaches:

(A) Traditional Approach

(B) Modern Approach



1 **Traditional Approach:** - Initially, the finance manager was concerned with the requirement of funds as & when required by a particular event. According to this approach the following aspects only were included in the scope of FM:

i) Estimation of requirement of funds.

ii) Arrangement of funds from financial institutions.

iii) Arrangement of funds through financial instruments such as shares, debentures, bonds & loans.

iv) After accounting & legal work connected with the raising of funds.

The notable feature of the traditional approach was the assumption that the duty of the finance manager was only to raise funds from external parties and that he was not concerned with taking the internal financial decisions. He was not responsible for the efficient use of funds.

Limitations of Traditional Approach: The traditional approach continued till mid 1950's. It has now been discarded as it suffers from the following limitations:

1. **More Emphasis on Raising of Funds:** This approach places more emphasis on procurement of funds from external sources and neglects the issues relating to the efficient utilization of funds. Since it is concerned with the raising of funds, it attaches more importance to the viewpoint of external parties who provide funds to the business and completely ignores the internal persons who make financial decisions.

2. **Ignores the Financial Problems of Non-Corporate Enterprises:** It places more emphasis on the problems faced by corporate enterprises in procuring the funds. The non-corporate enterprise like sole proprietorship and partnership firms are considered outside its scope.
3. **Ignored Routine Problems:** This approach concentrates on the financial problems on the occurrence of special events such as merger, incorporation etc, and fails to consider the day-to-day financial problems of a normal firm.
4. **Ignored Working Capital Financing:** This approach gives more emphasis on the problems relating to long term financing and the problems relating to working capital financing are considered outside the purview of this approach.

2 **Modern approach:** Over a period of time, the scope of his function has tremendously widened. Now his presence is required at every movement where decision taking on financial matters is required. Now the finance manager is concerned with

i) Procuring the required quantum of funds as & when necessary at the lowest cost.

ii) Investing these funds in various assets in the most profitable way.

iii) Distributing returns to the shareholders in order to satisfy their expectations from the firm.

The modern approach considers the term financial management in a broad sense. According to this approach, the finance function covers both acquisitions of funds as well as their efficient utilization. According to this approach the financial management is concerned with the solution of three major problems relating finance:

1) What is the total volume of funds an enterprise should commit?
2) How should the funds required be raised?
3) In what specific assets the enterprise should invest its funds.

Thus, in the modern approach, the financial management is responsible for taking three decisions:

(i) **The Investment Decision:** Investment decision also known as 'Capital Budgeting' is related to the selection of long-term assets or projects in which investments will be made by the business. Long term assets are the assets which would yield benefits over a period of time in future.

(ii) **The Financing Decision:** This function is related to rising of finance from different sources. For this purpose the financial manager is to determine the proportion of debt and equity. In other words there are two sources of finance:

a) **Debt:** Debt means long term loans and includes:

1 Debentures

2 Loan from Bank

Check Your Progress

1. Define Financial Management?
2. How NPV is calculated?
3. What are three broad areas of financial decision making?

NOTES

3 Loan from Financial Institutions
4 Mortgage Loans

b) **Equity:** Equity refers to shareholder's funds and includes:
1 Equity Share Capital
2 Preference Share Capital
3 Reserve
4 Accumulated Profits

(iii) **The Dividend Policy Decision:** The financial management has to decide as to which portion of the profits is to be distributed as dividend among shareholders and which portion is to be retained in the business. For this purpose the financial management should take into consideration the factors of dividend stability, bonus shares and cash dividends in practice.

THE FUNDAMENTAL PRINCIPLE OF FINANCE

The key question that you have to ask before making a business decision is: will the decision raise the market value of the firm? To answer this question, let us look at the fundamental principal of finance:

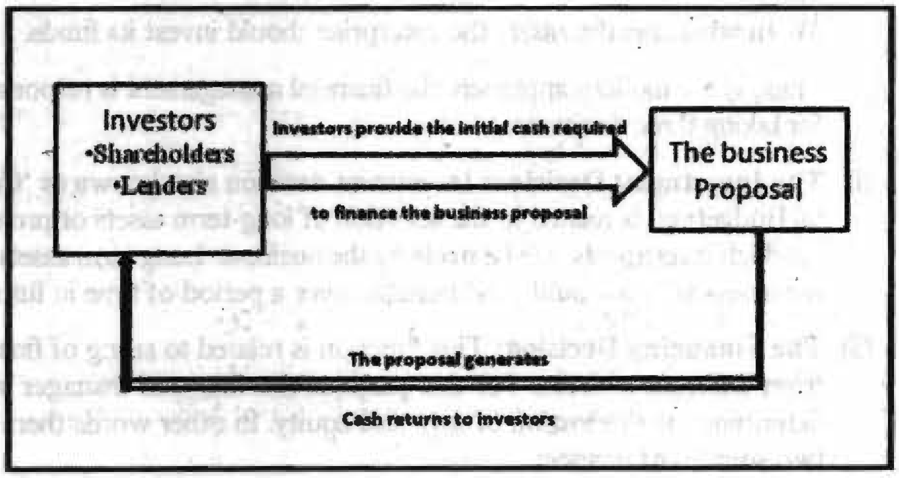
A Business proposal –regardless of whether it is a new investment or acquisition of another company or a restructuring initiative- raises the value of the firm only if the present value of the future stream of net cash benefits expected from the proposal is greater than the initial cash outlay required to implement the proposal.

The difference between the present value of future cash benefits and the initial outlay represents the net present value or NPV of the proposal:

Net present value = Present value of future cash benefits-Initial cash outlay

Note that the costs and benefits of a business proposal have to be measured in cash. As shown in figure, investors who finance a proposal invest cash and are hence interested only in cash returns.

Figure: CASH ALONE MATTERS



To convert the expected cash returns from the proposal into a present value figure an appropriate discount rate has to be applied. The discount rate reflects the riskiness of the proposal.

EMERGING ROLE OF THE FINANCIAL MANAGERS IN INDIA

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Until the early 1990s, the financial manager in India functioned in a highly regulated environment and enjoyed limited freedom in designing key financial policies. From early 1990s, the complexion of the economic and financial environment has changed in many ways. The Important changes have been as follows.

- The industrial licensing framework has been substantially relaxed, leading to considerable expansion in the scope of private sector investment.
- The Monopolies and Restrictive trade Practices Act has been virtually abolished and the Foreign Exchange Management Act has been substantially liberalized.
- Freedom has been given to companies in designing and pricing the securities issued by them.
- The system of cash credit has been replaced by a system of working capital loans.
- Stable and administered interest rates have given way to volatile and market-determined interest rates. Exchange rates, too, have become more volatile and market-determined.
- The scope for foreign direct investment has expanded considerably and foreign portfolio investment has assumed great significance.
- Investors have become more discerning, demanding, and assertive.
- The pace of mergers, acquisitions, and restructuring has intensified.
- Derivative instruments such as options and futures have been introduced.

Thanks to these changes, the job of the financial manager in India has become more important, complex, and demanding. More so in the wake of global competition, technological development, volatile financial prices, economic uncertainty, tax law changes, ethical concerns over financial dealings, and shareholder activism.

The key challenges for the financial manager appear to be in the following areas:

- Investment planning
- Financial structure
- Mergers, acquisitions, and restructuring
- Working capital management
- Performance management
- Risk management
- Investor relations

FUNCTIONS OF FINANCIAL MANAGER:

The financial manager is a member of top management. He is closely associated with the formulation of financial policies as well as financial decision making. He is expected to perform the following functions:

1) **Financial Planning:** The financial manager estimates the financial needs of the business, determines the capital structure and prepares financial plan.
2) **Procurement of Funds:** He arranges to acquire the funds from various sources such as shares, debentures etc.,

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3) **Coordination:** He maintains a proper coordination among the financial needs of different departments.

4) **Control:** He establishes the standards of financial performance and examines whether the actual performance is according to predetermined standards. He is responsible for:

   i) Controlling the Costs   ii) Analyzing the Profits   iii) Preparation of Reports

5) **Business Forecasting :** He keeps a close watch on the various events affecting the organization such as:

   i) Technological Changes
   ii) Competition
   iii) Change in Govt. Policy
   iv) Change in social and business environment and studies their effect on the firm.

6) **Other Functions:** Other functions we includes:

   i) Cash Management   ii) Banking Relations
   iii) Credit Management   iv) Assets Management
   v) Securities Management   vi) Accounting
   vii) Internal Auditing.

FUNCTIONS OF TREASURER

Here it is important to study the functions of a Treasurer and Controller because in every organization these posts are also related to the function of financial management.

1. **Cash Management:** It includes the managing of cash receipts and cash payments of the business.
2. **Banking Relations:** It includes banking relations, operating bank accounts, and managing deposits and withdrawals etc.
3. **Credit Management:** It includes determining the credit worthiness of the customers and arrangement for collection of credit sales.
4. **Assets Management:** It includes arrangement for the acquisition, disposal and insurance of various assets.
5. **Securities Management:** It includes the investment of surplus funds of the business.
6. **Protecting Funds and Securities:** It includes custody of funds and securities.

FUNCTIONS OF CONTROLLER

1. **Planning & Budgeting:** It includes profit planning, capital expenditure planning, budgeting, inventory control, sales forecasting ' etc.
2. **Financial Accounting:** He establishes a proper system of accounting controls it and prepares financial statements such as profit & loss Account and Balance Sheet etc.
3. **Cost Accounting:** He establishes a cost accounting system suitable to the business and controls it.

4. **Data Processing:** It includes the collection and analysis of business data.
5. **Internal Auditing:** He manages internal audit and internal control.
6. **Annual Reports:** He prepares annual reports and various other reports needed by the top management.
7. **Information to Government** He prepares annual reports to be submitted to the Government under various laws.

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FINANCIAL DECISIONS

There are three broad areas of financial decision making viz, Capital budgeting, capital structure and working capital management's.

- **Capital Budgeting:** The first and perhaps the most important decision that any firm has to make is to define the business or businesses that it wants to be. This is referred to as strategic planning and it has a significant bearing on how capital is allocated in the firm. As strategic planning calls for evaluating costs and benefits spread out over time, it is essentially a financial decision making process.

  Once the managers choose the business or businesses they want to be in, they have to develop a plan to invest in buildings, machineries, equipments, research and development, godowns, showrooms, distribution network, information infrastructure, brands, and other long-lived assets. This is the capital budgeting process.

- **Capital Structure:** once a firm has decided on the investment projects it wants to undertake, it has to figure out ways and means of financing them.

  The key issues in capital structure decision are: what is the optimal debt-equity ratio for the firm? Which specific instruments of equity and debt finance should the firm employ/which capital market should the firm access? When should the firm raise the finances? At what price should the firm offer its securities?

  An allied issue is the distribution policy of the firm. What is the optimal dividend payout ratio for the firm? Should the firm buyback its own shares?

  Capital structure and dividend decisions should be guided by considerations of cost and flexibility, at the main. The objective should be to minimize the cost of financing without impairing the ability of the firm to raise finances for value creating investment projects.

- **Working capital management:** WCM, also referred to as short term financial management, refers to the day-to-day financial activities that deal with current assets and current liabilities.

  The key issues in WCM are: What is the optimal level of inventory for the operations of the firm? Should the firm grants credit to its customers and, if so, on what term? How much cash should the firm carry on hand? Where should the firm invest its temporary cash surpluses? What sources of short-term finance are appropriate for the firm?

NATURE OF FINANCIAL DECISIONS

Financial decisions refer to decisions concerning financial matters of a business concern. Decisions regarding magnitude of funds to be invested to enable a firm to accomplish its ultimate goal, kind of assets to be acquired, pattern of capitalization,

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pattern of distribution of firms, income and similar other matters are included in financial decisions. A few specific points in this regard are:

a. Financial decisions are taken by a finance manager alone or in conjunction with his other management colleagues of the enterprise.

b. A finance manager is responsible to handle all such problems as involve financial matters.

The decisions are basically categorized into 2 parts:-

i) **Long term financial decisions-** These are called so, because they work in a long term & affect the firm's position accordingly. These are concerned with longer time horizon basically more than a year. They are basically associated with strategic determination. Top management is involved in these decisions. They are very important & crucial in nature & any wrong decision in this regard may affect the firm haphazardly. There are basically 3 decisions which come under this category:

a) **Investment Decisions-**

Firms have scarce resources that must be allocated among competitive uses. The financial management provides a framework for firms to take these decisions wisely. The investment decisions include not only those that create revenues and profits (e.g. introducing a new product line) but also those that save money (e.g. introducing a most efficient distribution system). So, the investment decisions are the decisions relating to the assets composition of the firm. Assets represent investment or uses of the funds that the firm makes in expectations of earning a return for its investors. Investment decision includes capital expenditure & also known as capital budgeting decisions. It includes allocation of funds to long term assets which give return in the form of cash flows in future. Here the evaluation of the new investment is done & also its opportunity cost is determined. The evaluation process includes in the frame of risk & return i.e. how much return can be expected by bearing a certain level of risk. The difficulty in this measurement is that future is uncertain. One can't claim for the certain return. The 2nd aspect in which the measurement of opportunity cost is done is also uncertain. Opportunity cost means, if the same amount is invested in any other equivalent asset/ class of assets at a definite level of risk, what will be the level of return.

Investment decisions, the most important financial decision, is concerned with determining the total amount of assets to be held in the firm, the make-up of these assets and the business risk complexion of the firm as perceived by the investors. The salient features of investment decisions are as follows:

a) The investment decisions are of two types, viz, long term investment decisions and short term investment decisions.

b) Long term investment decision decides about the allocation of capital to investment projects whose benefits accrue in the long run. It is concerned with deciding:

- What capital expenditure should the firm make?
- What volume of funds should be committed?

- How should funds be allocated as among different investment opportunities?

c) Short terms investment decision decides about allocation of funds as among cash and equivalents, receivables and inventories.

d) A firm may have a number of profitable investment proposals in hand. But owing to paucity of funds, finance manager should be meticulous in choosing the most profitable one.

e) Thrust of financial decisions is on building suitable asset mix.

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b) **Financing Decisions-**

This is 2nd decision in which a financial manager is involved. He/she has to decide the source of fund from where funds can be generated for the investment purpose. Here the manager will decide the capital mix (mixture of debt & equity in the capital) according to the firms need & strategy. For example- Excess equity can arise the risk of losing ownership to other hands where as excess debt may create burden on the organization. So deciding an optimum capital structure is also a herculean task & very necessary for the health of the organization.

In financing decision, finance manager has to decide about the optimal financing mix. It is concerned with how to raise money for business so as to maximize value of the firm. Highlights of financing decisions are as follows:

1. Question of making financing decision arise as soon as decision regarding investment outlets is made. At times investment decision follows financing decision.
2. A finance manager has to decide the appropriate mix of debt and equity in such a way that wealth of the shareholders is maximized.
3. A finance manager is supposed to delve into the following issues requiring financing decisions:
   - From which sources are funds available?
   - To what extent are funds available from these sources?
   - What is the cost of funds presently used?
   - What is the expected cost of future financing?
   - What instruments should be employed to raise funds and at what time?
   - Should firm approach financial institutions for securing funds?
   - What will be the terms and conditions on which the funds will be raised from different sources?
   - What will be the nature of underwriting arrangements?
   - What innovations can be made in raising funds from wide variety of sources?

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4. A finance manager has to be in constant touch with financial markets.
5. Financing decisions are primarily concerned with capital structure or debt equity compositions.

c) **Dividend Decisions-**

It is the decision about declaring dividend for the shareholders. A financial manager has to decide that the profit which has been earned by the company should be distributed wholly, partially or should be retained fully. The ratio of dividend (profit distributed) & whole profit is known as dividend pay-out ratio & the ratio of retained earning & whole profit is known as retention ratio. Now if the company has future projects for its growth then its retention ratio will be high & vice-versa.

Dividend policy decision decides about allocation of business earnings between payment to shareholders and retained earnings. A part of the profits is distributed amongst shareholders and other part is retained for growth of the company. A few specific points in this regard are as follows:

a) Closely related to the issue of raising finance is the issue of distribution of profits, which is effectively a source of total fund requirements. This constitutes the area of dividend decisions.

b) Although both growth and dividends are desirable, these two goals are conflicting: a higher dividend rate means less retained earnings and consequently, a slower rate of growth in earnings and stock prices.

c) For maximizing the shareholder's wealth, the finance manager has to strike a satisfactory compromise between the two.

d) Prudent finance manager takes dividend decision in the light of investor's preferences, liquidity position of the firm, and stability of earnings of the firm, need to repay debt, restrictions in debt contracts, access to capital markets etc.

e) Dividend policy decision is integral part of financing decisions.

ii) **Short term financial decisions-** It is involved in the financial decisions of less than a year. These decisions are basically associated with day to day working of the firm therefore also known as working capital or liquidity decisions. Working capital is comprised of current assets & current liabilities. There should be proper match between these two, so that the firm can safeguard itself from the problem of illiquidity. The problem of illiquidity arises when a firm becomes unable to meet its current liabilities. When a firm doesn't invest much in current asset then this situation arises. Similarly more investment in current asset may lead to some assets remain idle. Therefore proper trade-off is necessary so that profitability & liquidity of the firm should not be affected.

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FINANCIAL INSTRUMENTS / ASSETS

Financial instruments are legal documents that (embody) have monetary value. There are a number of different types of documents that are properly identified as a financial instrument. Under the broad heading of a financial instrument, some would be classified as cash instruments or derivative instruments. Let us make clear about these two terms first. Cash instruments are simply those documents that are recognized as cash & that can be utilized for various transactions on demand. These are truly liquid assets. Currency is the most easily identified of all cash instruments, although documents like checks or funds transfers from bank accounts would also be understood to be a financial instrument of this type. What make it differ from second type of asset is that it has its own independent value (It doesn't derive its value from any other asset class).

Derivative instruments or simply derivatives are 2nd class of the financial instruments. These instruments derive their value from another asset class. It means that the value of derivative instrument depends upon another asset class which is known as underlying asset for that particular derivative instrument. The fluctuations in the price of these underlying assets affect the price of related derivative. There are so many kinds of derivatives in the financial market. Example- Options, futures, Forwards, Swaps, & even derivatives related to weather also. These are further classified into their sub-categories. The derivative market in India is of recent origin (1995) & is not so much developed.

SOURCES OF FINANCE:

The Long-Term Finance may be Raised by the Companies from the following Sources:-

Capital Market

Capital market denotes an arrangement whereby transactions involving the procurement and supply of long-term funds take place among individuals and various organizations. In the capital market, the companies raise funds by issuing shares and debentures of different types. When long-term capital is initially raised by new companies or by existing companies by issuing additional shares or debentures, the transactions are said to take place in the market for new capital called, as 'New Issue Market'. But, buying and selling of shares and debentures already issued by companies takes place in another type of market called as 'the Stock market'.

Individuals and institutions which contribute to the share capital of the company become its shareholders. They are also known as members of the company. Before shares are issued, the directors of the company have to decide on the following matters:-

- The amount of capital which is to be raised by issue of shares.
- The types of shares which will be issued.
- The time of issuing shares.

When a company decides to issue additional shares at any time after its formation or after one year of the first allotment of shares, it is required under law that such shares must be first offered to the existing shareholders of the company. If the offer is declined by the existing shareholders, only then shares can be issued to the public. Such an issue is called 'rights issue' and these shares are known as 'right shares'. The Government controls the issue of shares and debentures under the Capital Issues (Control) Act, 1947.

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Special Financial Institutions

A large number of financial institutions have been established in India for providing long-term financial assistance to industrial enterprises. There are many all-India institutions like Industrial Finance Corporation of India (IFCI); Industrial Credit and Investment Corporation of India (ICICI); Industrial Development Bank of India(IDBI) , etc. At the State level, there are State Financial Corporation's (SFCs) and State Industrial Development Corporations (SIDCs). These national and state level institutions are known as 'Development Banks'. Besides the development banks, there are several other institutions called as 'Investment Companies' or 'Investment Trusts' which subscribe to the shares and debentures offered to the public by companies. These include the Life Insurance Corporation of India (LIC); General Insurance Corporation of India (GIC); Unit Trust of India (UTI), etc.

Leasing Companies

Manufacturing companies can secure long-term funds from leasing companies. For this purpose a lease agreement is made whereby plant, machinery and fixed assets may be purchased by the leasing company and allowed to be used by the manufacturing concern for a specified period on payment of an annual rental. At the end of the period the manufacturing company may have the option of purchasing the asset at a reduced price. The lease rent includes an element of interest besides expenses and profits of the leasing company.

Foreign Sources

Funds can also be collected from foreign sources which usually consist of:-

- **Foreign Collaborators**: - If approved by the Government of India, the Indian companies may secure capital from abroad through the subscription of foreign collaborator to their share capital or by way of supply of technical knowledge, patents, drawings and designs of plants or supply of machinery.
- **International Financial Institutions**: - like World Bank and International Finance Corporation (IFC) provide long-term funds for the industrial development all over the world. The World Bank grants loans only to the Governments of member countries or private enterprises with guarantee of the concerned Government. IFC was set up to assist the private undertakings without the guarantee of the member countries. It also provides them risk capital.
- **Non-Resident Indians**: - persons of Indian origin and nationality living abroad are also permitted to subscribe to the shares and debentures issued by the companies in India.

> ***Check Your Progress***
> 4. What is dividend decision?
> 5. What are financial instruments?

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Retained Profits or Reinvestment of Profits

An important source of long-term finance for ongoing profitable companies is the amount of profit which is accumulated as general reserve from year to year. To the extent profits are not distributed as dividend to the shareholders, the retained amount can be reinvested for expansion or diversification of business activities. Retained profit is an internal source of finance. Hence it does not involve any cost of floatation which has to be incurred to raise finance from external sources.

Short-Term Finance may be Raised by the Companies from the following Sources:-

Trade Credit

It is the credit which the firms get from its suppliers. It does not make available the funds in cash, but it facilitates the purchase of supplies without immediate payment. No interest is payable on the trade credits. The period of trade credit depends upon the nature of product, location of the customer, degree of competition in the market, financial resources of the suppliers and the eagerness of suppliers to sell his stocks.

Installment Credit

Firms may get credit from equipment suppliers. The supplier may allow the purchase of equipment with payments extended over a period of 12 months or more. Some portion of the cost price of the asset is paid at the time of delivery and the balance is paid in a number of installments. The supplier charges interest on the installment credit which is included in the amount of installment. The ownership of the equipment remains with the supplier until all the installments have been paid by the buyer.

Accounts Receivable Financing

Under it, the accounts receivable of a business concern is purchased by a financing company or money is advanced on security of accounts receivable. The finance companies usually make advances up to 60 per cent of the value of the accounts receivable pledged. The debtors of the business concern make payment to it which in turn forwards to the finance company.

Customer Advance

Manufacturers of goods may insist the customers to make a part of the payment in advance, particularly in cases of special order or big orders. The customer advance represents a part of the price of the products that have been ordered by the customer and which will be delivered at a later date.

Bank Credit

Commercial Banks play an important role in financing the short-term requirements of business concerns. They provide finance in the following ways:-

- **Loans**: - When a bank makes an advance in lump sum, the whole of which is withdrawn to cash immediately by the borrower who undertakes to repay

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it in one single installment, it is called a loan. The borrower is required to pay the interest on the whole amount.

- **Cash credit**: - It is the most popular method of financing by commercial banks. When a borrower is allowed to borrow up to a certain limit against the security of tangible assets or guarantees, it is known as secured credit but if the cash credit is not backed by any security, it is known as clean cash credit. In case of clean cash credit the borrower gives a promissory note which is signed by two or more sureties. The borrower has to pay interest only on the amount actually utilized.
- **Overdrafts**: - Under this, the commercial bank allows its customer to overdraw his current account so that it shows the debit balance. The customer is charged interest on the account actually overdrawn and not on the limit sanctioned.
- **Discounting of bills**: - Commercial banks finance the business concern by discounting their credit instruments like bills of exchange, promissory notes and hundies. These documents are discounted by the bank at a price lower than their face value.

Case Study-CIMA on Financial Decisions

CIMA is the Chartered Institute of Management Accountants. It supports over 164,000 members and students in 161 countries. CIMA works with some of the world's leading businesses and provides a professional qualification in management accounting.

Management accounting plays a vital role in a business. Management accountants look forward and use financial information to help a business make key decisions about its future. This demonstrates the value of the qualification in supporting business.

CIMA's qualification is the leading management accounting qualification in the world. CIMA-qualified members work in both the public sector and private sector, in commercial and not-for-profit organizations. CIMA updates its qualifications regularly to take account of the changing needs of employers, students, managers and businesses.

CIMA stakeholders include its own students, qualified members and major employers. It supports students and members through all stages of their careers, with a focus on lifelong learning.

CIMA works to maintain the highest standards that businesses want. Its training provides CIMA members with the necessary skills to manage some of the world's most successful businesses. CIMA members may lead the finance function in any organization or work in roles outside finance. They have roles in top management leading companies like Norwich Union, Cadbury Schweppes and Nintendo.

SUMMARY

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- Financial Management is a managerial activity of planning & controlling the firm's financial resources.
- The three broad areas of financial management are Capital budgeting, Capital structure, and Working capital management.
- The primary goal of financial management is to maximize the value of the firm.
- A business proposal augments the value of the firm if its net present value is positive.
- Financial management is an integral part of the job of managers. There are, however, many task of financial management and allied areas (like accounting), which are specialized in nature and attended by key financial officers, like treasurer and the controller.
- Financial decision making requires considerable inputs from accounting.
- The important objective of business organization is Profit maximization and Wealth maximization.
- The important forms of business organization are Sole proprietorship, the partnership firm, the private limited company, and the public limited company. From this point of view of shareholder wealth maximization, the public limited company form appears to be most appropriate.
- Since the early 1990's the complexion of the economic and financial environment has altered in any ways, making the job of the financial manager more important, complex and demanding.

ANSWERS TO 'CHECK YOUR PROGRESS'

1. "Financial Management is the application of the planning & control functions to the finance function."
2. Net present value = Present valueof future cash benefits-Initial cash outlay.
3. There are three broad areas of financial decision making viz, Capital budgeting, capital structure and working capital management's.
4. It is the decision about declaring dividend for the shareholders.
5. Financialinstruments are legal documents that (embody) have monetary value. There are a number of different types of documents that are properly identified as a financial instrument.

TEST YOURSELF

1) What do you understand by Financial Management?
2) What are the functions and scope of Financial Management?

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3) What are the various sources of long term finance?
4) How company may raise its short term finance?
5) Discuss the areas of financial decision making?
6) Comment on emerging role of financial manager in India

FURTHER READINGS

- Accounting for Managers: Sharma and Gupta
- Management Accounting: Mr. Agrawal
- Fundamentals Accounting: Jain, Khandelwal, Pareek

11 Financial Analysis

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The Chapter Covers :

Learning Objectives:

After going through this chapter, you should be able to:

- Understand financial analysis
- Find out various ratios and their analysis
- Learn fund flow statement
- Explain cash flow statement
- Perform CVP Analysis

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Introduction

We know business is mainly concerned with the financial activities. In order to ascertain the financial status of the business every enterprise has to prepare certain statements, known as financial statements. Financial statements are mainly prepared for decision making purposes. But the information as is provided in the financial statements is not adequately helpful in drawing a meaningful conclusion. Thus, an effective analysis and interpretation of financial statements is required.

Analysis means establishing a meaningful relationship between various items of the two financial statements with each other in such a way that a conclusion is drawn. By financial statements we mean two statements:

(i) Profit and loss Account or Income Statement

(ii) Balance Sheet or Position Statement

These are prepared at the end of a given period of time. They are the indicators of profitability and financial soundness of the business concern. The term financial analysis is also known as analysis and interpretation of financial statements. It refers to the establishing meaningful relationship between various items of the two financial statements i.e. Income statement and position statement. It determines financial strength and weaknesses of the firm. Analysis of financial statements is an attempt to assess the efficiency and performance of an enterprise. Thus, the analysis and interpretation of financial statements is very essential to measure the efficiency, profitability, financial soundness and future prospects of the business units.

Financial analysis serves the following purposes:

Measuring the profitability

The main objective of a business is to earn a satisfactory return on the funds invested in it. Financial analysis helps in ascertaining whether adequate profits are being earned on the capital invested in the business or not. It also helps in knowing the capacity to pay the interest and dividend.

Indicating the trend of Achievements

Financial statements of the previous years can be compared and the trend regarding various expenses, purchases, sales, gross profits and net profit etc. can be ascertained. Value of assets and liabilities can be compared and the future prospects of the business can be envisaged.

Assessing the growth potential of the business

The trend and other analysis of the business provide sufficient information indicating the growth potential of the business.

Comparative position in relation to other firms

The purpose of financial statements analysis is to help the management to make a comparative study of the profitability of various firms engaged in similar businesses. Such comparison also helps the management to study the position of their firm in respect of sales, expenses, profitability and utilizing capital, etc.

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Assess overall financial strength

The purpose of financial analysis is to assess the financial strength of the business. Analysis also helps in taking decisions, whether funds required for the purchase of new machines and equipments are provided from internal sources of the business or not.

Assess solvency of the firm

The different tools of an analysis tell us whether the firm has sufficient funds to meet its short term and long term liabilities or not.

PARTIES INTERESTED

Analysis of financial statements has become very significant due to widespread interest of various parties in the financial results of a business unit. The various parties interested in the analysis of financial statements are:

(i) **Investors:** Shareholders or proprietors of the business are interested in the well being of the business. They like to know the earning capacity of the business and its prospects of future growth.

(ii) **Management:** The management is interested in the financial position and performance of the enterprise as a whole and of its various divisions. It helps them in preparing budgets and assessing the performance of various departmental heads.

(iii) **Trade unions:** They are interested in financial statements for negotiating the wages or salaries or bonus agreement with the management.

(iv) **Lenders:** Lenders to the business like debenture holders, suppliers of loans and lease are interested to know short term as well as long term solvency position of the entity.

(v) **Suppliers and trade creditors:** The suppliers and other creditors are interested to know about the solvency of the business i.e. the ability of the company to meet the debts as and when they fall due.

(vi) **Tax authorities:** Tax authorities are interested in financial statements for determining the tax liability.

(vii) **Researchers:** They are interested in financial statements in undertaking research work in business affairs and practices.

(viii) **Employees:** They are interested to know the growth of profit. As a result of which they can demand better remuneration and congenial working environment.

(ix) **Government and their agencies:** Government and their agencies need financial information to regulate the activities of the enterprises/ industries and determine taxation policy. They suggest measures to formulate policies and regulations.

(x) **Stock exchange:** The stock exchange members take interest in financial statements for the purpose of analysis because they provide useful financial information about companies. Thus, we find that different parties have interest in financial statements for different reasons.

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Nature of Financial Analysis

The nature of financial analysis can be understood from the following points:

Accounting Conventions- There are some accounting conventions which are followed while preparing financial statements.

Postulates- The accountant makes certain assumptions while preparing accounting records. For Example- Assets are shown on going concern basis.

Recorded Facts- The term recorded facts refers to the data taken out from the accounting records. The original or historical costs are the basis of recording various facts.

Types of Financial Analysis

The financial analysis is made on the following basis:

a) On the basis of material used for the same.

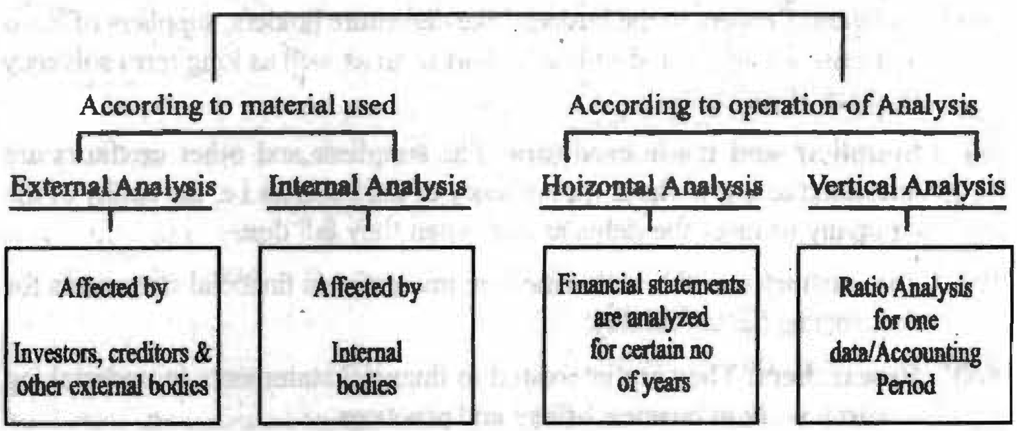
- External Analysis
- Internal Analysis

b) On the basis of operation of the analysis.

- Horizontal Analysis
- Vertical Analysis

Please go through the following diagram to understand the above classification:

Type of Financial Analysis



Limitations of Financial Analysis:

There are some of the limiting factors of this analysis we must keep in mind:

* Past financial performance, good or bad, is not necessarily a good predictor of what will happen with a customer in the future.
* The more out-of-date a customer's financial statements are, the less value they are to the credit department.
* Without the notes to the financial statements, credit managers cannot get a clear picture of the scope of the credit risk they are considering.

* Unless the customer financial statements are audited, there is no assurance they conform to generally accepted accounting principles. As a result, the statements may be misleading or even completely fraudulent.
* To see the big picture, it is necessary to have at least three years of financial statements for comparison. Trends will only become apparent through comparative analysis.

In performing liquidity analysis, most credit managers use the current and/or quick ratio. The problem is that these two ratios only provide an estimate of a customer's liquidity - they are not accurate enough to be used to predict whether or not a customer is capable of paying trade creditors and your company in particular - on time

Now we will go through the following types of Analysis:

- Ratio Analysis
- Fund Flow & Cash Flow Analysis
- Cost Volume Profit Analysis

Ratio Analysis

The term **"accounting ratios"** is used to describe significant relationship between figures shown on a balance sheet, in a profit and loss account, in a budgetary control system or in any other part of accounting organization. Accounting ratios thus shows the relationship between accounting data. When these ratios are used for the purpose of financial analysis, it is known as Ratio Analysis.

Ratios can be found out by dividing one number by another number. Ratios show how one number is related to another. It may be expressed in the form of co-efficient, percentage, proportion, or rate. For example the current assets and current liabilities of a business on a particular date are $200,000 and $100,000 respectively. The ratio of current assets and current liabilities could be expressed as 2 (i.e. 200,000 / 100,000) or 200 percent or it can be expressed as 2:1 i.e., the current assets are two times the current liabilities. Ratio sometimes is expressed in the form of rate. For instance, the ratio between two numerical facts, usually over a period of time, e.g. stock turnover is three times a year.

Advantages of Ratios Analysis:

Ratio analysis is an important and very old technique of financial analysis. The following are some of the advantages / Benefits of ratio analysis:

1. **Simplifies financial statements:** It simplifies the detailing of financial statements. Ratios tell the whole story of changes in the financial condition of the business.
2. **Facilitates inter-firm comparison:** It provides data for inter-firm comparison. Ratios highlight the factors associated with successful and unsuccessful firm. They also reveal strong firms and weak firms, overvalued and undervalued firms.
3. **Helps in planning:** It helps in planning and forecasting. Ratios can assist management, in its basic functions of forecasting, Planning, co-ordination, control and communications.

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4. **Makes inter-firm comparison possible:** Ratios analysis also makes possible comparison of the performance of different divisions of the firm. The ratios are helpful in deciding about their efficiency or otherwise in the past and likely performance in the future.
5. **Help in investment decisions:** It helps in investment decisions in the case of investors and lending decisions in the case of bankers etc.

Limitations of Ratios Analysis:

The ratios analysis is one of the most powerful tools of financial management. Though ratios are simple to calculate and easy to understand, they suffer from serious limitations.

1. **Limitations of financial statements:** Ratios are based only on the information which has been recorded in the financial statements. Financial statements themselves are subject to several limitations. Thus ratios derived, there from, are also subject to those limitations. For example, non-financial changes though important for the business are not relevant by the financial statements. Financial statements are affected to a very great extent by accounting conventions and concepts. Personal judgment plays a great part in determining the figures for financial statements.
2. **Comparative study required:** Ratios are useful in judging the efficiency of the business only when they are compared with past results of the business. However, such a comparison only provide glimpse of the past performance and forecasts for future may not prove correct since several other factors like market conditions, management policies, etc. may affect the future operations.
3. **Ratios alone are not adequate:** Ratios are only indicators; they cannot be taken as final regarding good or bad financial position of the business. Other things have also to be seen.
4. **Problems of price level changes:** A change in price level can affect the validity of ratios calculated for different time periods. In such a case the ratio analysis may not clearly indicate the trend in solvency and profitability of the company. The financial statements, therefore, be adjusted keeping in view the price level changes if a meaningful comparison is to be made through accounting ratios.
5. **Lack of adequate standard:** No fixed standard can be laid down for ideal ratios. There are no well accepted standards or rule of thumb for all ratios which can be accepted as norm. It renders interpretation of the ratios difficult.
6. **Limited use of single ratios:** A single ratio, usually, does not convey much of a sense. To make a better interpretation, a number of ratios have to be calculated which is likely to confuse the analyst than help him in making any good decision.
7. **Personal bias:** Ratios are only means of financial analysis and not an end in itself. Ratios have to interpret and different people may interpret the same ratio in different way.

8. **Incomparable:** Not only industries differ in their nature, but also the firms of the similar business widely differ in their size and accounting procedures etc. It makes comparison of ratios difficult and misleading.

Types of Ratios

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(1) **Liquidity Ratios-** These Ratios measure the firm position to meet its current liabilities. Following ratios come under this category:

- Current Ratio- It reflects the solvency of the firm.

Current Ratio= Current Assets/Current liabilities.

Higher the ratio will be, greater the safety for the creditors & vice versa. Ideal Current Ratio is 2:1.

- **Liquid Ratio/Quick Ratio/Acid Test Ratio-** The two components of **liquid ratio (acid test ratio or quick ratio)** are liquid assets and liquid liabilities. Liquid assets normally include cash, bank, sundry debtors, bills receivable and marketable securities or temporary investments. Similarly, Liquid liabilities means current liabilities i.e., sundry creditors, bills payable, outstanding expenses, short term advances, income tax payable, dividends payable, and bank overdraft (only if payable on demand).

Liquid Ratio = Liquid Assets / Current Liabilities

Liquid ratio is more rigorous test of liquidity than the current ratio because it eliminates inventories and prepaid expenses as a part of current assets. Usually a high liquid ratio is an indication that the firm is liquid and has the ability to meet its current or liquid liabilities in time and on the other hand a low liquidity ratio represents that the firm's liquidity position is not good. As a convention, generally, a quick ratio of "one to one" (1:1) is considered to be satisfactory.

3 Absolute Liquid Ratio/Cash Ratio = Cash+ Bank+ Short term Sec / Current Liabilities. Ideal Ratio is 1:2

(2) **Solvency Ratios-**

- **Debt-to-Equity ratio** indicates the relationship between the external equities or outsiders funds and the internal equities or shareholders funds.

Debt Equity Ratio = External Equities / Internal Equities or [Outsiders funds / Shareholders funds]

As a long term financial ratio it may be calculated as follows:

Total Long Term Debts / Total Long Term Funds or Total Long Term Debts / Shareholders Funds

The outsiders' funds include all debts / liabilities to outsiders, whether long term or short term or whether in the form of debentures, bonds, mortgages or bills. The shareholders funds consist of equity share capital, preference share capital, capital reserves, revenue reserves, and reserves representing accumulated profits and surpluses like reserves for contingencies, sinking funds, etc. The accumulated losses and deferred expenses, if any, should be deducted from the total to find out shareholder's funds. Debt to equity ratio indicates the proportionate claims of owners and the outsiders against the firm's assets. The purpose is to get an idea of the

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cushion available to outsiders on the liquidation of the firm. A ratio of 1:1 is usually considered to be satisfactory ratio although there cannot be rule of thumb or standard norm for all types of businesses.

- Proprietary Ratio or Equity Ratio:

This is a variant of the debt-to-equity ratio. It is also known as **equity ratio** or net worth to total assets ratio.

Proprietary or Equity Ratio = Shareholders funds / Total Assets

- Fixed Assets to Proprietor's Fund Ratio:

Fixed assets to proprietor's fund ratio establish the relationship between fixed assets and shareholders' funds. The ratio of fixed assets to net worth indicates the extent to which shareholder's funds are sunk into the fixed assets. Generally, the purchase of fixed assets should be financed by shareholder's equity including reserves, surpluses and retained earnings. If the ratio is less than 100%, it implies that owners' funds are more than fixed assets and a part of the working capital is provided by the shareholders. When the ratio is more than the 100%, it implies that owners' funds are not sufficient to finance the fixed assets and the firm has to depend upon outsiders to finance the fixed assets. There is no rule of thumb to interpret this ratio by 60 to 65 percent is considered to be a satisfactory ratio in case of industrial undertakings.

Fixed Assets to Proprietors Fund = Fixed Assets / Proprietors Fund

- Current Assets to Proprietor's Fund Ratio:

Current Assets to Proprietors' Fund Ratio establishes the relationship between current assets and shareholder's funds. The purpose of this ratio is to calculate the percentage of shareholders funds invested in current assets.

Current Assets to Proprietors Funds = Current Assets / Proprietor's Funds

- **Debt Service Ratio or Interest Coverage Ratio:** Interest coverage ratio is also known as debt service ratio or debt service coverage ratio. This ratio relates the fixed interest charges to the income earned by the business. It indicates whether the business has earned sufficient profits to pay periodically the interest charges. It is calculated by using the following formula. The interest coverage ratio is very important from the lender's point of view. It indicates the number of times interest is covered by the profits available to pay interest charges. Formula of Debt Service Ratio or interest coverage ratio:

[Interest Coverage Ratio = Net Profit before Interest and Tax / Fixed Interest Charges]

- **Capital Gearing Ratio:**

Closely related to solvency ratio is the **capital gearing ratio**. Capital gearing ratio is mainly used to analyze the capital structure of a company. The term capital structure refers to the relationship between the various long-term form of financing such as debentures, preference and equity share capital including reserves and surpluses. Leverage of capital structure ratios is calculated to test the long-term financial position of a firm.

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[Capital Gearing Ratio = Equity Share Capital / Fixed Interest Bearing Funds]

(3) Profitability Ratios-

- **Gross Profit Ratio (GP Ratio):** Gross profit ratio (GP ratio) is the ratio of gross profit to net sales expressed as a percentage. It expresses the relationship between gross profit and sales. Gross profit ratio may be indicated to what extent the selling prices of goods per unit may be reduced without incurring losses on operations. It reflects efficiency with which a firm produces its products. As the gross profit is found by deducting cost of goods sold from net sales, higher the gross profit better it is. There is no standard GP ratio for evaluation. It may vary from business to business.

[Gross Profit Ratio = (Gross profit / Net sales) × 100]

- **Net Profit Ratio (NP Ratio):** Net profit ratio is the ratio of net profit (after taxes) to net sales. It is expressed as percentage. NP ratio is used to measure the overall profitability and hence it is very useful to proprietors. The ratio is very useful as if the net profit is not sufficient, the firm shall not be able to achieve a satisfactory return on its investment. This ratio also indicates the firm's capacity to face adverse economic conditions such as price competition, low demand, etc. Obviously, higher the ratio the better is the profitability.

Net Profit Ratio = (Net profit / Net sales) × 100]

- **Operating Ratio:** Operating ratio is the ratio of cost of goods sold plus operating expenses to net sales. It is generally expressed in percentage. Operating ratio shows the operational efficiency of the business. Lower operating ratio shows higher operating profit and vice versa. An operating ratio ranging between 75% and 80% is generally considered as standard for manufacturing concerns. This ratio is considered to be a yardstick of operating efficiency but it should be used cautiously because it may be affected by a number of uncontrollable factors beyond the control of the firm

Operating Ratio = [(Cost of goods sold + Operating expenses) / Net sales] × 100

Expense Ratio: Expense ratios indicate the relationship of various expenses to net sales. Expense ratios are calculated by dividing each item of expenses or group of expense with the net sales to analyze the cause of variation of the operating ratio.

[Particular Expense = (Particular expense / Net sales) × 100]

- **Return on Shareholders' Investment or Net worth Ratio:** It is the ratio of net profit to share holder's investment. It is the relationship between net profit (after interest and tax) and share holder's/proprietor's fund.

Return on share holder's investment = {Net profit (after interest and tax) / Share holder's fund} × 100

This ratio is one of the most important ratios used for measuring the overall efficiency of a firm. As the primary objective of business is to maximize its earnings, this ratio indicates the extent to which this primary objective of businesses being achieved.

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- **Return on Equity Capital (ROEC) Ratio:**

In real sense, ordinary shareholders are the real owners of the company. They assume the highest risk in the company. (Preference share holders have a preference over ordinary shareholders in the payment of dividend as well as capital.

Return on Equity Capital = [(Net profit after tax ? Preference dividend) / Equity share capital] × 100

This ratio is more meaningful to the equity shareholders who are interested to know profits earned by the company and those profits which can be made available to pay dividends to them. Interpretation of the ratio is similar to the interpretation of return on shareholder's investments and higher the ratio better is.

- Return on Capital Employed Ratio (ROCE Ratio):

The prime objective of making investments in any business is to obtain satisfactory return on capital invested. Hence, the return on capital employed is used as a measure of success of a business in realizing this objective. Return on capital employed ratio is considered to be the best measure of profitability in order to assess the overall performance of the business. It indicates how well the management has used the investment made by owners and creditors into the business.

Gross capital employed = Fixed assets + Investments + Current assets

Net capital employed = Fixed assets + Investments + Working capital*.

*Working capital = current assets ? current liabilities.

Return on Capital Employed= (Adjusted net profits*/Capital employed) ×100]

- Dividend Yield Ratio:-

Dividend yield ratio is the relationship between dividends per share and the market value of the shares. This ratio helps as intending investor knows the effective return he is going to get on the proposed investment.

Dividend Yield Ratio = Dividend per Share / Market Value per Share]

- **Dividend Payout Ratio:**

Dividend payout ratio is calculated to find the extent to which earnings per share have been used for paying dividend and to know what portion of earnings has been retained in the business. It is an important ratio because investing back of profits enables a company to grow and pay more dividends in future.

Dividend Payout Ratio = Dividend per Equity Share / Earnings per Share

A complementary of this ratio is **retained earnings ratio**. Retained earnings ratio is calculated by using the following formula:

[Retained Earnings Ratio = Retained Earning Per Equity Share / Earning Per Equity Share]

The payout ratio and the retained earnings ratio are the indicators of the amount of earnings that have been ploughed back in the business. The lower the payout ratio, the higher will be the amount of earnings ploughed back in the business and vice versa.

- Earnings per Share (EPS) Ratio: **Earnings per share ratio (EPS Ratio) is a small variation of return on equity capital ratio and is calculated by dividing the net profit after taxes and preference dividend by the total number of equity shares.**

Earnings per share (EPS) Ratio = (Net profit after tax ? Preference dividend) / No. of equity shares (common shares)]

The earnings per share ratio is a good measure of profitability and when compared with EPS of similar companies, it gives a view of the comparative earnings or earnings power of the firm. EPS ratio calculated for a number of years indicates whether or not the earning power of the company has increased.

Price Earnings Ratio (PE Ratio):

Price earnings ratio (P/E ratio) is the ratio between market price per equity share and earnings per share. Price earnings ratio helps the investor in deciding whether to buy or not to buy the shares of a particular company at a particular market price. Generally, higher the price earnings ratio the better it is. If the P/E ratio falls, the management should look into the causes that have resulted into the fall of this ratio.

Price Earnings Ratio = Market price per equity share / Earnings per share

Funds Flow Statement

The funds-flow-statement is a report on changes in financial operations & flow or movements of funds during the period. It is a statement which shows the sources an application of funds or it shows how the activity of a business is financed in a particulate period. In other words, such a statement shows how the financial resources have been used during a particular period of time. It is, thus, a historical statement showing sources and application of funds between the two dates designed especially to analyze the changes in the financial conditions of an enterprise. In the words of Foulke, it is- **"A statement of Sources and Application of Funds is a technical device designed to analyze the changes in the financial condition of a business enterprises between two dates."**

The objective of this statement can be outlined as below:

(1) **Analysis of Financial Position.** The basic purpose of preparing the statement is to make the financial operations effective. It analyses how the funds were obtained and used in the past. In this sense, it is a valuable tool for the finance manager for analyzing the past and future plans of the firm and their impact on the liquidity.

(2) **Evaluation of the Firm's Financing.** One important use of the statement is that it evaluates the firm' financing capacity. The analysis of sources of funds reveals how the firm's financed its development projects in the past i.e., from internal sources or from external sources. It also reveals the rate of growth of the firm.

(3) **Effective Allocation of Resources.** In modern large scale business, available funds are always short for expansion programmes and there is always a problem of allocation of resources. It is, therefore, a need of evolving an order of priorities for putting through their expansion programmes which are

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phased accordingly, and funds have to be arranged as different phases of programmes get into their stride.

(4) **Effective Communication to Outside World.** Funds Flow Statement helps in gathering the financial states of Business. In the present world of credit financing, it provides a useful information to bankers, creditors etc, regarding amount of loan required, its proposes, the terms of repayment sources for repayment of loan etc.

(5) **Can be used for Future Reference.** An analysis of Funds Flow Statements of several years reveals certain valuable information for the financial manager for planning the future financial requirements of the firm and their nature too i.e. Short term, long-term or midterm. The management can formulate its financial policies based on information gathered from the analysis of such statements. Financial manager can rearrange the firm's financing more effectively on the basis of such information along with the expected changes in trade p payables and the various accruals. In this way, it guides the management in arranging its financing more effectively.

Preparation of Fund Flow Statement

(i) Prepare Schedule of Changes in working Capital to get Net increase/Decrease in working capital.

Current Assets	As on.........	As on........	Increase(+)	Decrease(–)
• Cash Balance				
• Bank Balance				
• Marketable Securities				
• Accounts Receivable				
• Stock-in-Trade				
• Prepaid Expenses				
Current Liabilities				
• Bank Over draft				
• Accounting Payable				
• Outstanding Expenses				
Net Increase/Decrease in working capital				

(ii) Prepare Fund Flow Statement

Particulars	Amount	Particulars	Amount
Source of funds		Application of funds	
Issues of Shares		Redemption of redeemable share	
Issues of Debentures		Redemption of Debentures	
Long Term Borrowings		Payment of other long term loans	
Sale of fixed Assets		Purchase of fixed assets	
Operating profit		Operating loss	
*Decrease in working capital		*Increase in working capital	

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Example: From the following information prepare

i) A Schedule of Changes in Working Capital

ii) A Funds Flow Statement

Balance Sheet

Of M/s _____ as on

Liabilities	**31st March**		**Assets**	**31st March**	
	2010	**2011**		**2010**	**2011**
Capital	18,50,000	21,00,000	Goodwill (at	6,00,000	6,00,000
Profit/Loss	14,78,000	17,64,000	Cost)	18,50,000	22,00,00
Appropriation	12,00,000	9,00,0000	Land and	4,74,000	0
Bank Loan	4,00,000	6,80,000	Buildings	1,94,000	5,24,000
Bills Payable	14,00,000	12,20,000	Plant and	8,26,000	1,94,000
Sundry	2,00,000	1,80,000	Machinery	12,00,000	7,24,000
Creditors			Furniture and	8,00,000	12,80,00
Reserve for			Fittings	5,00,000	0
Taxation			Stock/Inventories	84,000	7,21,000
					4,83,000
			Sundry Debtors		1,18,000
			Bills Receivable		
			Bank		
			Cash		
	65,28,000	68,44,000		65,28,000	68,44,000

Solution:

Schedule/Statement of Changes in Working Capital for the period from _______ to _______

Particulars/Account	**Previous Period**	**Current Period**	**Working Capital Change**	
			Increase	**Decrease**
A. CURRENT ASSETS				
1) Stock/Inventories	8,26,000	7,24,000		1,02,000
2) Sundry Debtors	12,00,00	12,80,000	80,000	
3) Bills Receivable	0	7,21,000		79,000
4) Bank	8,00,000	4,83,000		17,000
5) Cash	5,00,000	1,18,000	34,000	
	84,000			
	34,10,00 0	33,26,000	1,14,000	1,98,000

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B. CURRENT LIABILITIES/PROVISIONS 1) Bills Payable 2) Sundry Creditors 3) Provision for Taxation	4,00,000 14,00,00 0 2,00,000	6,80,000 12,20,000 1,80,000	 1,80,000 20,000	2,80,000
	20,00,00 0	20,80,000	3,14,000	4,78,000
Working Capital (A ? B)	14,10,00 0	12,46,000		
Change in Working Capital	(12,46,000 ? 14,10,000) (Or) (3,14,000 ? 4,78,000)			1,64,000

Working Notes:

In this problem, we need to prepare

- Capital a/c
- Profit and Loss Appropriation a/c Bank Loan a/c
- Land and Buildings a/c
- Plant and Machinery a/c

Capital a/c

Date	Particulars	J/F	Amount (in Rs)	Date	Particulars	J/F	Amount (in Rs)
31-03-11	To Balance c/d	–	21,00,000	01-04-10 –	By Balance b/d By Bank a/c (?)	– –	18,50,000 2,50,000
	Total		21,00,000		Total		21,00,000
				01-04-11	By Balance b/d	–	21,00,000

Bank Loan a/c

Date	Particulars	J/F	Amount (in Rs)	Date	Particulars	J/F	Amount (in Rs)
– 31-03-11	To Bank a/c (?) To Balance c/d	– –	3,00,000 9,00,000	01-04-10	By Balance b/d	–	12,00,000
	Total		12,00,000		Total		12,00,000
				01-04-11	By Balance b/d	–	9,00,000

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Land and Buildings a/c

Date	Particulars	J/F	Amount (in Rs)	Date	Particulars	J/F	Amount (in Rs)
01-04-10 –	To Balance b/d To Bank a/c (?)	– –	18,50,000 3,50,000	31-03-11	By Balance c/d	–	22,00,000
	Total		22,00,000		Total		22,00,000
01-04-11	To Balance b/d	–	9,00,000				

Plant and Machinery a/c

Date	Particulars	J/F	Amount (in Rs)	Date	Particulars	J/F	Amount (in Rs)
01-04-10 –	To Balance b/d To Bank a/c (?)	– –	4,74,000 50,000	31-03-11	By Balance c/d	–	5,24,000
	Total		5,24,000		Total		5,24,000
01-04-11	To Balance b/d	–	5,24,000				

Profit and Loss Appropriation a/c

Date	Particulars	J/F	Amount (in Rs)	Date	Particulars	J/F	Amount (in Rs)
31-03-11	To Balance c/d	–	17,64,000	01-04-10 31-03-11	By Balance b/d By P/L (FFO) a/c	– –	14,78,000 2,86,000
	Total		17,64,000		Total		17,64,000
				01-04-11	By Balance b/d	–	17,64,000

Changes in Fund Accounts

Item	Amount Previous Period	Amount Current Period	Change	Nature	Result
Capital	18,50,000	21,00,000	2,50,000	Liability - Increase	Inflow
Profit/Loss Appropriation	14,78,000	17,64,000	2,86,000	Liability - Increase	Inflow
Bank Loan	12,00,000	9,00,000	3,00,000	Liability - Increase	Inflow
Land and Building	18,50,000	22,00,000	3,50,000	Liability - Increase	Inflow
Plant and Machinery	3,70,000	4,74,000	50,000	Asset - Increase	Outflow

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Funds Flow Statement

Statement of Sources and Applications of Funds for the period from __ to __			
Sources (Inflow) of Funds	**Amount**	**Applications (Outflow) of Funds**	**Amount**
1) Capital 2) Profit/Loss Appropriation	2,50,000 2,86,000	1) Land and Buildings 2) Plant and Machinery 3) Bank Loan	3,50,000 50,000 3,00,000
	5,36,000		7,00,000
		Change in Working Capital	**1,64,000**

Cash Flow Statement

The cash flow statement shows how much cash comes in and goes out of the company over the quarter or the year. It sounds like the income statement in that it records financial performance over a specified period. But there is a big difference between the two.

What distinguishes the two is the principle of accrual accounting, on which only the income statement is based. Accrual accounting requires companies to record revenues and expenses when transactions occur, not when cash is exchanged. At the same time, the income statement, on the other hand, often includes non-cash revenues or expenses, which the statement of cash flows does not include.

Example- The income statement shows net income of $10 does not means that cash on the balance sheet will increase by $10. Whereas when the bottom of the cash flows statement reads $10 net cash inflow that means the increase in cash by $ 10.

Cash flow statement is divided into three sections: cash flows from operations, financing and investing.

- Cash flow from operating activities - This section measures the cash used or provided by a company's normal operations. It shows the company's ability to generate consistently positive cash flow from operations. Think of "normal operations" as the core business of the company. For example, Microsoft's normal operating activity is selling software. Some cash flows in this respect are
  - Cash receipt for the sale of goods
  - Cash receipt from sale of royalties
  - cash payment on behalf of employees
  - cash payment for taxes cash payment for premiums of insurances
- Cash flows from investing activities - This area list all the cash used or provided by the purchase and sale of income-producing assets. If Microsoft, again our example, bought or sold companies for a profit or loss, the resulting figures would be included in this section of the cash flow statement. Some cash flows in this respect are

- Cash payment for acquiring assets
- Cash receipt from disposal of fixed assets
- Cash payment for acquiring shares
- Cash receipt from disposal of shares

- Cash flows from financing activities - This section measures the flow of cash between a firm and its owners and creditors. Negative numbers can mean the company is servicing debt but can also mean the company is making dividend payments and stock repurchases, which investors might be glad to see. Some cash flows in this respect are
    - Cash receipts from issuing shares or debentures
    - Cash payment for redemption of debentures

Distinction between funds flow statement and cash flow statement

A distinction between these two statements may be briefed as under:-

(i) Funds Flow Statement is concerned with all items constituting funds (Working Capital) for the business while Cash Flow Statement deals only with cash transactions. In other words, a transaction affecting working capital other than cash will affect Funds statement, and not the Cash Flow Statement.

(ii) In Funds Flow Statement, net increase or decrease in working capital is recorded while in Cash Flow Statement; individual item involving cash is taken into account.

(iii) Funds Flow statement is started with the opening cash balance and closed with the closing cash balance records only cash transactions.

(iv) Cash Flow Statement is started with the opening cash balance and closed with ht closing cash balance while there a no opening or closing balances in Funds Flow Statement.

Uses of Cash Flow Statement

(i) **Planning and Co-ordination of Financial Operations:** Cash Flow Statement is useful is evaluating Financial policies and current cash position. Since cash is the basis for carrying on operations, the Cash Flow Statement prepared on an estimated basis for the next accounting period will enable the management to plan and co-ordinate the financial operations probably. The management comes to know how much cash is needed in the future and at what time and how can it be arranged-how much internally and how much from outside. It is especially useful in preparing cash budgets.

(ii) **A Control Device:** Cash Flow statement is also a control device for the management. A comparison of cash flow statement of previous year with the budget for that year would indicate to what extent the resources of the enterprise were raised an applied according to the plan. Thus a comparison of original forecast with actual results may highlights trends of movement that might otherwise go undetected.

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(iii) **Useful to internal Financial Management:** Since it gives a clear picture of cash inflow from operations (and not income flow of operation), it is, therefore, very useful to internal financial management in considering the possibility of retiring ling-term debts, in planning replacement of plant facilities or in formulating dividend policies.

(iv) **Profit and Cash Positions:** It enables the management to account for situation when business has earned huge profits yet run without money or when it has suffered a loss and still has plenty of money at the bank.

(v) **Short-term Financial Decisions:** Cash Flow Statement helps the management in taking short-term financial decisions. Suppose, if firm wants to know its state of solvency after one month from to date, it is possible only from Cash Flow analysis and not from Fund Flow Statement. Shorter the period, greater is the importance of Cash Flow Statement.

OBJECTIVE OF CASH FLOW STATEMENTS:

Cash Flow statement is prepared with an objective to high light the sources and uses of cash and cash equivalents for a period. Cash flow statement is classified under operating activities and financing activities. It shows the net increase or net decrease of cash and cash equivalents under each activity.

LIMITATIONS OF CASH FLOW STATEMENT

Through the cash flow Statement is a very useful tool of financial analysis, yet it has its own limitations which must be kept in mind at the time of its use. These limitations are:

1. Non-Cash Transactions are ignored.
2. Not a Substitute for Income Statement.
3. Not a test of Total Financial Position.
4. Historical in Nature.

Procedure for preparing Cash Flow Statement

(i) It starts with opening or closing balance

(ii) All the inflows of cash are added & outflows of cash are deducted.

(iii) The balance is reconciled with the balance of cash.

Sources of cash inflow

- Cash flow from operations
- Increase in existing liabilities or creation of new liabilities.
- Reduction in or sale of assets.

Application of cash

- Cash lost in operations
- Discharge of liabilities
- Purchase of assets

- Non trading payments

Format of Cash Flow Statement Approved by SEBI is given below:

Cash Flow Statement for the year ended............

NOTES

Particulars	Amount
A. Cash Flow Operating Activities	
Net Profit/Loss before tax and extraordinary items	
Adjustments for:	
Depreciation	
Gain/Loss on sale of fixed assets	
Foreign exchange	
Miscellaneous expenditure written off	
Investment income	
Interest	
Dividend	
Operating profit before working capital changes	
Adjustments for:	
Trade and other receivables	
Inventories	
Trade Payables	
Cash generated from operations	
Interest paid	
Direct taxes paid	
Cash flow before items	
Extraordinary items	
Net Cash from Operating Activities	
B. Cash Flow From Investing Activities	
Purchase of fixed assets	
Sales of fixed assets	
Purchase of investments	
Sale of investments	
Interest received	
Dividend received	
Net Cash from/used in investing activities	
C. Cash Flow Financing Activities	
Proceeds from issue of share capital	
Proceeds from long-term borrowings/banks	
Payment of long-term borrowings	
Dividend paid	
Net Cash from /used in financing activities.	
Net Increase /Decrease in Cash and Cash Equivalents	
Cash and Cash Equivalents as at.......(Opening Balance)	
Cash and Cash Equivalents as at.......(Closing Balance)	

Example-XYZ Company started on January 1, 2011, when it issued 60,000 shares of $1 par value common stock for $60,000 cash. The company rented its office space and furniture and equipment, and it performed tax consulting services throughout the first year. The comparative balance sheets at the beginning and at the end of the year 2011 appear as follows.

NOTES

	Dec. 31, 2011	Jan. 2011	Change Increase/Decrease
Assets			
Cash	$49,000	$-0-	$49,000 increase
Accounts receivable	$36,000	$-0-	$36,000 increase
Total	$85,000	$-0-	
Liabilities and Stockholder's Equity			
Accounts payable	$ 5,000	$-0-	$ 5,000 increase
Common stock	$60,000	$-0-	$60,000 increase
Retained earnings	$20,000	$-0-	$20,000 increase
Total	$85,000	$-0-	

The income statement and additional information for Tax Consultation Inc. are as follows.

Revenue	$ 125,000
Operating expenses	$ 85,000
Income before income taxes	$ 40,000
Income tax expenses	$ 6,000
Net income	$ 34,000

Solution-(i) The Company has no cash on hand at the beginning of the year 2011, but $49,000 at the end of 2003. Thus the change in cash for 2011 was an increase of $49,000

(ii) **Determine Net Cash Flow from Operating Activities:**

Cash collected from revenues
Cash payment for expenses

Income before income taxes
Cash payments for income taxes

Net cash provided by operating activities

$89,000

NOTES

$ 80,000
$ 9,000
$ 6,000
$ 3,000

(iii)Preparation of Cash Flow Statement

Cash flow statement
for the year ended December 31, 2011

Cash Flows From Operating Activities:		
Net income		$34,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	$(36,000)	
Increase in accounts payable	$ 5,000	($31,000)
Net cash provided by operating activities		$ 3,000
Cash Flows From Financing Activities:		
Issuance of common stock	$60,000	
Payment of cash dividend	$(14,000)	
Net cash provided by financing activities		$46,000
Net increase in cash		49,000
Cash, January 1, 2011		-0-
Cash, December 31, 2011		$49,000

COST-VOLUME-PROFIT (CVP) ANALYSIS

Cost-volume-profit (CVP) analysis is a technique that examines changes in profits in response to changes in sales volumes, costs, and prices. Accountants often perform CVP analysis to plan future levels of operating activity and provide information about:

- Which products or services to emphasize?
- The volume of sales needed to achieve a targeted level of profit.
- The amount of revenue required to avoid losses.
- Whether to increase fixed costs?
- How much to budget for discretionary expenditures?
- Whether fixed costs expose the organization to an unacceptable level of risk?

Cost-volume-profit analysis (CVP) is used to compute the volume level at which total revenues are equal to total costs. When total costs and total revenues are equal, the business organization is said to be "breaking even." The analysis is based on a set of linear equations for a straight line and the separation of variable and fixed costs.

Total variable costs are considered to be those costs that vary as the production volume changes. In a factory, production volume is considered to be the number of units produced, but in a governmental organization with no assembly process, the units produced might refer, for example, to the number of welfare cases processed.

NOTES

Objectives of CVP Analysis:

Cost volume profit analysis (CVP analysis) is one of the most powerful tools that managers have at their command. It helps them understand the interrelationship between cost, volume, and profit in an organization by focusing on interactions among the following five elements:

1. Prices of products
2. Volume or level of activity
3. Per unit variable cost
4. Total fixed cost
5. Mix of product sold

Because cost-volume-profit (CVP) analysis helps managers understand the interrelationships among cost, volume, and profit it is a vital tool in many business decisions.

Contribution Margin:

Contribution margin is the amount remaining from sales revenue after variable expenses have been deducted. Thus it is the amount available to cover fixed expenses and then to provide profits for the period. Contribution margin is first used to cover the fixed expenses and then whatever remains go towards profits. If the contribution margin is not sufficient to cover the fixed expenses, then a loss occurs for the period. This concept is explained in the following equations:

Sales revenue ? Variable cost* = Contribution Margin

***Both Manufacturing and Non Manufacturing**

Contribution margin ? Fixed cost* = Net operating Income or Loss

***Both Manufacturing and Non Manufacturing**

For further clarification of the **basic concept of cost volume and profit Analysis (CVP analysis)** we now take an example.

Example:

Assume that XYZ Private Ltd. has been able to sell only one unit of product during the period. If company does not sell any more units during the period, the company's contribution margin income statement will appear as follows:

XYZ Private Ltd
Contribution margin Income Statement
For the month of------------

	Total	Per Unit
Sales (1 Unit only)	$250	$250
Less Variable expenses	150	150
	---------	---------

Check Your Progress

1. What do you mean by financial statements?
2. How financial analysis is made?

Contribution margin	100	100
Less fixed expenses	35,000	======

Net operating loss	$(34,900)	
	======	

NOTES

For each additional unit that the company is able to sell during the period, $100 more in contribution margin will become available to help cover the fixed expenses. If a second unit is sold, for example, then the total contribution margin will increase by $100 (to a total of $200) and the company's loss will decrease by $100, to $34800. If enough units can be sold to generate $35,000 in contribution margin, then all of the fixed costs will be covered and the company will have managed to at least break even for the month-that is to show neither profit nor loss but just cover all of its costs. To reach the point, the company will have to sell 350 units in a period, since each unit sold contribute $100 in the contribution margin. This is shown as follows by the **contribution margin format income statement.**

XYZ Private Ltd
Contribution Margin Income Statement
For the month of------------

	Total	**Per Unit**
Sales (350 Units)	$87,500	$250
Less variable expenses	52,500	150
	---------	---------
Contribution margin	35,000	$100
Less fixed expenses	35,000	======

Net operating profit	$0	
	======	

Note that the break even is the level of sales at which profit is ZERO.
Once the point has been reached, net income will increase by unit contribution margin by each additional unit sold. For example, if 351 units are sold during the period then we can expect that the net income for the month will be $100, since the company will have sold 1 unit more than the number needed to break even. This is explained by the following contribution margin income statement.

XYZ Private Ltd
Contribution Margin Income Statement
For the month of------------

	Total	**Per Unit**
Sales (351 Units)	$87,750	$250
Less Variable expenses	52,500	150
	----------	----------

NOTES

Contribution margin	35,100	100
Less fixed expenses	35,000	======

Net operating loss	$100	
	======	

If 352 units are sold then we can expect that net operating income for the period will be $200 and so forth. To know what the profit will be at various levels of activity, therefore, managers do not need to prepare a whole series of income statements. To estimate the profit at any point above the point, the manager can simply take the number of units to be sold above the and multiply that number by the **unit contribution margin**. The result represents the anticipated profit for the period. Or to estimate the effect of a planned increase in sale on profits, the manager can simply multiply the increase in units sold by the **unit contribution margin**. The result will be expressed as increase in profits. To illustrate it suppose company is currently selling 400 units and plans to sell 425 units in near future, the anticipated impact on profits can be calculated as follows.

Increased number of units to be sold	25
Contribution margin per unit	×100
	———
Increase in the net operating income	2,500
	======

To summarize these examples, if there were no sales, the company's loss would equal to its **fixed expenses**. Each unit that is sold reduces the loss by the amount of the **unit contribution margin**. Once the point has been reached, each additional unit sold increases the company's profit by the amount of the unit contribution margin.

Difference between Gross Margin and Contribution Margin:

Gross Margin is the **Gross Profit** as a percentage of Net Sales. The calculation of the Gross Profit is: Sales minus Cost of Goods Sold. The Cost of Goods Sold consists of the fixed and variable product costs, but it excludes all of the selling and administrative expenses.

Contribution Margin is Net Sales minus the variable product costs and the variable period expenses. The Contribution Margin Ratio is the Contribution Margin as a percentage of Net Sales.

Example:

Let's illustrate the **difference between gross margin and contribution margin** with the following information: company had Net Sales of $600,000 during the past year. Its inventory of goods was the same quantity at the beginning and at the end of year. Its Cost of Goods Sold consisted of $120,000 of variable costs and $200,000 of fixed costs. Its selling and administrative expenses were $40,000 of variable and $150,000 of fixed expenses.

NOTES

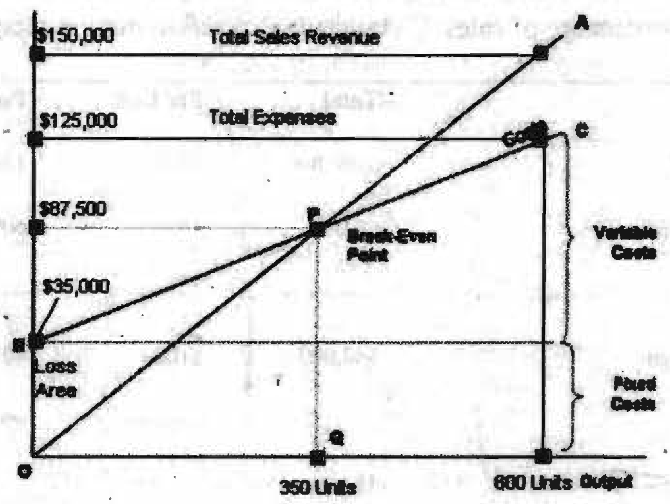
The company's Gross Margin is: Net Sales of $600,000 minus its Cost of Goods Sold of $320,000 ($120,000 + $200,000) for a Gross Profit of $280,000 ($600,000 - $320,000). The Gross Margin or Gross Profit Percentage is the Gross Profit of $280,000 divided by $600,000, or 46.7%.

The company's Contribution Margin is: Net Sales of $600,000 minus the variable product costs of $120,000 and the variable expenses of $40,000 for a Contribution Margin of $440,000. The Contribution Margin Ratio is 73.3% ($440,000 divided by $600,000).

Preparing a CVP Graph or Break-Even Chart:

In a CVP graph sometimes called a break even chart unit volume is commonly represented on the horizontal (X) axis and dollars on the vertical (Y) axis. Preparing a CVP graph involves three steps.

1. Draw a line parallel to the volume axis to present total fixed expenses. For **example** we assume total fixed expenses $35,000.



2. Choose some volume of sales and plot the point representing total expenses (fixed and variable) at the activity level you have selected. For example we select a level of 600 units. Total expenses at that activity level are as follows:

Fixed Expenses	$35,000
Variable Expenses (150×600)	$90,000
Total Expenses	$125,000

After the point has been plotted, draw a line through it back to the point where the fixed expenses line intersects the dollars axis.

3. Again choose some volume of sales and plot the point representing total sales dollars at the activity level you have selected. For example we have chosen a volume of 600 units. Sales at this activity level are $150,000 (600units × $250) draw a line through this point back to the origin. The point is where the total revenue and total expense lines cross. See the graph and note that point is at 350 units. It means when the company sells 350 units the profit is zero. When the sales are

NOTES

below the break even the company suffers a loss. When sales are above the breakeven point, the company earns a profit and the size of the profit increases as sales increase.

Contribution Margin Ratio:

The contribution margin as a percentage of total sales is referred to as **contribution margin ratio (CM Ratio).**

Formula of CM Ratio:

CM Ratio = Contribution Margin / Sales

This ratio is extensively used in cost-volume profit calculations.

Calculation / Computation of Contribution Margin Ratio:

Example:

Consider the following contribution margin income statement of XYZ Private Ltd private Ltd. in which sales revenues, variable expenses, and contribution margin are expressed as percentage of sales. Calculate contribution margin ratio

	Total	**Per Unit**	**Percent of Sales**
Sales (400 units)	$100,000	$250	100%
Less variable expenses	60,000	150	60%
Contribution margin	$40,000	$100	40%
Less fixed expenses	35,000		
Net operating income	$5,000		

According to above data of XYZ Private Ltd. the computations are:

Contribution Margin Ratio = (Contribution Margin / Sales) × 100

= ($40,000 / $100,000) × 100

= 40%

In a company that has only one product such as XYZ Private Ltd CM ratio can also be calculated as follows:

Contribution Margin Ratio = (Unit contribution margin / Unit selling price) × 100

= ($100 / $250) × 100

= 40%

Applications of Cost Volume Profit (CVP) Concepts:

Now we can explain how CVP concepts developed on above pages can be used in planning and decision making. We shall use these concepts to show how changes in variable costs, fixed costs, sales price, and sales volume affect contribution margin and profitability of companies in a variety of situations. For Example

- Change in variable cost and sales volume
- Change in fixed cost, sales price and sales volume
- Change in variable cost, fixed cost, and sales volume
- Change in regular sales price

Assumptions of Cost-Volume-Profit (CVP) Analysis:

A number of assumptions underlie cost-volume-profit (CVP) analysis: These cost volume profit analysis assumptions are as follows:

1. Selling price is constant. The price of a product or service will not change as volume changes.
2. Costs are linear and can be accurately divided into variable and fixed elements. The variable element is constant per unit, and the fixed element is constant in total over the relevant range.
3. In multi-product companies, the sales mix is constant.
4. In manufacturing companies, inventories do not change. The number of units produced equals the number of units sold.

Limitations of Cost-Volume-Profit (CVP) Analysis:

Cost volume profit (CVP) is a **short run, marginal** analysis: it assumes that unit variable costs and unit revenues are constant, which is appropriate for small deviations from current production and sales, and assumes a neat division between fixed costs and variable costs, though in the long run all costs are variable. For longer-term analysis that considers the entire life-cycle of a product, one therefore often prefers activity-based costing or throughput accounting.

Break Even Analysis:

Break even is the level of sales at which the profit is zero. Cost volume profit analysis is some time referred to simply as break even analysis. This is unfortunate because break even analysis is only one element of cost volume profit analysis. Break even analysis is designed to answer questions such as "How far sales could drop before the company begins to lose money." For detailed study about break even click on a link below:

Definition of Breakeven point:

Breakeven point is the level of sales at which profit is zero. According to this definition, at breakeven point sales are equal to **fixed cost plus variable cost**. This concept is further explained by the following equation:

[Break even sales = fixed cost + variable cost]

The breakeven point can be calculated using either the **equation method** or **contribution margin method**. These two methods are equivalent.

NOTES

Equation Method:

The **equation method** centers on the contribution approach to the income statement. The format of this statement can be expressed in equation form as follows:

[Profit = (Sales ? Variable expenses) ? Fixed expenses]

Rearranging this equation slightly yields the following equation, which is widely used in cost volume profit (CVP) analysis:

[Sales = Variable expenses + Fixed expenses + Profit]

According to the definition of breakeven point, breakeven point is the level of sales where profits are zero. Therefore the breakeven point can be computed by finding that point where sales just equal the total of the variable expenses plus fixed expenses and profit is zero.

Example:

For **example** we can use the following data to calculate breakeven point.

- Sales price per unit = $250
- variable cost per unit = $150
- Total fixed expenses = $35,000

Calculate breakeven point

Calculation:

Sales = Variable expenses + Fixed expenses + Profit

$250Q* = $150Q* + $35,000 + $0**

$100Q = $35000

Q = $35,000 /$100

Q = 350 Units

Q* = Number (Quantity) of units sold.

****The breakeven point can be computed by finding that point where profit is zero**

The breakeven point in sales dollars can be computed by multiplying the breakeven level of unit sales by the selling price per unit.

350 Units × $250 per unit = $87,500

Contribution Margin Method:

The **contribution margin method** centers on the idea that each unit sold provides a certain amount of contribution margin that goes toward covering fixed cost. To find out how many units must be sold to break even, divide the total fixed cost by the unit contribution margin.

Breakeven point in units = Fixed expenses / Unit contribution margin

\$35,000 / \$100* per unit

350 Units

NOTES

*S250 (Sales) ? \$150 (Variable exp.)

A variation of this method uses the Contribution Margin ratio (CM ratio) instead of the **unit contribution margin**. The result is the break even in total sales dollars rather than in total units sold.

Breakeven point in total sales dollars = Fixed expenses / CM ratio

\$35,000 / 0.40

= \$87,500

This approach is particularly suitable in situations where a company has multiple products lines and wishes to compute a single breakeven point for the company as a whole.

The following formula is also used to calculate breakeven point

Break Even Sales in Dollars = [Fixed Cost / 1 – (Variable Cost / Sales)]

This formula can produce the same answer:

Break Even Point = [\$35,000 / 1 – (150 / 250)]

= \$35,000 / 1 – 0.6

= \$35,000 / 0.4

= \$87,500

Benefits / Advantages of Break Even Analysis:

The main **advantages of breakeven point analysis** are that it explains the relationship between cost, production, volume and returns. It can be extended to show how changes in fixed cost, variable cost, commodity prices, and revenues will affect profit levels and break even points. Break even analysis is most useful when used with partial budgeting, capital budgeting techniques. The major **benefits** to use break even analysis are that it indicates the lowest amount of business activity necessary to prevent losses.

Assumption of Break Even Point:

The Break-even Analysis depends on three key assumptions:

1. **Average per-unit sales price (per-unit revenue):** This is the price that you receive per unit of sales taking into account sales discounts and special offers. Get this number from your Sales Forecast. For non-unit based businesses, make the per-unit revenue \$1 and enter your costs as a percent of a dollar. The most common questions about this input relate to averaging

NOTES

many different products into a single estimate. The analysis requires a single number, and if you build your Sales Forecast first, then you will have this number. You are not alone in this, the vast majority of businesses sell more than one item, and have to average for their Break-even Analysis.

Average per-unit cost: This is the incremental cost, or variable cost, of each unit of sales. If you buy goods for resale, this is what you paid, on average, for the goods you sell. If you sell a service, this is what it costs you, per dollar of revenue or unit of service delivered, to deliver that service. If you are using a Units-Based Sales Forecast table (for manufacturing and mixed business types), you can project unit costs from the Sales Forecast table. If you are using the basic Sales Forecast table for retail, service and distribution businesses, use a percentage estimate, e.g., a retail store running a 50% margin would have a per-unit cost of .5, and per-unit revenue of 1.

2. **Monthly fixed costs:** Technically, a break-even analysis defines fixed costs as costs that would continue even if you went broke. Instead, we recommend that you use your regular running fixed costs, including payroll and normal expenses (total monthly Operating Expenses). This will give you a better insight on financial realities. If averaging and estimating is difficult, use your Profit and Loss table to calculate a working fixed cost estimate—it will be a rough estimate, but it will provide a useful input for a conservative Break-even Analysis.

Limitations of Break Even Analysis:

It is best suited to the analysis of one product at a time. It may be difficult to classify a cost as all variable or all fixed; and there may be a tendency to continue to use a break even analysis after the cost and income functions have changed.

Review Problem:

Voltar Company manufactures and sells a telephone answering machine. The company's contribution format income statement for the most recent year is given below:

	Total	Per unit	Percent of sales
Sales	$1,200,000	$60	100%
Less variable expenses	900,000	45	?%
	-------	-------	-------
Contribution margin	300,000	15	?%
Less fixed expenses	240,000	=====	=====

Net operating income	$60,000		
	=====		

Calculate breakeven point both in units and sales dollars. Use the equation method.

Solution:

Sales = Variable expenses + Fixed expenses +Profit

$60Q = $45Q + $240,000 + $0

$15Q = $240,000

Q = $240,000 / 15 per unit

Q = 16,000 units; or at $60 per unit, $960,000

Alternative solution:

X = 0.75X + 240,000 + $0

0.25X = $240,000

X = $240,000 / 0.25

X = $960,000; or at $60 per unit, 16,000 units

NOTES

Margin of safety (MOS) Definition and Explanation:

Margin of safety (MOS) is the excess of budgeted or actual sales over the break even volume of sales. It stats the amount by which sales can drop before losses begin to be incurred. The higher the margin of safety, the lower the risk of not breaking even.

Formula of Margin of Safety:

The formula or equation for the calculation of margin of safety is as follows:

[Margin of Safety = Total budgeted or actual sales ? Break even sales]

The margin of safety can also be expressed in percentage form. This percentage is obtained by dividing the margin of safety in dollar terms by total sales. Following equation is used for this purpose.

[Margin of Safety = Margin of safety in dollars / Total budgeted or actual sales]

Example:

Sales(400 units @ $250)	$100,000
Break even sales	$87,500

Calculate margin of safety

Calculation:

Sales(400units @$250)	$100,000

Break even sales	$ 87,500
Margin of safety in dollars	$ 12,500

NOTES

Margin of safety as a percentage of sales:

12,500 / 100,000 = 12.5%

It means that at the current level of sales and with the company's current prices and cost structure, a reduction in sales of $12,500, or 12.5%, would result in just breaking even. In a single product firm, the margin of safety can also be expressed in terms of the number of units sold by dividing the margin of safety in dollars by the selling price per unit. In this case, the margin of safety is 50 units ($12,500 ÷ $ 250 units = 50 units).

Review Problem:

Voltar Company manufactures and sells a telephone answering machine. The company's contribution margin income statement for the most recent year is given below:

Description	Total	Per unit	Percent of Sales
Sales (20,000 units)	$ 1,200,000	$60	100%
Less variable expenses	900,000	$45	?%
	---------	---------	---------
Contribution margin	300,000	$15	?%
Less fixed expenses	240,000	======	=====

Net operating income	60,000		
	======		

Required: Calculate margin of safety both in dollars and percentage form.

Solution:

Margin of safety = Total sales – Break even sales*

= $1,200,000 – $960,000

= $240,000

Margin of safety percentage = Margin of safety in dollars / Total sales

= $240,000 / $1,200,000

= 20%

*The break even sales have been calculated as follows:

Sales = Variable expenses + Fixed expenses + Profit

$60Q = $45Q + $240,000 + $0**

$$\$15Q = \$240,000$$
$$Q = \$240,000 / \$15 \text{ per unit}$$
$$Q = 16,000 \text{ units; or at } \$60 \text{ per unit. } \$960,000$$

We know that break even is the level of sales where profit is **zero

NOTES

Financial Forecasting

Financial forecasting is looking ahead to develop a financial plan for the future. A forecast is a prediction about a future condition or situation. In terms of a business, financial forecasting means looking ahead to a point in the future and trying to estimate the financial situation that the company will be in at that time. Decisions about whether to spend more or less money on a project today will be determined by financial forecasting. A company needs to feel secure that their future finances will be able to recover the money they have spent and keep their bank balances healthy. Most organizations with strong financial departments spend a lot of time and effort on financial forecasting. The nature of the business world means that managers need to look ahead and plan for a future that is in no way certain. Financial forecasting helps a company to make important decisions today that will affect the company in the future. These decisions affect things like whether to spend or borrow money, where to invest or when to start a new project.

The difficulty with financial forecasting is that it involves uncertainty. The future is uncertain and a single financial policy can have numerous results. However, when businesses draw up strategies to deal with risk management they build in forecasting procedures which strengthen the company's position. Risk cannot be eliminated by financial forecasting but it is beneficial for a company to have a better understanding of what the future could hold. Companies accept that uncertainty is an integral part of any financial forecast. Another important thing to consider is the timing of a financial forecast. Forecasts necessarily need to be updated because new information comes to light and things are constantly changing. So managers need to think about a series of financial forecasts, not just one. The question then becomes "how often do forecasts need to be made?" Each time there is an updated forecast there will be an additional cost. Linked to this is the need to establish how far into the future a forecast needs to reach. A ten year forecast will be more complicated – and expensive – than a two year forecast.

Financial forecasting Methods

- Percent of Sales Method
- Linear Trend Extrapolation
- Regression Analysis

Percent of Sales Method

The Percentage of Sales Method is a Financial Forecasting approach which is based on the assumption that most Balance Sheet and Income Statement Accounts vary with sales. Therefore, the key driver of this method is the Sales Forecast and

Check Your Progress

3. What is ratio analysis?
4. What is current ratio?
5. Explain dividend payout ratio?

NOTES

based upon this, forecasted Financial Statements can be constructed and the firms needs for external financing can be identified.

Linear Trend Extrapolation

This method examines trends and cycles in historical data, and then use mathematical techniques to estimate value to the future. The assumption of all these techniques is that the forces responsible for creating the past will continue to operate in the future. This is often a valid assumption when forecasting short term horizons, but it falls short when creating medium and long term forecasts.

The stability of the environment is the key factor in determining whether trend extrapolation is an appropriate forecasting model. The concept of "developmental inertia" embodies the idea that some items are more easily changed than others. Clothing styles is an example of an area that contains little inertia. It is difficult to produce reliable mathematical forecasts for clothing. Energy consumption, on the other hand, contains substantial inertia and mathematical techniques work well. The developmental inertia of new industries or new technology cannot be determined because there is not yet a history of data to draw from.

There are many mathematical models for forecasting trends and cycles. Choosing an appropriate model for a particular forecasting application depends on the historical data. The study of the historical data is called exploratory data analysis. Its purpose is to identify the trends and cycles in the data so that appropriate model can be chosen.

Regression Analysis

Regression is the study of relationships among variables, a principal purpose of which is to predict, or estimate the value of one variable from known or assumed values of other variables related to it. To make predictions or estimates we must identify the effective predictors of the variable of interest: which variables are important indicators and can be measured at the least cost, which carry only a little information, and which are redundant.

CASE STUDY:

Financial Analysis of Tata Motors

- On the back of a 3.9% volume growth, the company registered 14.4% y-o-y growth in net revenue to Rs.60.57 bn during 1QFY09 due to vehicle price increases and favorable mix
- Significant cost increases were witnessed in raw material consumption and employee cost which witnessed y-o-y growth of 18.2% and 13.9% respectively.
- Excluding the impact of foreign exchange valuation related losses, the Company's EBITDA stood at Rs.5,304.7 mn, compared to Rs.5,463.0 mn

the year ago quarter. EBITDA margin, excluding foreign exchange losses was 7.7% in 1QFY09, compared to 9.0% 1QFY08.

NOTES

- In a rising cost scenario, pressure on margins was visible as the company's raw material cost as percentage of net revenues of the Company rose by 240 bps to 72.0% in 1QFY09; from 69.7% in 1QFY08.
- Cost reduction in 1Q FY09 stood at 294 mn.
- Net interest expense increased 37.7% y-o-y to Rs.1123.3 mn in Q1 FY09, compared to Rs.815.6 mn due to rising interest rates and higher debt. However, the interest expense as a % of net sales increased marginally from 1.3% in Q1 FY08 to 1.6% in Q1 FY09.
- Tax rate for first quarter declined substantially and stood at 5.5% as compared to 21.2% for same period last year, on account of large dividends received by Company on its Investments/Subsidiaries which are not taxable in the hands of the Company and weighted deductions available on R&D expenditure.
- As on 30th June'08, the balance sheet size of the Company was Rs. 183.98 bn as compared to Rs 150.96 bn as on 31st March'08. Net of vehicle financing loans and receivables the Company's capital employed was Rs 178.33 bn as on 30th June'08 againstRs.135.76 bn as on 31st March'08.
- As on 30th June'08, 385.62 mn shares (Face value Rs.10) were outstanding on the balance sheet of Tata Motors.
- The Gross total debt (inc. FCCNs) stood Rs 94.97 bn as on 30th June'08 as compared to Rs. 62.8 bn as on 31st March'08. The Company's Net Debt (Net of the surplus investible funds) stood at Rs 89.3 bn as on 30th June'08. As on 30th June'08, the Company's net debt to equity ratio stood at 1.12:1.
- Up to June 30th, 2008, 99.94% of the 1% convertible Notes (due 2008) and 97.09% of the Zero coupon Convertible Notes (due 2009) have been converted into Ordinary Shares / ADSs. There have been no conversions of the other FCCNs issued by the Company.
- The Company's Balance Sheet includes Receivables and loans of Rs. 27.94 bn on account of vehicle financing business as on 30th June, 2008.
- The Company had an investible surplus of around Rs. 5.65 bn as on 30th June, 2008.

SUMMARY

- The balance sheet shows the financial position of a firm at a given point of time.

NOTES

- Corporate managements have discretion in influencing the occurrence, measurement, and reporting of revenues, expenses, assets and liabilities. They may use this latitude to manage the bottom line.
- The term "**accounting ratios**" is used to describe significant relationship between figures shown on a balance sheet, in a profit and loss account, in a budgetary control system or in any other part of accounting organization.
- Financial ratios may be divided into four board types: liquidity ratio, leverage ratios, turnover ratios.
- Liquidity refers to the ability of the firm to meet its obligations in the short run, usually one year. Current ratio and acid-test ratio are the important liquidity ratio.
- Leverage refers to the use of debt finance. Debt-equity ratio, interest coverage ratio, and fixed charges coverage ratio are the important leverage ratios.
- Turnover refers to the efficiency of asset use. Inventory turnover ratio, receivable turnover ratio, fixed assets turnover ratio, and total assets turnover ratio are the important turnover ratios.
- Profitability reflects the final result of business operations. Gross profit margin, net profit margin return on assets, earning power, return on capital employed, and return on equity are the important profitability ratios.
- In common size analyses, the items in the balance sheet are stated as percentages of total assets and the items in the profit and loss account are stated as percentages of sales.
- Financial statement analysis can be a very useful tool; there are certain problems and issues encountered in such analysis that call for care, circumspection, and judgment.
- Comprehensive business analysis calls for going beyond conventional financial measures to consider qualitative factor relevant for evaluating the performance and prospects of a company.

ANSWERS TO 'CHECK YOUR PROGRESS'

1. By financial statements we mean two statements:

   (i) Profit and loss Account or Income Statement

   (ii) Balance Sheet or Position Statement

2. The financial analysis is made on the following basis:

   a) On the basis of material used for the same.

External Analysis

Internal Analysis

b) On the basis of operation of the analysis.

Horizontal Analysis

Vertical Analysis

3. The term "accounting ratios" is used to describe significant relationship between figures shown on a balance sheet, in a profit and loss account, in a budgetary control system or in any other part of accounting organization.

4. Current Ratio- It reflects the solvency of the firm.

   Current Ratio= Current Assets/Current liabilities.

   Higher the ratio will be, greater the safety for the creditors & vice versa. Ideal Current Ratio is 2:1.

5. Dividend payout ratio is calculated to find the extent to which earnings per share have been used for paying dividend and to know what portion of earnings has been retained in the business.

NOTES

TEST YOURSELF

1) What do you mean by Financial Analysis? Explain its nature and limitations.
2) What are the various parties interested in the analysis of financial statements?
3) Explain Ratio Analysis. What are the advantages and disadvantages of Ratios Analysis?
4) What do you mean by Fund Flow Statement?
5) Explain Cash Flow Statement. What is the procedure of preparing Cash Flow Statement?
6) What is the difference between funds flow statement and cash flow statement?
7) What is the Cost-volume-profit (CVP) analysis? Explain the applications of Cost Volume Profit (CVP) concept.
8) What do you mean by Break Even Analysis? Explain various advantages of Break Even Analysis.
9) Explain Financial Forecasting. What are the various Methods Financial forecasting?

NOTES

10) Write a short note on:

i) Quick Ratio
ii) Capital Gearing Ratio
iii) Dividend Payout Ratio
iv) Operating Ratio
v) Margin of Safety

FURTHER READINGS

- Accounting for Managers: Sharma and Gupta
- Management Accounting: Mr. Agrawal
- Fundamentals Accounting: Jain, Khandelwal, Pareek