

# **BALAJI INSTITUTE OF I.T AND MANAGEMENT KADAPA**

**FINANCIAL ACCOUNTING FOR MANAGERS  
(21E00104)**

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**ICET CODE: BIMK**

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**1<sup>ST</sup> & 2<sup>ND</sup> INTERNAL EXAM**



**Name of the Faculty: P.NAGENDRA**

**Units covered: 1-5 UNITS**


**JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY ANANTAPUR**

(Established by Govt. of A.P., ACT No.30 of 2008)

**ANANTHAPURAMU – 515 002 (A.P) INDIA**
**MASTER OF BUSINESS ADMINISTRATION  
MBA; MBA (General Management); MBA (Business Management)  
COMMON COURSE STRUCTURE**

Course Code	FINANCIAL ACCOUNTING FOR MANAGERS	L	T	P	C
21E00104		4	0	0	4
Semester		I			
Course Objectives:					
<ul style="list-style-type: none"><li>To introduce accounting , accounting rules, accounting process and preparation of financial statements.</li><li>To explain methods of valuation of assets,</li><li>To explore the meaning and interpretation of financial statements through ratio analysis technique.</li></ul>					
Course Outcomes (CO): Student will be able to					
<ul style="list-style-type: none"><li>Prepare the financial statements with accounting knowledge</li><li>Value the assets of the business organizations under different methods</li><li>Analyse the financial performance and position of the business organization and interpret the results from the point of company and investor</li></ul>					
UNIT - I	Lecture Hrs: 8				
Introduction to Accounting: Definition, Importance, Objectives and principles of accounting, uses of accounting and book keeping Vs Accounting, Single entry and Double entry systems, classification of accounts – rules of debit & credit. (Only theory)					
UNIT - II	Lecture Hrs: 12				
The Accounting Process: Overview, Books of Original Record; Journal and Subsidiary books, ledger, Trial Balance, Final accounts: Trading accounts- Profit & loss accounts- Balance sheets with adjustments. (Problems on Only Final Accounts)					
UNIT - III	Lecture Hrs:12				
Valuation of Assets: Introduction to Depreciation- Methods (Simple problems from Straight line method, Diminishing balance method and Annuity method). Inventory Valuation: Methods of inventory valuation (Simple problems from LIFO, FIFO).					
UNIT - IV	Lecture Hrs:12				
Financial Analysis -I Analysis and interpretation of financial statements from investor and company point of view, Liquidity, leverage, solvency and profitability ratios – Du Pont Chart (A Case study on Ratio Analysis).					
UNIT - V	Lecture Hrs:12				
Financial Analysis-II: Objectives of fund flow statement - Steps in preparation of fund flow statement, Objectives of Cash flow statement- Steps in Preparation of Cash flow statement – Analysis of Cash flow and Funds flow statements - Funds flow statement Vs Cash flow statement. (Only theory).					
Textbooks:					
<ul style="list-style-type: none"><li>Financial Accounting, Dr.S.N. Maheshwari and Dr.S.K. Maheshwari, Vikas Publishing House Pvt. Ltd.,</li><li>Accountancy .M P Gupta &amp;Agarwal ,S.Chand</li></ul>					
Reference Books:					
<ul style="list-style-type: none"><li>Financial Accounting ,P.C.Tulisan ,S.Chand</li><li>Financial Accounting for Business Managers, Asish K. Bhattacharyya, PHI</li><li>Financial Accounting Management An Analytical Perspective, Ambrish Gupta, Pearson Education</li><li>Accounting and Financial Management, Thukaram Rao, New Age Internationals.</li><li>Financial Accounting Reporting &amp; Analysis, Stice&amp;Stice, Thomson</li><li>Accounting for Management, Vijaya Kumar,TMH</li><li>Accounting for Managers, Made Gowda, Himalaya</li></ul>					



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8. Accounting for Management ,N.P.Srinivasan, &M.ShakthivelMurugan, S.Chand

**Online Learning Resources:**

[https://onlinecourses.swayam2.ac.in/cec20\\_mg02/preview](https://onlinecourses.swayam2.ac.in/cec20_mg02/preview)  
[https://onlinecourses.swayam2.ac.in/imb19\\_mg06/preview](https://onlinecourses.swayam2.ac.in/imb19_mg06/preview)  
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<https://www.coursera.org/learn/wharton-accounting>

# UNIT-1

## INTRODUCTION TO ACCOUNTING

### 1.1. Meaning of Account:

- Purchase or sale of goods on credit.
- Receipt or payment of money.
- Receipt or payment of money on account of previous dues.

**DEFINITION OF ACCOUNTING:** “The American Institute of Certified Public Accountants has defined “Accounting is a recording classifying summarizing& reporting to the business transaction”.

“Accounting is a means of measuring and reporting the results of economic activities”

- **Smith and Ashburne** –

“Accounting systems is a means of collecting, summarizing, analyzing and reporting in monetary terms, the information about the business”.

- **R.N.Anthony** –

“The art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events, which are, in part at least, of a financial character and interpreting the results thereof”.

- **American Institute of Certified Public Accountants (AICPA)** –

**Accounting:** American Institute of Certified Public Accountant (AICPA)

Accounting is the art of recording business transactions classify and summarizing in a significant manner and in terms of money transactions and events within part at least of a financial and interpreting the results thereof.

Ex:

1. B has paid Rs.1,00,000/- to X
2. N has paid Rs. 25,000/- to Business
3. Puneth today is leave
4. A has received Rs.1000



**Meaning of accounting:** Accounting is the language of business.

*“The art of recording, classifying and summarizing in a significant manner in terms of money transactions”.*

The main aim of a business is to earn a profit. For earning profit, the businessman will either purchase the goods in one market at certain price and sell it in another market at higher price or will convert the raw materials into finished products and sell it to the different customers at a price which will give him some percentage of profit on cost of production. But this may not be true in all cases.

### **1.1.1 History of Accounting:**

- Accounting is as old as civilization itself. From the ancient relics of Babylon, it can be well proved that accounting did exist as long as 2600 B.C.
- However, in modern form accounting based on the principles of Double Entry System, which came into existence in the 15<sup>th</sup> century.
- Fra Luka Paciolo, a mathematician published a book De competence scriptures in 1494 at Venice in Italy. This book was translated into English in 1543. In this book he covered a brief section on ‘book-keeping’.
- Paciolo used the terms ‘debito’ and ‘credito’ these words came from latic words debeo and credo. The terms debit and credit used today have its origin from debito and credito.

### **1.1.2 Origin of Accounting in India:**

- Accounting was practiced in India a thousand years ago and there is clear evidence for this. In his famous book *Arthashastra* ‘Kautilya’ dealt with not only politics and economics but also the art of proper keeping of accounts.
- However, the accounting on modern lines was introduced in India after 1850 with the formation of joint-stock companies in India.
- Accounting in India is now a fast developing discipline.
- The two premier accounting institutes in India viz., chartered Accountants o India and the Institute of Cost and Works Accountants of India are making continuous and substantial contributions.

## 1.2. IMPORTANCE OF ACCOUNTING:

- i) **Replacement of Human Memory:** as human memory is limited and short, it is difficult to remember all the transactions of the business. Therefore, all the financial transactions of the business are recorded in the books. In this way, the businessmen cannot only see the records at the required time but can also remember them for a long time. Thus, recording of the transactions is the replacement of human's memory.
- ii) **Helpful In The Determination Of Financial Results And Presentation Of Financial Position:** accounting is very useful in the determination of the profit and loss of business and showing the financial position of the business.
- iii) **Helpful in assessing the tax liability:** generally, a businessman has to pay corporate tax, VAT and excise duty, etc. therefore, it is necessary that proper accounts should be maintained to compute the tax liability of the business.
- iv) **Helpful in the case of insolvency:** sometimes the businessman becomes insolvent. If he has properly maintained the accounts, he will not face the problems in explaining few things in the court.
- v) **Helpful in the valuation of business:** if the business is shut down and sold, accounting helps the businessman to determine the value of the business. It would be possible only in that case when the accounts of the business are properly maintained.
- vi) **Helpful in the valuation of goodwill and shares:** if accounts of the business are properly maintained, it would be quite convenient to determine the value of goodwill. Goodwill is very important for the determination of the value of shares of the company.
- vii) **Accounting makes comparative statement possible:** proper and adequate accounting helps in comparing the income, expenditure, purchase, sale of the current year with that of the previous years. And then future plans, policies, and forecasting may be possible.
- viii) **It helps to make inter period and inter-firm comparison.** Accounting information recorded properly can be used to compare the results of one year with those of previous years and with those of their other enterprises.

ix) **It is an aid to the management.:** The information recorded properly can be used for meaning full analysis, so as to assist the management in decision making.

x) **It is needed for legal reasons:** Accounting information as recorded can be produced as a firm, evidence in a court of law. It helps in taxation matters and finalizing other contract details, etc.

### **1.3. OBJECTIVES OF ACCOUNTING:**

**1. Designing Work:** It includes the designing of the accounting system, basis for identification and classification of financial transactions and events, forms, methods, procedures, etc.,

**2. To maintain records of business:** One of the important objectives of accounting is the systematic maintenance of all monetary aspects of business transactions. This is known as book-keeping.

**3. To calculate Profit or Loss:** The profit earned or the loss suffered during a specific period can be calculated easily from the accounting books.

**4. To ascertain financial position:** By preparing the financial statements profit and loss account and balance sheet, the financial position of the business can be found out. From these statements it is possible to know the resources owned by the firm. These statements also provide information about the obligations of the business. Thus accounting aims at depicting the true and fair financial position of a concern.

**5. TO communicate financial information:** Accounting is called the language of business. It aims at communicating financial information to various interested parties.

**6. Preparation of Budget:** The management must be able to reasonably estimate future requirements and opportunities. As an aid to this process, the accountant has to prepare budgets, like cash budget, capital budget, purchases budget, sales budget, etc. this is known as 'Budgeting'.

**7. Taxation work:** The accountant has to prepare various statements and returns pertaining to income-tax, sales-tax, excise or customs duties, etc., and file that returns with the authorities concerned.

**8. Auditing:** It involves a critical review and verification of the books of accounts statements and reports with a view to verifying their accuracy. This is 'Auditing'.

## **1.4. USE, NATURE, FUNCTIONS, AND SCOP OF ACCOUNTING**

**1) Recording:** This is the basic function of accounting. It is essentially concerned not only with ensuring that all business transactions of financial character are recorded, but also that they are recorded in an orderly manner. The recording is done in the book “journal”. This may be further subdivided into various subsidiary books such as cash journal, purchases journal, sales journal, etc. the number of subsidiary books to be maintained will be according to the nature and size of the business.

**2) Classifying:** classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature in one place. The work of classification is done in the book termed as “Ledger”. This book contains on different pages, individual account heads under which, all financial transactions of similar nature are collected. For example, there may be separate account heads for traveling expenses, printing, and stationery, advertising, etc. all expenses under these heads, after being recorded in the journal, will be classified under separate heads in the ledger. This will help in finding out the total expenditure incurred under each of the above heads.

**3) Summarizing:** this involves presenting the classified data in a manner that is understandable and useful to the internal as well as external end-users of accounting statements. This process leads to the preparation of the following statements:

- i) trial balance
- ii) income statement and
- iii) balance sheet

**4) Dealing with financial transactions:** accounting records only those transactions and events in terms of money which are of a financial character. other transactions are not recorded in the books of account. For example, if a company has a team of dedicated and trusted employees, it is of great use to the business; but since it is not of a financial character and not capable of being expressed in terms of money, it will not be recorded in the books of business.

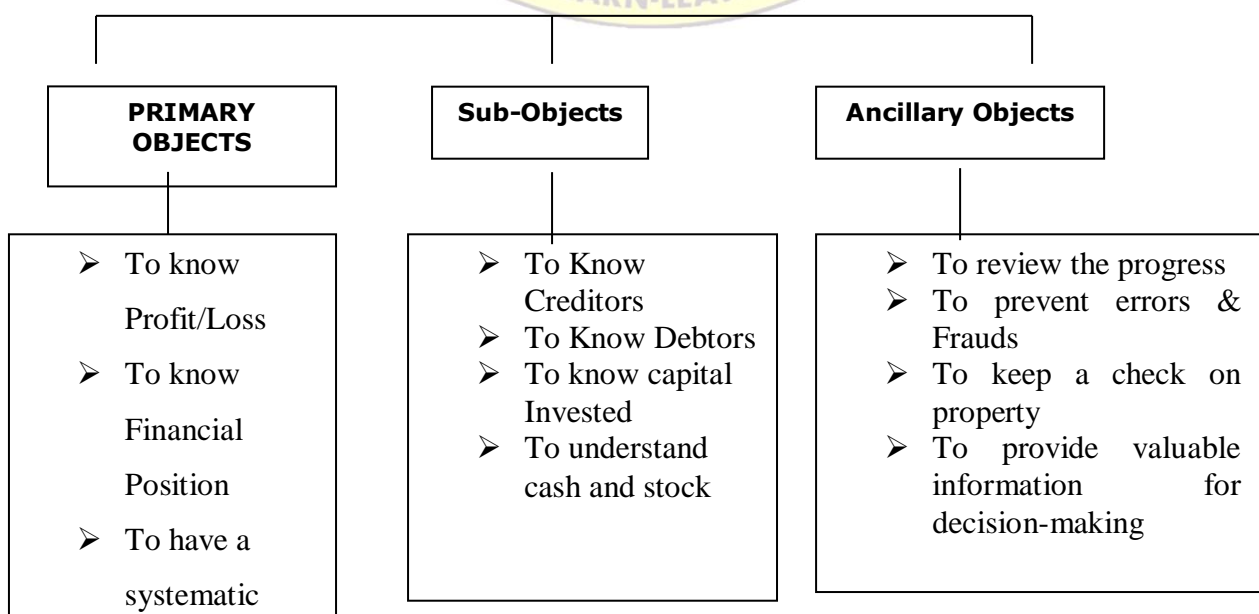
**5) Analyzing and interpreting:** this is the final function of accounting. The recorded financial data is analyzed and interpreted in a manner that will enable the end-users to make a meaningful judgment about the financial condition and profitability of the business operations. The data is also used for preparing future plans and framing the policies for executing such plans.

**6) Communicating:** the accounting information after being meaningfully analyzed and interpreted has to be communicated in a proper form and manner, to the proper person. This is done through the preparation and distribution of accounting reports, which include – besides the usual income statement and the balance sheet economists the marginal cost refers to the cost of producing one additional unit. Such cost per unit may increase or decrease depending upon the law of returns. For example in the case of law of increasing returns, the cost per unit .

### **1.5 BOOK-KEEPING Vs ACCOUNTING**

Sl.No	Points of Difference	Book-Keeping	Accounting
1	Object	The Object of Book-Keeping is to prepare original books of Accounts.	The main object of accounting is to record, analyze and interpret the business transactions.
2	level of work	Book-Keeping is restricted to the level of work. Clerical work is mainly involved in it.	Accountancy, on the other hand, is concerned with all levels of management
3	Principles of Accountancy	All without any difference.	On the other hand, various firms follow various methods of reporting and interpretation in accounting.
4	Final Result	In Book-Keeping it is not possible to know the final result of business every year.	Accounting gives the net results of the business every year.

### **5.1 Objects of book-keeping at a glance**





## **1.6. SINGLE ENTRY SYSTEM**

- A single entry system is an incomplete form of recording financial transactions.
- It is the system, which does not record two aspects or accounts of all the financial transactions.
- It is the system, which has no fixed set of rules to record the financial transactions of the business. A single entry system records only one aspect of transaction.
- Thus, a single entry system is not a proper system of recording financial transactions, which fails to present complete information required by the management.
- The single entry system mainly maintains cash books and personal accounts of debtors and creditors.
- Single entry system ignores nominal account and real account except cash account.
- Hence, it is an incomplete form of the double-entry system, which fails to disclose true profit or loss and financial position of a business organization.

### **1.6.1 Features of single entry system**

- 1. No Fixed Rules:** Single entry system is not guided by a fixed set of accounting rules for determining the amount of profit and preparing the financial statements.
- 2. Incomplete System:** Single entry system is an incomplete system of accounting, which does not record all the aspects of financial transactions of the business.
- 3. Cash Book:** Single entry system maintains a cash book for recording cash receipts and payments of the business organization during a given period of time.
- 4. Personal Account:** Single entry system maintains personal accounts of all the debtors and creditors for determining the number of credit sales and credit purchases during a given period of time.
- 5. Variations in Application:** Single entry system has no fixed set of principles for recording financial transactions and preparing different financial statements. Hence, it has variations in its application from one business to another.

### **Single Entry vs. Double Entry Accounting**

The single entry approach contrasts with double-entry accounting, in which every financial event brings at least two equal and offsetting entries. One is a debit (DR) and the other a credit (CR). As a result:

- ❖ Firms using the double-entry approach report financial results with an accrual reporting system.
- ❖ Firms using a single entry approach are effectively limited to reporting on a cash basis.

## **1.7. DOUBLE ENTRY SYSTEM**

- Every transaction as two aspects when you received something we give something else in writing. “Rule Double entry system. Purchase goods for cash. “Every debt they must be a corresponding credit”.
- In this business transaction we receive goods and give cash in return similarly when we sell goods on credit goods are given another customer becomes debtors this method of writing may transaction divided into two types debt and credit.
- One account is to be debt and another account is credit for every transaction in order to have a complete record of the same.
- Every transaction affects two accounts in opposite direction a transaction is to be recorded in two different accounts in opposite side for annual value both the accounts cannot be debited and another account is to be credit the basic principle of double-entry systems is to every debt they must be corresponding credit of equal value.
- The double-entry system is a scientific way of presenting accounts. As such all the business concerns feel it convenient to prepare the accounts under the double-entry system. The taxation authorities also compel the businessmen to prepare the accounts under the double-entry system.
- Under the dual aspect concept, the Accountant deals with the two aspects of business transactions. i.e.
  1. Receiving aspect (Debit Aspect)
  2. Giving aspect (Credit Aspect)

In the double-entry system book-keeping system these two aspects are recorded facilitating the preparation of trial balance and the final accounts therefrom.

### **1.7.1 Principle of double entry system**

- The systematically way of presenting the accounts is duly under the double-entry system. The single entry system is in fact not a system at all. It is nothing but an incomplete form of double-entry.



- Every business transaction has got two accounts, where one account is debited and another account is credited.
- If own account receives a benefit, there should be another account to part the benefit.
- The principle of double-entry is based on the fact that there can be no giving without receiving nor can there be receiving without something giving.

### **1.7.2 Advantages double-entry system:**

**1.Scientific System:** Double entry system records, classifies and summarizes business transactions in a systematic manner and, thus, produces useful information for decision-makers.

**2.Full Information:** Full and authentic information can be had about all transactions as the trader maintains the ledger with all types of accounts.

**3.Assessment of Profit and Loss:** The businessman/trader will be able to know correctly whether he had earned profit or sustained loss. It facilitates the trade to take such steps so as to increase the efficiency of the firm.

**4.Knowledge of debtors:** The trader will be able to know exactly what amounts are owed by different customers to the firm. If any amount is pending for a long time from any customer, he may stop credit facility to that customer.

**5.Knowledge of Creditors:** The trader also knows the exact amounts owed by the firm to others and he will be able to arrange prompt payment to obtain a cash discount.

**6.Arithmetical accuracy:** The arithmetical accuracy of the books can be proved by preparing a trial balance.

**7.Assessment of Financial Position:** The trader will be able to prepare the balance sheet which will help the interested parties to know fully about the financial position of the firm.

**8.Comparison of results:** It facilitates the comparison of the current year's results with previous years.

**9.Maintenance according to Income Tax Rules:** Proper maintenance of books will satisfy the tax authorities and facilitates accurate assessment. In India, joint-stock companies should maintain accounts under the double-entry system.

**10. Detection of frauds:** The systematic and scientific recording of business transactions on the basis of this system minimizes the chances of embezzlement and fraud. The frauds or errors can be easily detected by vouching. Verification and auditing of accounts.

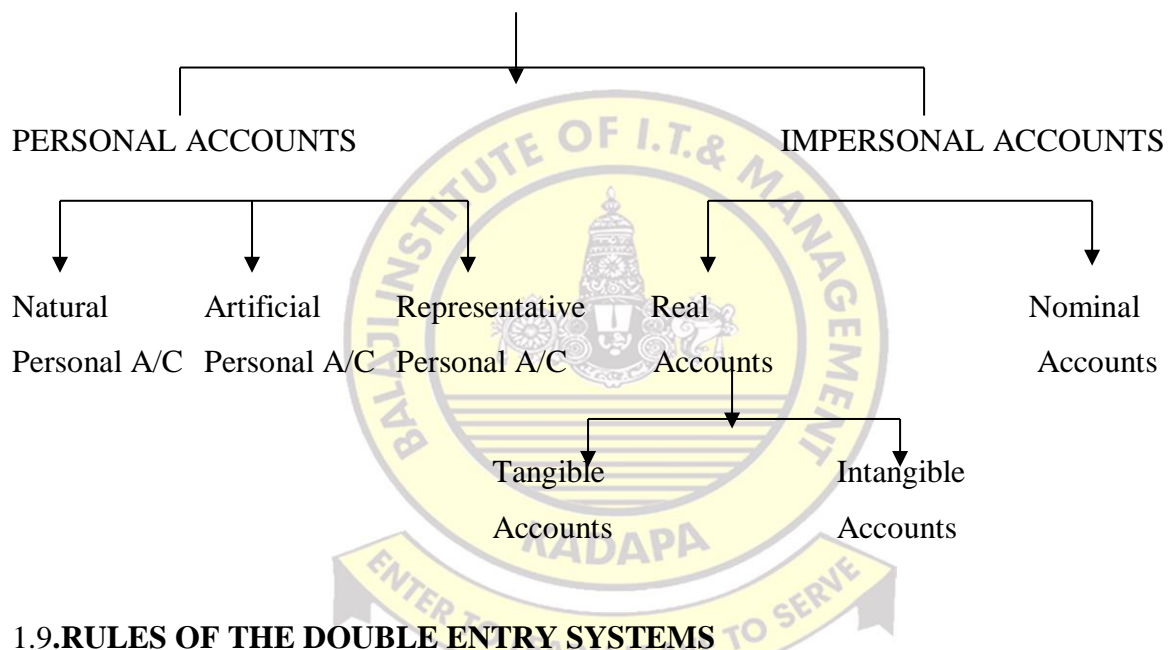
### **1.7.3 Disadvantage double entry systems:**

**1.Errors of Omission:** In case the entire transaction is not recorded in the double of accounts the mistake cannot be detected by accounting. The Trial Balance will tally in spite of the mistakes.

**2.Errors o principle:** Double entry is based upon the fact that every debit has to corresponding credit. It will not be able to detect the mistake such as debiting Ram's account instead of Rao's account or building an account in place of repairs account.

**3.Compensating errors:** If Rahim's account is by mistake debited with Rs.15 lesser and Mohan's account is also by mistake credited with Rs.15 lesser, the Trail balance will tally but the mistake will remain in accounts.

### **1.8. CLASSIFICATIONS OF ACCOUNTS (OR) TYPES OF ACCOUNTS**



### **1.9.RULES OF THE DOUBLE ENTRY SYSTEMS**

**I. personal accounts:** these accounts record a business's dealings with persons or firms. The person receiving something is given debited and the person giving something is given credit.

**a) Natural Personal A/C:** An account recording transactions with and individual human being is known as natural personal accounts.

**Ex:** Ramu A/C, Sindhu A/C, Nagendra A/C.

**b)Artificial Personal A/C:** An account recording financial transactions with an artificial person created by the law is called as artificial personal accounts.

**Ex:** SBI Bank A/C, Satyam InfoTech Ltd A/C

**c)Representative personal A/C:** An account indirectly representing a person or group of persons is known as representative personal A/C.

**Ex:** Salaries outstanding A/C, Interest outstanding A/C

**Rule: Debit the Receiver, Credit the giver**

**II. Real Accounts:** Real accounts means the business transactions deal with assets. these are the accounts of assets, asset entering the business is given credit. Real accounts again classified into two types i.e.,

1. Tangible real A/C
2. Intangible Real A/C

**a) Tangible Real A/C:** It relates to an asset that can be touchable felt sun and measured.

**Ex:** machinery A/C, Cash A/C

**b) Intangible Real A/C:** It relates to an asset that can be touched physically but can be measured in valued.

**Ex:** Goodwill A/C, Patents A/C

Rule: **Debit what comes in                      Credit what goes out**

**III Nominal Accounts:** It means the business transaction deals with expenses, loss incomes, and gains. Accounts of expenses and losses are debited and accounts of incomes and gains are credited.

Rule: **Debit all expenses and losses, Credit all incomes and gains**

### 1.9.1 Advantages of accounting:

1. **Provides systematic records:** since all the financial transactions are recorded in the books, one need not rely on memory. Any information required is readily available from these records.
2. **Facilitate the preparation of financial statements:** Profit and loss account and balance sheet can be easily prepared with the help of the information in the records. This enables the trader to know the net result of business operations during the accounting period and the financial position of the business at the end of the accounting period.
3. **Provides control over assets:** Book-keeping provides information regarding cash in hand, cash at bank, stock of good, accounts receivables from various parties and the amounts invested in various other assets. As the trader knows the values of the assets he will have control over them.
4. **Provides the required information:** Interested parties such as owners, lenders, creditors, etc., get necessary information of frequent intervals.

5. **Comparative study:** One can compare the present performance of the organization with that of its past. This enables the managers to draw useful conclusions and make proper decisions.
6. **Less scope for fraud or theft:** It is difficult to conceal fraud or theft etc., because of the balancing of the books of accounts periodically. As the work is divided among many persons, there will be a check and counter check.
7. **Tax matters:** Properly maintained bookkeeping records will help in the settlement of all tax matters with the tax authorities.
8. **Ascertaining the value of business:** The accounting records will help in ascertaining the correct value of the business. This helps in the event of sale or purchase of a business.
9. **Documentary evidence:** Accounting records can also be used as evidence in the court to substantiate the claim of the business. These records are based on a documentary proof. Every entry is supported by authentic vouchers. As such, courts accept these records as evidence.
10. **Helpful to management:** Accounting is useful to management in various ways. It enables the management to find the achievement of its performance. The weakness of the business can be identified and corrective measures can be applied to remove them with help of accounting.

#### **1.9.2 Limitations of accounting:**

1. **It does not record all events:** Only the transactions of a financial character will be recorded under bookkeeping. So it does not reveal a complete picture of the quality of human resources, location advantage, business contacts.
2. **Does not reflect current values:** The data available under book-keeping is historical in nature. So they do not reflect current values. For instance, we record the value of the stock at cost price or market price, whichever is less.
3. **Estimates based on Personal Judgment:** The estimates used for determining the values of various items may not be correct.
4. **Inadequate information on costs and profits:** Book-keeping only provides information about the overall profitability of the business. No information is given about the cost and profitability of different activities of products or divisions.

## ACCOUNTING EQUATION:

American accountants have derived the rules of debit and credit through accounting equation which is given below:

Assets = Equities

The equation is based on the principle that accounting deals with property and rights to property and the sum of the properties owned are equal to the sum of the rights to the properties. The properties owned by a business are called assets and the rights to properties are known as liabilities or equities of the business.

Equities may be divided into equities of creditors representing debts of the business known as liabilities and equity of the owner known as capital. Keeping in view the two types of equities the equation given above can be stated as below:

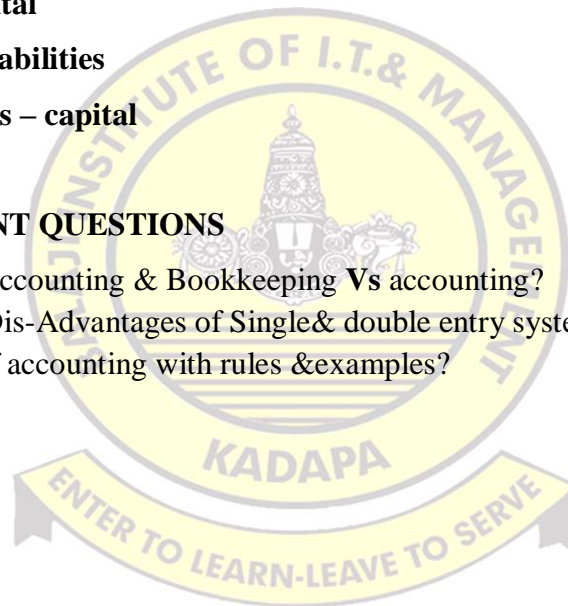
**Assets = liabilities capital**

**Or Capital = assets-liabilities**

**Or Liabilities = Assets – capital**

## UNIT-1 IMPORTANT QUESTIONS

- ✓ Importance, of accounting & Bookkeeping Vs accounting?
- ✓ Advantages & Dis-Advantages of Single& double entry system?
- ✓ Classification of accounting with rules &examples?






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**COMMON COURSE STRUCTURE & SYLLABI**

8. Accounting for Management ,N.P.Srinivasan, &M.ShakthivelMurugan, S.Chand

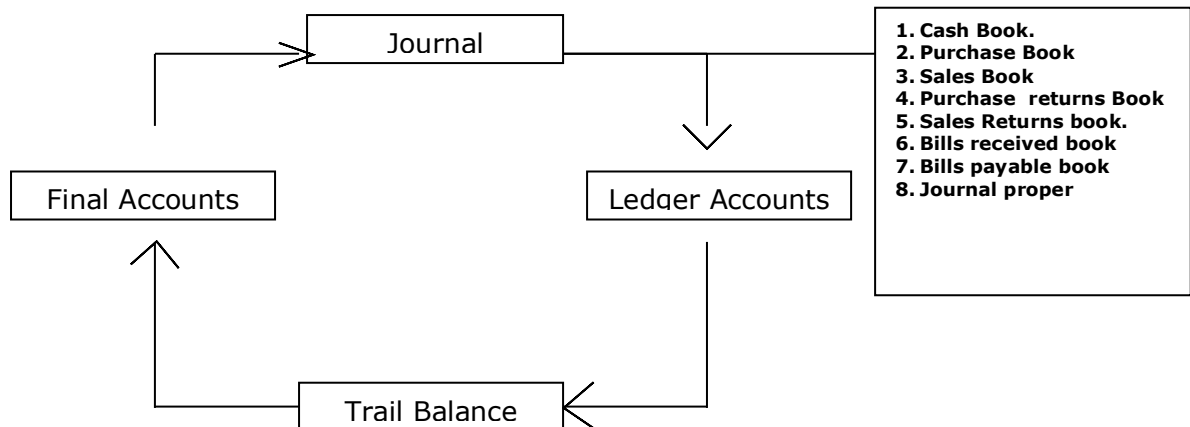
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## UNIT-2

### THE ACCOUNTING PROCESS



#### 2.1. ACCOUNTING OVERVIEW

- Every company needs the accounts department and accounting details of the company. An accounting department is the backbone of every business. It records all the business transactions and keeps a track of the incomes and expenses of the business. The business depends on these incomes for its profits and should know all the expenses that are incurred to keep it going. For the systematic and accurate recording of the transactions, accounting is important. Let us understand the accounting process in detail.

The accounting process can be defined as *"the process that begins when the transaction takes place and ends when the transaction is recorded in the books of accounts"*.

- The accounting process, also known as the accounting cycle process, includes the steps mentioned below. In order to follow these steps, you will need to know all the accounting principles and concepts well.
- The first step involves identifying the transaction and finding the source documents of the transaction.
- Analyze which account affecting and what is the amount of the transaction.
- Record the entry into the journal as a credit or debit, according to its nature.
- Transfer the journal entries into the appropriate accounts in the ledger.
- A trial balance is then created which sees to it that the debit amount equals the credit amounts.

- Prepare the final trial balance on the basis of the closing journal entries.
- Prepare financial statements( Trading and profit & loss account, Balance sheet)

## **2.2. BOOKS OF ORIGINAL RECORD**

**2.1 JOURNAL:** Journal is derived from the French word ‘jour’ which means a day. Journal, therefore, means a daily record of business transactions. Journal is a book of original entry because transaction is first written in the journal from which it is posted to the ledger at any convenient time. The ruling of the journal is as follows:

Journal

Date	Particulars	L.F.	Dr.Amount Rs.	Cr. Amount Rs.
Year Month Date	Name of account to be debited To Name of Account to be credited (Narration)  (A)            (B)			

**Column 1 (date):** the date of the transaction on which it takes place is written in this column. The year is written only in the first entry appearing on each page. This column is divided into two parts: the first part is used for writing the month and the second part is used for writing the date.

**Column2 \_ (particulars):** in this column, the name of the account to be debited is written first and is written close to the line marked (A). The word Dr. is written near the line marked (B). In the next line, the account to be credited is written preceded by the word “To” leaving a few spaces away from the (A). an explanation of the entry known as “narration” is also recorded in this column below the line giving credit to the account.

**Column 3 – (L.F.)** L.F. stands for ledger folio which means the page of the ledger. In this column are entered the page numbers on which the various accounts appear in the ledger.

**Column 4 \_ (Dr. Amount):** in this column, the amount to be debited against the ‘Dr’. The account is written along with nature of currency.

**Column 5\_ (Cr. Amount)** in this column the amount to be credited against the ‘Cr’. The account is written along with the nature of currency.

### **2.2.1.1 points to be noted before journalizing:**

**1. Capital account:** if the proprietor has introduced cash or goods or property in business, it is known as capital. It should be debited to the cash/stock of goods/property account and credited to the proprietor's capital account. It must be clearly understood that the entity of the proprietor is totally different from the business.

**2. Drawings account:** if the proprietor has withdrawn cash or goods from the business for his personal or domestic use, it is called drawings. It should be debited to the drawings account and credited to cash/ purchases account.

**3. Cash/credit transactions:** when goods are purchased or sold for cash, it is known as a cash transaction. If the goods are purchased or sold on credit i.e., the payment will be made or received after some time, it will be a credit transaction. If nothing is mentioned whether it is a credit or cash transaction, then it should be treated as a credit transaction. For example, goods sold to X for Rs.2,000 or goods purchased from Y for Rs. 1,000 etc.

**4. Casts and Carry forwards:** when journal entries extend to several pages of the journal, the totals are cast at the end of each page. At the end of each page the words ' Total C/f' stands for carried forward are written in the particulars column against the debit and credit totals. On the next page, in the beginning the words 'Total b/f' is written in the particulars column against the debit and credit totals. At the end of a specified period or on the last page, the grand total is cast.

**5. Goods are given away as Charity:** if some goods from the business are given away as charity to a particular person or institution, it should be debited to charity account and credited to purchases account.

**6. Compound journal entry:** if there are two or more transactions of a similar nature occurring on the same day and either Dr. or Cr. Account is common, such transactions can be conveniently recorded in the form of one journal entry instead of making a separate entry for each transaction. Such entry is known as a compound journal entry.

**7. Opening entry:** the balances of the previous year are brought forward at the beginning of the year by means of an entry in a going concern. Such entry is made on the basis of accounting equation i.e., by debiting all assets and crediting liabilities and capital account.

**8. Cash Discount:** This discount is allowed by a creditor to a debtor when the latter pays the amount of goods purchased by him either immediately or within a specified period. It is an incentive given to a debtor for making an early payment. Thus if the seller allows 2% discount for payment within a month. On a bill of Rs. 20,000, the customer would pay Rs. 19,600 if the payment is made within a month otherwise he would have to pay Rs. 20,000 i.e., full amount of the bill. This discount is recorded in the books of accounts and a separate account is opened in the ledger. Being a nominal account discount allowed is debited and discount received credited. For examples:

i) **cash received from Mahesh Rs. 1900 and allowed him to discount Rs.100**

Cash A/c	Dr.	1,900	
Discount A/c	Dr.	100	
To Mahesh's A/c			2,000

ii) **Paid to Suresh Rs. 20,000 less 2% cash discount.**

Suresh A/c	Dr.	20,000	
To Cash A/c			19,600
To discount A/c			400
(Cash paid and discount received)			

**9. Trade discount:** it is a deduction on the gross value or list price of goods allowed by the manufacturer to the wholesaler or a wholesaler to a retailer in order to enable them to sell the goods further at list price to the consumer and yet earn a profit. Suppose, a manufacturer produced an article for Rs. 40 may fix Rs,100 as list price and allows 35% discount to the wholesaler. The wholesaler will thus get it at Rs.65 and may sell to the retailer at 20% trade discount. The retailer would thus get it for Rs. 80 and sell to the consumer at Rs. 100. Thus, the manufacturer earns a profit of Rs.25, the wholesaler Rs. 15 and the retailer Rs.20. it is deducted from the invoice or cash memo itself from the gross value of goods and is not recorded at all in the books of account. The journal entry will be passed with the net value of goods. For example, bought goods worth Rs.6,000 from Ram less 20% trade discount.

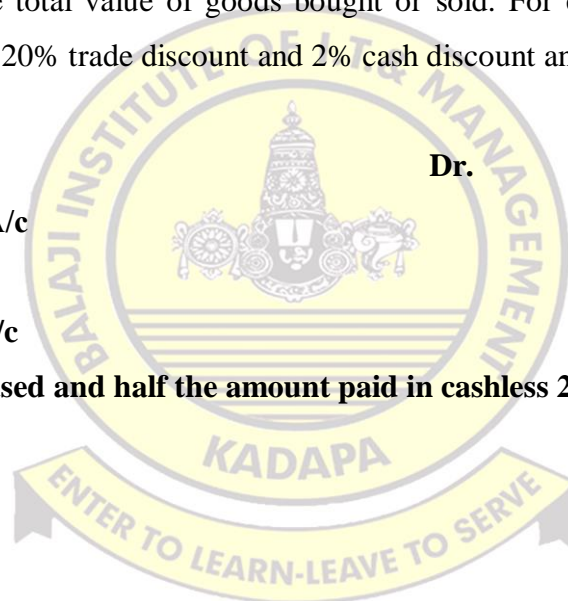
Purchases A/c	Dr.	4,800	
To Ram's A/c			4,800
(For goods purchased from Ram)			

Sometimes the purchaser may get the benefit of both discounts. In such a case, firstly trade discount is calculated on the gross value of goods sold and then the cash discount is calculated on the net value of goods. For example, bought goods worth Rs.6,000 from Ram less 29% trade discount and paid in cash full less 2% cash discount.

<b>Purchases Account</b>	<b>Dr.</b>	<b>4,800</b>
<b>To Cash</b>		<b>4,704</b>
<b>To Discount A/c</b>		<b>96</b>
<b>(For goods purchased for cash and discount received)</b>		

If the payment is made in part then the cash discount is calculated only on the amount paid and not on the total value of goods bought or sold. For example – Bought goods worth Rs.6,000 less 20% trade discount and 2% cash discount and paid half the amount in cash

<b>Purchases A/c</b>	<b>Dr.</b>	<b>4,800</b>
<b>To Supplier's A/c</b>		<b>2,400</b>
<b>To Cash A/c</b>		<b>2,352</b>
<b>To Discount A/c</b>		<b>48</b>
<b>( For goods purchased and half the amount paid in cashless 2% cash discount)</b>		





The following example will clear the accounting process from journalizing to posting transactions in the ledger.

**Example 13:** Journalize the following transactions and post them into ledger:

Date	Particulars
Aug. 1	Deposited ₹40,000 in the company's bank account in exchange for 4000 shares
2	Paid two months' office rent in advance ₹2,200
3	Bought testing equipment on credit ₹6,500
4	Bought office supplies for cash, ₹480
7	Received fees for services provided ₹6,900
13	Ordered testing equipment ₹3,200
16	Paid assistants' salaries for first fortnight ₹2,300
19	Billed customers for services provided ₹9,700
20	Received testing equipment ordered on August 15 and agreed to pay for it on September 5
28	Paid telephone bill for the month ₹390
29	Received cash for services to be provided later ₹2,700
30	Paid assistants' salaries for second fortnight, ₹2,300

You are required to prepare journal entries to record the transactions in the general journal and post entries in ledger on August 31<sup>st</sup>.

**Solution:**

**Journal Entries**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
August 1	Bank A/c Dr. To Share Capital A/c (Being deposited 40,000 in the company's bank account in exchange for 4,000 shares )		40,000	40,000
August 2	Prepaid Office Rent A/c Dr. To Cash A/c (Being paid office rent in advance )		2,200	2,200
August 3	Testing Equipment A/c Dr. To Creditors A/c (Being bought testing equipment on credit)		6,500	6,500
August 4	Office Supplies A/c Dr. To Cash A/c (Being bought office supplies for cash)		480	480
August 7	Cash A/c Dr. To Revenue from Services A/c (Being revenue received from providing services)		6,900	6,900
August 16	Salaries A/c Dr. To Cash A/c (Being paid assistance salaries)		2,300	2,300
August 19	Debtors A/c Dr. To Revenue from Service A/c (Billed customer for services provided)		9,700	9,700
August 20	Testing Equipment A/c Dr. To Creditors A/c (Being received testing equipment which is ordered for 3,200)		3,200	3,200
August 28	Telephone Expenses A/c Dr. To Cash A/c (Being paid telephone bill)		390	390
August 29	Cash A/c Dr. To Advance from Customer A/c (Being cash received for providing later services)		2,700	2,700
August 30	Salaries A/c Dr. To Cash A/c (Being salaries paid for second fortnight)		2,300	2,300
	<b>Total</b>		<b>76,670</b>	<b>76,670</b>



Ledger							
Dr.				Cr.			
Bank Account							
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
August 1	To Share Capital A/c		40,000	August 31	By Balance c/d		40,000
			40,000				40,000
	To Balance b/d		40,000				

Share Capital Account							
Dr.				Cr.			
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
August 31	To Balance c/d		40,000	August 1	By Bank A/c		40,000
			40,000				40,000
					By Balance b/d		40,000

Advance Office Rent Account							
Dr.				Cr.			
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
August 2	To Cash A/c		2,200	August 31	By Balance c/d		2,200
			2,200				2,200
	To Balance b/d		2,200				

Cash Account							
Dr.				Cr.			
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
August 7	To Revenues from Services A/c		6,900	August 2	By Advance Office Rent A/c		2,200
August 29	To Advance from Customer A/c		2,700	August 4	By Office Supplies A/c		480
				August 16	By Salaries A/c		2,300
				August 28	By Telephone Expenses A/c		390
				August 30	By Salaries A/c		2,300
				August 31	By Balance c/d		1,930
			9,600				9,600
	To Balance b/d		1,930				

Testing Equipment Account							
Dr.				Cr.			
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
August 3	To Creditors A/c		6,500	August 31	By Balance c/d		9,700
August 20	To Creditors A/c		3,200				9,700
			9,700				
	To Balance b/d		9,700				

Creditors Account							
Dr.				Cr.			
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
August 31	To Balance c/d		9,700	August 3	By Testing Equipment A/c		6,500
				August 20	By Testing Equipment A/c		3,200
			9,700				9,700
					By Balance b/d		9,700

Office Supplies Account							
Dr.				Cr.			
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
August 4	To Cash A/c		480	August 31	By Balance c/d		480
			480				480
	To Balance b/d		480				

Revenue from Services Account							
Dr.				Cr.			
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
August 31	To Balance c/d		16,600	August 7	By Cash A/c		6,900
				August 19	By Debtors A/c		9,700
			16,600				16,600
					By balance b/d		16,600

Salaries Account							
Dr.				Cr.			
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
August 16	To Cash A/c		2,300	August 31	By Balance c/d		4,600
August 30	To Cash A/c		2,300				4,600
			4,600				
	To Balance b/d		4,600				



Debtors Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr.
	August 19	To Revenue from Services A/c		9,700	August 31	By Balance c/d	9,700
				9,700			9,700
		To Balance b/d		9,700			

Telephone Expense Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr.
	August 28	To Cash A/c		390	August 31	By Balance b/d	390
				390			390
		To Balance b/d		390			

Advance from Customer Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr.
	August 31	To Balance c/d		2,700	August 29	By Cash A/c	2,700
				2,700			2,700
						By balance b/d	2,700

### 2.1.2. Difference between Trade Discount and Cash Discount

The following are the main differences between a trade discount and cash discount.

Basis of Distinction	Trade Discount	Cash discount
1. When allowed	It is allowed on a certain quantity being purchased or as a trade practice.	It is allowed when payment is made before a certain date.
2. Purpose	It is given to promote sales.	It is allowed to encourage early cash payment.
3. Vary with	It may vary with the number of goods purchased.	It may vary with the period within which the payment is to be made.
4. Entry in books	It is not recorded in the books of account.	A separate account in the ledger is maintained for such a discount.
5. Deduction	It is deducted from the Invoice. It is offered at the time of sale or purchase.	It is not deducted from the invoice. It is offered at the time of getting a quick payment.
6. When offered	It is usually given in percentage.	It may be given in percentage or in the absolute figure.
7. Form	it is given on the list price or catalogue price or retail price.	

### 2.2.2 SUBSIDIARY BOOKS:

- Subsidiary Books are those books of original entry in which transactions of similar nature are recorded in one place and in chronological order.

- In a big concern, recording of all transactions in one Journal and posting them into various ledger accounts will be very difficult and involve a lot of clerical work.
- This is avoided by sub-dividing the journal into various subsidiary journals or books.
- The subdivisions of the journal into various subsidiary journals for recording transactions of similar nature are called as ‘Subsidiary Books.

### 2.2.2.1 TYPES OF SUBSIDIARY BOOKS

- 1. Purchases Day Book** – for recording credit purchase of goods only. Cash purchases or assets purchased on credit are not entered in this book.
- 2. Sales Day Book** – for recording credit sales of goods only. Assets sold or cash sales are not recorded in this book.
- 3. Purchases Returns Book** – for recording the goods returned to the suppliers when purchased on credit.
- 4. Sales Returns Books** – for recording goods returned by the customers when sold on credit.
- 5. Bills Receivable Book** – for recording the bills received [Bills Receivables] from customers for credit sales.
- 6. Bills Payables Book** – for recording the acceptances [Bills Payables] given to the suppliers for credit purchases.
- 7. Cash Book** – for all receipts and payments of cash.
- 8. Journal Proper** – for recording any transaction which could not be recorded in the above-mentioned subsidiary books. For example, assets purchased or sold on credit and opening entry, etc., are entered in this book.

Prepare proper subsidiary books from the following data.

Date	Particulars	₹
<b>2014</b>		
April 1	Purchased goods from Sakshi	12,000
April 5	Sold goods to Prakash	15,000
April 8	Bought goods from Shwetha	5,000
April 12	Returned goods to Sakshi	400
April 15	Goods returned to from Prakash	200
April 18	Goods returned to Shwetha	500
April 21	Purchased goods from Sakshi	20,000
April 25	Purchased goods from Shwetha	2,000
April 30	Sold goods to Prakash	5,000
April 30	Returned goods to Sakshi	2,000

#### Purchase Book

Date	Particulars	L.F.	Inward Invoice Number	₹
2014				
April 1	Sakshi			12,000
April 8	Shwetha			5,000
April 21	Sakshi			20,000
April 25	Shwetha			2,000
	<b>Total</b>			<b>39,000</b>

#### Sales Book

Date	Particulars	L.F.	Outward Invoice Number	₹
2014				
April 5	Prakash			15,000
April 30	Prakash			5,000
	<b>Total</b>			<b>20,000</b>

#### Purchase Return Book

Date	Particulars	L.F.	Debit Note	₹
2014				
April 12	Sakshi			400
April 18	Shwetha			500
April 30	Sakshi			2,000
	<b>Total</b>			<b>2,900</b>

#### Sales Return Book

Date	Particulars	L.F.	Credit Note	₹
2014				
April 15	Prakash			200
	<b>Total</b>			<b>200</b>



## Bills Receivable Book

Bills which are written by the trader but accepted by other party (customers) and returned to the trader after acceptance, are known as Bills Receivables and are recorded in a subsidiary book known as Bills Receivable Book/Journal. The rulings such book is as under:

### Proforma

The simplest proforma of Bills Receivable Book is shown below:

#### Bills Receivable Book

S. No.	Date of Receipt	From whom received	Drawer	Acceptor	Where Payable	Date of Bill	Term	Due date	L.F.	Amount	Remarks

## Bills Payable Book

The bills which have been drawn by other parties (suppliers) but accepted by the trader are called Bills Payable for the proprietor because he has to pay these bills on due dates. All such bills are recorded in a separate subsidiary book known as Bills Payable Book. The rulings of such book are as under:

### Proforma

The simplest format of Bills Payable Book is shown below:

#### Bills Payable Book

S. No.	Date of Bill	To whom given	Drawer	Payee	Where Payable	Term of Bill	Due Date	L.F.	Amount	Payment Date	C. B. Folio	Remarks

**Example 12:** Prepare Bills Receivable and Bills Payable Book from the following particulars:

Date	Particulars
2014	
April 5	Hamid accepted the bills for ₹8,000 payable after 3 months.
7	Bills payable accepted from Raja for ₹12,000 payable 2 months.
9	We accepted bills of Anuj for ₹10,000 payable 50 days.
17	Bill for ₹5,000 payable after 4 months accepted by Suraj.
27	Mukesh accepted our bill for ₹9,000 payable after 90 days received.

### Solution:

#### Bills Receivable Book

Date	From whom Received	Term	Due Date	L.F.	₹	Remarks
2014			2014			
April 5	Hamid	3 months			8,000	
17	Suraj	4 months			5,000	
27	Mukesh	90 days			9,000	

#### Bills Payable Book

Date	From whom Received	Term	Due Date	L.F.	₹	Remarks
2014						
April 7	Raja	2 months			12,000	
9	Anuj	50 days			10,000	

**Example 1:** Record the following transactions in Three-column cash book:

2014 Feb., 1 <sup>st</sup>	Commenced business with cash ₹10,000
Feb., 6 <sup>th</sup>	Received a cheque for ₹5,000 for goods sold
Feb., 7 <sup>th</sup>	Issued a cheque for ₹500 furniture purchased
Feb., 8 <sup>th</sup>	Purchased good for ₹3,000 and paid by cheque
Feb., 8 <sup>th</sup>	Received a cheque for ₹490 in settlement of ₹500 on account
Feb., 10 <sup>th</sup>	Paid into Bank of India ₹5,000 received from Rangan
Feb., 15 <sup>th</sup>	Paid wages in cash ₹200
Feb., 18 <sup>th</sup>	Drew a cheque for personal use ₹400
Feb., 25 <sup>th</sup>	Drew for office use ₹250
Feb., 27 <sup>th</sup>	Paid electricity charges in cash ₹15
Feb., 28 <sup>th</sup>	Paid salaries by cheque ₹1,000

**Solution:**

**Three Column Cash Book**

Dr.						Cr.					
Receipts						Payments					
Date	Particulars	L.F.	Discount (₹)	Cash (₹)	Bank (₹)	Date	Particulars	L.F.	Discount (₹)	Cash (₹)	Bank (₹)
2014						2014					
1 Feb	To Capital A/c			10,000		7 Feb	By Furniture A/c				500
6 Feb	To Sales A/c				5,000	8 Feb	By Purchase A/c				3,000
8 Feb	To Debtor A/c		10		490	15 Feb	By Wages A/c			200	
10 Feb	To Rangan A/c				5,000	18 Feb	By Drawing A/c				400
25 Feb	To Bank A/c	(C)*		250		25 Feb	By Cash A/c	(C)*			250
						27 Feb	By Electric Charges A/c			15	
						28 Feb	By Salary A/c				1,000
						29 Feb	By Balance c/d				
			10	10,250	10,490					10,035	5,340
1 <sup>st</sup> March	To balance b/d			10,035	5,340					10,250	10,490

### 2.2.3 LEDGER:

- As we know, the journal records all business transactions separately and date wise.
- The transactions pertaining to a particular person, asset, expense or income are recorded at different places in the journal as they occur on different dates.
- Thus, to have a consolidated view of the similar transactions different accounts are prepared in the ledger.
- A ledger account may be defined as a summary statement of all the transactions relating to a person, asset, expense or income which have taken place during a given period of time and shows their net effect.

### **2.2.3.1 Advantages or merits:**

- It provides complete information about all accounts in one book.
- It is easy to ascertain how much money is due to suppliers (from creditor's ledgers) and how much money is one from customers (from debtors ledgers).
- It enables us to ascertain, what are the main items of revenue or incomes (nominal account).
- It enables to ascertain what are the expenses of the main items (nominal account)
- It enables to know the kind of assets the company holds and their respective values (real account)
- It facilitates the preparation of trial balance and thereafter preparation of financial statements i.e., P&L A/c and balance sheet.

### **2.2.3.2 Differences between Journal and Ledger:**

S.NO	Basis of difference	Journal	Leger
1.	Nature of Book	It is a book of original entry	It is a book of final entry.
2.	Object	It is prepared to record all the transactions in chronological order (date wise)	It is prepared to know the effect of various transactions affecting a particular account.
3.	Basis of Preparation	It is prepared on the basis of transactions.	It is prepared on the basis of the journal.
4.	Stage of recording	Recording in the journal is the first stage.	Recording in the ledger is the second stage.
5.	Balancing	Journal is not balanced	All ledger A/c are balanced.
6.	Narration	Narration is written for each entry.	No narration is given
7.	Format	In the journal, there are 5 columns viz, date, particulars, L.F. Dr and Cr.	In ledger there are 4 columns on debit and credit side viz. date, particulars, journal folio and amount.
8.	Name of the process	The process of recording in a journal is called journalizing.	The process of recording in the ledger is called ledger posting.
9.	Basis of preparation of Final A/c	Journal directly doesn't serve as the basis for preparation of final account.	Ledger serves the basis for the preparation of final accounts.



### **2.2.4 TRIAL BALANCE:**

- The agreement of the trial balance reveals that both the aspects of each transaction have been recorded and that the books are arithmetically accurate.
- If the trial balance does not agree, it shows that there are some errors that must be detected and rectified if the correct final accounts are to be prepared.
- Thus, trial balance forms a connecting link between the ledger accounts and the final accounts.

#### **2.2.4.1 Preparation of trial balance:**

1. Total method: in this method, the debit and credit totals of each account are shown in the two amount columns against it.
2. Balance method: in this method, the difference of each account is extracted. If the debit side of an account is bigger in amount than the credit side, the differences are put in the debit column of the trial balance and if the credit side is bigger, the difference is written in the credit columns of the trial balance.

Trial balance can be prepared on a loose sheet having four columns. A specimen is given as follows:

Trial balance of - - - - As on - - - -

Serial No.	Name of the account	Dr. Balance (or Total ) Rs.	Cr. Balance (or Total) Rs.

Of the two methods of preparation, the second is usually used in practice because it facilitates the preparation of the final accounts

A trial balance can be prepared by the following two methods:

1. Total method: in this method, the debit and credit totals of each account are shown in the two amount columns (one for the debit total and the other for the credit total) against it.
2. Balance method: in this method, the difference of each account is extracted. If the debit side of an account is bigger in amount than the credit side, the difference is put in the debit column of the trial balance and if the credit side is bigger, the difference is written in the credit column of the trial balance.

Of the two methods of preparation, the second is usually used in practice because it facilitates the preparation of the final accounts.



### 2.2.4.2 Specimen of trial balance

Particulars	Debit (Assets & Expenditure) Rs.	Credit (Liabilities & Incomes) Rs.
Capital		XXX
Purchases	XXX	
Purchase returns		XXX
Sales		XXX
Sales returns	XXX	
Carriage	XXX	
Wages	XXX	
<b>All expenses and losses</b>	XXX	
Direct and indirect expenses		
<b>All incomes and gains</b>		
<b>All assets</b>	XXX	
Current assets, fixed assets, intangible assets, and fictitious assets.		
<b>All liabilities</b>		XXX
Current liabilities, long-term liabilities etc.	XXX	
Discount allowed		XXX
Discount received	XXX	
Drawings	XXX	
Taxation paid	XXX	
Dividend paid	XXX	
Bad debts and reserves	XXX	
Suspense A/c		
	XXX	XXX

**Example** : A book-keeper drew-up the following Trial Balance for the year ended 31<sup>st</sup> December 2013:

Heads of Accounts	L.F.	Dr. (₹)	Cr. (₹)
Capital A/c		-	30,000
Drawings A/c		5,000	-
Purchases A/c		16,000	-
Sales A/c		-	45,000
Returns Inwards A/c		-	3,000
Returns Outwards A/c		2,000	-
Carriage Inwards A/c		1,000	-
Carriage Outwards A/c		-	2,000
Bank Overdraft A/c		6,000	-
Provision for Bad Debts A/c		3,000	-
Discount Allowed A/c		-	1,000
Discount Received A/c		2,000	-
General Expenses A/c		5,000	-
Plant and Machinery A/c		10,000	-
Sundry Debtors A/c		8,000	-
Sundry Creditors A/c		-	5,000
Opening Stock A/c		4,000	-
Cash in hand A/c		8,000	-
Dividend Received		-	4,000
Goodwill A/c		17,000	-
		<b>87,000</b>	<b>90,000</b>

**You are required to:**

Draw up a corrected Trial Balance after transferring the errors to Suspense Account.

**Solution:**

In the books of .....

**Trial Balance**

(as at 31<sup>st</sup> December 2013)

Heads of Accounts	L.F.	Dr. (₹)	Cr. (₹)
Capital A/c		-	30,000
Drawings A/c		5,000	-
Purchases A/c		16,000	-
Sales A/c		-	45,000
Returns Inwards A/c		3,000	-
Returns Outwards A/c		-	2,000
Carriage Inwards A/c		1,000	-
Carriage Outwards A/c		2,000	-
Bank Overdraft A/c		-	6,000
Provision for Bad Debts A/c		-	3,000
Discount Allowed A/c		1,000	-
Discount Received A/c		-	2,000
General Expenses A/c		5,000	-
Plant and Machinery A/c		10,000	-
Sundry Debtors A/c		8,000	-
Sundry Creditors A/c		-	5,000
Opening Stock A/c		4,000	-
Cash in hand A/c		8,000	-
Dividend Received A/c		-	4,000
Goodwill A/c		17,000	-
Suspense A/c		17,000	-
		<b>97,000</b>	<b>97,000</b>

**Example :** Prepare Trial balance from the following:

Capital ₹50,000; Sales ₹25,000; Opening stock 5,200; Debtors ₹2,500; Creditor ₹1,000; Purchases ₹20,000; Salaries ₹2,000; Rent ₹1,500; Cash ₹2,000; Insurance ₹300; Drawing ₹10,000; Plant ₹28,000, and Bank ₹4,500.

**Solution:**

Trial Balance			
Particulars	L.F.	Dr. (₹)	Cr. (₹)
Capital		-	50,000
Sales		-	25,000
Opening stock		5,200	-
Debtors		2,500	-
Creditors		-	1,000
Purchases		20,000	
Salaries		2,000	
Rent		1,500	
Cash		2,000	
Insurance		300	
Drawings		10,000	
Plant		28,000	
Bank		4,500	
<b>Total</b>		<b>76,000</b>	<b>76,000</b>

## 2.3.FINAL ACCOUNTS

- Two main objectives of maintaining accounts are to find out the profit or loss made by the business at the end of regular periodic intervals and to ascertain the financial position of the business on a given date.
- Final accounts are prepared to achieve the objectives of accountancy.
- In order to know the profit or loss earned by a firm, Income Statement or Trading and Profit and Loss account is prepared.
- Balance Sheet or Position Statement will portray the financial condition of the firm on a particular date. These two statements, i.e., Trading and Profit & Loss Account and Balance Sheet are prepared to give the final results of the business, that is why both these are collectively called as final accounts.

Thus, final accounts include the preparation of :

- I. Trading and Profit and Loss Account; and
- II. Balance Sheet.



### **2.3.1 TRADING ACCOUNT**

<b>Particulars</b>	<b>Amount Rs.</b>	<b>Particulars</b>	<b>Amount Rs.</b>
To Opening Stock To Purchases Less: Purchase Returns To Direct Expenses To Carriage Inward To Wages To Wage and Salaries To Fuel and Power To Manufacturing or Production Expenses. To Coal, Water, and Gas To Motive Power To Factory Lighting To Octroi To Import Duty To Custom Duty To Excise Duty To Consumable Stores To Foreman/Works Manager's Salary To Factory Rent, Rated and Taxes To Royalty on Manufactured Goods To Gross Profit C/d		By Sales Less: Sales Returns By Closing Balance By Gross Loss C/d	
	<b>XXXX</b>		<b>XXXX</b>

**2.3.2 PROFIT AND LOSS ACCOUNT:** This account is prepared to calculate the net profit of the business.

**The specimen of profit and loss A/c, For the year ended 31<sup>st</sup> March 2000**

<b>To Gross Loss b/d</b> <b>To Selling and Distribution</b> Expenses: Advertisement Travelers' Salaries, Expenses & Commission Bad Debts Carriage Outward Bank charges Agent's Commission Upkeep of Motor Lorries <b>To Management Expenses:</b> Rent, Rates, and Taxes Heating and Lighting office Salaries Printing & Stationery Postage & Telegrams Telephone Charges Legal Charges Audit Fees Insurance General Expenses <b>To Depreciation and</b> Maintenance: Depreciation Repairs & Maintenance <b>Financial Expenses:</b> Discount Allowed Interest on Capital Interest on Loans Discount on Bills Discounted <b>To Extraordinary Expenses:</b> Loss by fire (not covered by Insurance) Cash Defalcations <b>To Net Profit transferred to          Capital A/c*</b>	Rs.	<b>By Gross Profit b/c</b> By Interest Received By Discount Received By Commission Received By Rent From Tenants Received By Income from Investments By Apprenticeship Premium By Interest on Debentures By Income from any other Source By Miscellaneous Revenue Receipts By Net Loss transferred to Capital A/c*	

\* **Balancing figure will be either net profit or a net loss.**

### **2.3.3 BALANCE SHEET**

- A balance sheet is a statement prepared with a view to measure the financial position of a business on a certain fixed date.
- The financial position of concern is indicated by its assets on a given date and its liabilities and that date.
- Excess of assets over liabilities represent the capital and is indicative of the financial soundness of a company; a balance sheet is also described as a 'statement showing the sources and application of capital'.
- It is a statement and not an account and prepared from real and personal accounts.
- The left-hand side of the balance sheet may be viewed as a description of the sources from which the business has obtained the capital with which it currently operates and the right-hand side as a description of the form in which that capital is invested on a specified date.
- On the left-hand side of the balance sheet, the several liability items described how much capital was obtained from trade creditors, from banks, from bill holders and other outside parties. The owner's equity section shows the capital supplied by the owner.

#### **Grouping and Marshalling of Assets and Liabilities:**

<i>Liabilities</i>	<i>Amount Rs.</i>	<i>Assets</i>	<i>Amount Rs.</i>
<b>Current Liabilities:</b> Bills Payable Sundry Creditors Bank Overdraft <b>Long Term Liabilities:</b> Loan from Bank Loan from Wife <b>Fixed Liabilities:</b> Capital		<b>Liquid Assets:</b> Cash in Hand Cash at Bank <b>Floating Assets:</b> Sundry Debtors Investments Bills Receivable Stock in Trade Prepaid Expenses <b>Fixed Assets:</b> Machinery Building Furniture & Fixtures Motor Car <b>Intangible Assets:</b> Goodwill Patents Copyright Licenses <b>Fictitious Assets:</b> Advertisement Misc. Expenses (to the extent not written off) Profit & Loss A/c	



### **2.3.4 Treatment of items appearing in the trial balance:**

<b>Items</b>	<b>Profit &amp; loss account</b>	<b>Balance sheet</b>
1. closing stock	_____	Shown in the asset side of balance sheet.
2. outstanding expenses or accrued expenses	_____	Shown in the liability side of the balance sheet.
3. prepaid expenses	_____	Shown in the asset side of the balance sheet
4. Accrued income	_____	Shown in the asset side of the balance sheet.
5. unearned income	_____	Shown in the liability side of the balance sheet.
6. Depreciation	Shown in the Dr side of Profit & Loss account	_____
7. Interest on capital	Shown in the Dr side of Profit & Loss account	_____
8. drawings	_____	Less from the capital on the balance sheet liabilities side

**Example :** From the following balances extracted from the books of R and Co. prepare Trading and Profit and Loss account and Balance sheet.

Particulars	₹	Particulars	₹
Opening Stock	1,250	Plant and Machinery	6,230
Sales	11,800	Purchase Returns	1,380
Depreciation	700	Cash	1,195
Commission received	200	Salaries Paid	750
Insurance Premium	380	Debtors	2,905
Carriage Inwards	300	Discount Paid	300
Furniture	2,670	Bills receivables	3,250
Printing and Stationery	481	Wages	1,589
Carriage Outwards	200	Sales Returns	1,659
Capital	9,004	Bank Overdraft	6,000
Creditors	3,300	Purchases	8,679
Bills payable	1,084	Petty cash	50
Bad Debts	180		

Value of the stock as on 31st December 2013 was 3,700.

**Solution:**

Trading and Profit and Loss Account for the year ended 31 <sup>st</sup> December, 2013)			
Dr.			Cr.
Particulars	₹	Particulars	₹
To Opening Stock	1,250	By Sales	11,800
To Purchases	8,679	Less: Sales Returns	<u>1,659</u>
Less: Purchase Return	<u>1,380</u>	By Closing Stock	3,700
To Wages	1,589		
To Carriage Inwards	300		
To Gross Profit c/d	3,403		
	<u>13,841</u>		<u>13,841</u>
To Depreciation	700	By Gross Profit b/d	3,403
To Insurance	380	By Commission	200
To Printing and Stationery	481		
To Carriage outward	200		
To Salaries	750		
To Discount	300		
To Bad Debts	180		
To Net Profit	612		
	<u>3,603</u>		<u>3,603</u>

**Balance Sheet**  
(as on 31<sup>st</sup> December, 2013)

Liabilities	₹	Assets	₹
Bills Payable	1,084	Cash	1,195
Creditors	3,300	Petty cash	50
Bank Overdraft	6,000	Bills Receivable	3,250
Capital	9,004	Debtors	2,905
Add: Net Profit	<u>612</u>	Closing Stock	3,700
	9,616	Plant and Machinery	6,230
		Furniture	2,670
	<u>20,000</u>		<u>20,000</u>

**2.4. FINAL ACCOUNTS WITH ADJUSTMENTS :** Every adjustment item will come two times or three times. In the final accounts all trial balance items will come only one time in the final accounts. **Treatment of adjustment items in the final accounts:**

Adjustments	Trading account	Profit & loss account	Balance sheet
1. closing stock	Shown in the Cr side of the trading account.		Shown in the asset side
2.outstanding expenses		Shown in the Dr side of trading or profit & loss account by way of addition to the concern expenses.	The liability side of the balance sheet
3.unexpired or prepaid expenses		Shown in the Dr profit and loss account by the way of deduction from concern expenses.	Shown on the asset side of the balance sheet.
4.Accrued income		Showing in the Cr profit & loss account by the way of addition concerning.	Shown on the addition to the asset side balance sheet.
5. Income received in advance		It is shown on the profit and loss account by the way of deduction from concern income.	Shown on the liabilities side of the balance sheet.
6. Depreciation	Shown on the Dr side of Profit and loss account.		Shown on the asset side by way of deduction from the concerned asset.
7. Interest on capital		Shown in the Dr side of profit & loss account	Shown on the liabilities side of the balance sheet by way of adding to the capital.
8.Interest on drawings		Shown on the “cr” side of profit & loss account	Shown on the liabilities side of the balance sheet by way of addition to the drawings which are ultimately redacted from the capital
9.Provision of doubtful debts		Shown on the “Dr” side of P/L account or by way of addition to bad debts (old provision for doubtful debts at the	Shown on the assets side by way of deduction from the sundry debtors ( after deduction of further bad debts) if any



		beginning of the year will be deducted)	
10.Provision for discount on debtors		Shown on the "Dr" side of P/L account	Shown by way of deduction from sundry debtors (after deduction of further bad debts & provision for doubtful debts) on the asset side of the balance sheet
11.additional bad debts		Shown on the "Dr" side by way of addition to the bad debts	Shown the assets side by way of deduction from the amount of sundry debtors.
12.Reserve for a discount on creditors		Shown on the Cr side of P/L account	Shown on the liabilities side of the balance sheet by way of deduction from sundry creditors.
13.Deferred Revenue Expenditure		Shown on the "Dr" side of P/L account (some proportionate amount on deferred revenue expenses)	Shown on asset side by way of deduction from the capitalized expenditure.
15. bad debts		Shown on the debit side of Profit & loss account.	Shown on the assets side of the B/S by way of deduction from sundry debtors.
16.(Interest On Loan)hidden adjustments		Shown on the Dr side of the P/L account by way of addition to the interest on the loan.	Shown on the liabilities side of the balance sheet by way of addition to the loan account.

#### Illustration 8 :

From the following Trial Balance of Ramesh, prepare Trading and Profit & Loss Account for the year ending 31<sup>st</sup> March 2010 and Balance Sheet as on that date.

#### Trial Balance of Ramesh as on 31<sup>st</sup> March 2010

Particulars	Dr (₹)	Cr (₹)
Buildings	50,000	
Capital		96,000
Purchases & Sales	15,000	40,450
Opening Stock ( 1/4/2009 )	8,000	
Debtors & Creditors	10,000	5,000
Drawings	3,500	
Sales Returns & Purchase Returns	1,000	500
Freight	3,250	
Office Salaries	10,000	
Wages	1,200	
Postage & Telegrams	1,000	
Machinery	20,000	
Bills Receivable & Bills Payable	9,000	3,000
Advertisement	4,000	
Cash in Hand	5,000	
Loose Tools	4,000	
	1,44,950	1,44,950

### Adjustments :

1. Closing Stock was valued at Rs 10,000
2. Depreciate Building by 5% and Loose Tools are revalued at ₹3,500
3. Interest on Capital is at 5% and on Drawings is at 10%

### Solution :

Trading and Profit & Loss Account of Ramesh for the year ending 31.03. 2010

Particulars	₹	Particulars	₹
To Opening Stock	8,000	By Sales	40,450
To Purchases	15,000	Less : Returns	<u>1,000</u>
Less : Returns	<u>500</u>		39,450
	14,500	By Closing Stock	10,000
To Freight	3,250		
To Wages	1,200		
To Gross Profit c/d	22,500		
	<u>49,450</u>		<u>49,450</u>
To Office Salaries	10,000	By Gross Profit b/d	22,500
To Postage & Telegrams	1,000	By Interest on Drawings	350
To Advertisement	4,000	(@ 10% on Rs. 3,500)	
To Depreciation :			
Building	2,500		
Loose Tools (4,000 - 3,500)	500		
To Interest on Capital			
96000 * 5/100	4,800		
To Net Profit	50		
	<u>22,850</u>		<u>22,850</u>

### Balance Sheet of Ramesh as on 31<sup>st</sup> March, 2010

Liabilities	₹	₹	Assets	₹	₹
Capital	96,000		Cash in Hand		5,000
Add : Interest (5%)	4,800		Machinery		20,000
	<u>1,00,800</u>		Buildings	50,000	
Add : Net Profit	50		Less : Depreciation (5%)	<u>2,500</u>	47,500
	<u>1,00,850</u>		Loose Tools	4,000	
Less : Drawings	3,500		Less : Depreciation	<u>500</u>	3,500
	<u>350</u>				
Less : Interest on Drawings		97,000	Sundry Debtors		10,000
Sundry Creditors		5,000	Bills Receivable		9,000
Bills Payable		3,000	Closing Stock		10,000
		<u>1,05,000</u>			<u>1,05,000</u>



**Example :** The following balances were extracted from the books of Mohan on 31-12-2013:

Particulars	₹	Particulars	₹
Capital Account	9,000	Purchases	15,000
Furniture	800	Carriage Outwards	200
Creditors	1,600	Salaries	2,000
Premises	13,000	Sales	18,000
Bad Debts	80	Rent Received	800
Cash	40	Discount Allowed	180
Drawings	900	Loan	4,000
Overdraft at Bank	905	Reserve for Bad Debts	100
Debtors	1,500	Expenses	705

**Adjustments:**

- 1) Make provision for bad debts @ 3%.
- 2) Salary due ₹200.
- 3) Stock on 31-12-2013 ₹3,500.
- 4) Write-off 10% from furniture for depreciation.
- 5) Due from tenants rent ₹100.

**Solution:**

**Trading and Profit and Loss Account**  
(for the year ending 31-12-2013)

Dr.	Particulars	₹	Cr.	Particulars	₹
To Purchases		15,000	By Sales		18,000
To Gross Profit c/d		6,500	By Closing Stock		3,500
		<b>21,500</b>			<b>21,500</b>
To Salaries	2,000		By Gross Profit b/d		6,500
Add: Outstanding	200	2,200	By Rent	800	
To Discount Allowed		180	Add: Outstanding	100	900
To Bad Debts	80				
Add: Provision for Bad Debts	45				

Less: Old Reserve	100	25	
To Carriage Outward		200	
To Depreciation on Furniture		80	
To Expenses		705	
To Net Profit (Transferred to Capital)		4,010	
		<b>7,400</b>	<b>7,400</b>

**Balance Sheet**  
(as on 31-12-2013)

Liabilities	₹	Assets	₹
Creditors	1,600	Cash	40
Bank Overdraft	905	Stock	3,500
Outstanding Salary	200	Debtors	1,500
Loan	4,000	Less: Provision for Bad Debts	45
Capital	9,000		1,455
Add: Net Profit	4,010	Rent Outstanding	100
	13,010	Premises	13,000
Less: Drawings	900	Furniture	800
	<b>12,110</b>	Less: Depreciation	80
	<b>18,815</b>		<b>720</b>
			<b>18,815</b>

**Example :** The account balances of M/s XYZ as on 31.12.13 are as follows:

Purchases	1,62,505	Postage	4,226	Sales	2,52,600
Debtors	50,200	Power	1,350	Bad Debt Reserve	5,200
Opening Stock	26,725	Trade Expenses	5,831	Creditors	30,326
Wages	23,137	Bad debts	525	Bills Payable	3,950
Salaries	5,575	Cash	10,000	Outstanding wages	2,000
Furniture	7,250	Drawings	4,452	Outstanding salaries	700
				Capital	10,000

Loan to Ram @ 10% on 1.9.13 3,000

Prepare trading, P&L A/c and Balance Sheet considering the following:

- 1) Depreciation on furniture @ 10% p.a.
- 2) Bad debts ₹500 and provision for bad debt to be maintained is 5%.
- 3) Goods costing ₹1,500 destroyed by fire and insurance claim has been admitted for ₹1,000.
- 4) Closing stock as on 31.12.13 is ₹12,250.

**Solution:**

**Trading and Profit & Loss Account**  
(for the year ending 31.12.2013)

Dr.			Cr.	
Particular		₹	Particular	₹
To Opening Stock		26,725	By Sales	2,52,600
To Purchase	1,62,505		By Closing Stock	12,250
<b>Less: Loss by Fire</b>	<u>1,500</u>	1,61,005		
To Wages		23,137		
To Power		1,350		
To Gross Profit c/d		52,633		
		<b>2,64,850</b>		<b>2,64,850</b>
To Salary		5,575	By Gross Profit b/d	52,633
To Postage		4,226	By Bad Debts Reserve	5,200
To Trade Expenses		5,831	By Interest on Loan	100
To Bad Debts	525			
<b>Add: New Bad Debts</b>	<u>500</u>			
<b>Add: Provision for Bad Debts</b>	<u>2,485</u>	3,510		
To Depreciation on Furniture		725		
To Accidental Loss (1,500 – 1,000)		500		
To Net Profit		3,75,66		
		<b>57,933</b>		<b>57,933</b>

**Balance Sheet**



(as on 31<sup>st</sup> December 2013)

Liabilities		₹	Assets		₹
Capital	10,000		Cash		10,000
Add: Net Profit	3,75,66		Debtors	50,200	
			Less: Bad Debts	500	
	4,75,66			49,700	
Less: Drawing	4,452	43,114	Less: Provision for Bad Debts	2,485	47,215
Creditors		30,326	Furniture	7,250	
Bills Payable		3,950	Less: Depreciation @ 10%	725	
Outstanding Wages		2,000	Loan to Ram	3,000	6,525
Outstanding Salaries		700	Add: Accrued Interest	100	3,100
			(3,000 * 10% * 4/12)		
			Closing Stock		12,250
			Insurance Claim		1,000
		80,090			80,090

## 2.5. ACCOUNTING PRINCIPLES

Accounting principles

a) ACCOUNTING CONCEPTS

b) ACCOUNTING CONVENTIONS

### a) ACCOUNTING CONCEPTS:

- 1. Money measurement Concept:** This means that the accounting record is made only of those transactions, which can be measured and expressed in terms of money.
- 2. Business Entity Concept:** Accounting assumes that business is a separate entity distinct from its owner under this concept. Business is treated like a legal person owning assets, liabilities without such restrictions the affairs of the business will be mixed with the private affairs and entire picture of the business.

3. **Going Concern Concept:** It means that in accounting a concern that will continue to operate for an indefinitely long period of time.
4. **Cost Concept:** This concept states that assets are recorded at the actual cost to the business and not the market values or some other imaginary values.
5. **Dual Aspects Concept:** Every business transaction involves a dual or double aspect of equal value is called dual aspect concept. The accounting equation is

**Assets – Liabilities + Capital**

6. **Accounting Period Concept:** It means that measuring the financial results of business periodically. The business working life is split into convenient short period of time is called accounting period. The financial position of the business is ascertained at the end of the accounting period by preparing financial statements.
7. **Objective Evidence Concept:** It means that all accounting entities should be evidenced and supported by source documents such as invoice, vouchers, etc.,
8. **Revenue Realization Concept:** It means that revenue is earned by sales of goods or from provisions of services to customers and revenue is to be recognized or considered to be realized only when goods or services transferred to a customer and the customer becomes legally liable to pay for it.
9. **Accrual Concept:** This concept means that when a transaction has been entered into its consequences will certainly follow so all transaction must be brought into record whether they are settled in cash or not.
10. **Matching Concept:** Expenses incurred in the accounting period should be matched with revenue realized in that period. Thus if revenue is realized on goods sold in a period all expensed attributable to that sales should be recorded in that period.

**b) ACCOUNTING CONVENTIONS:**

1. **Full disclosure concept:** This concept deals with the convention that all information which is of material importance should be disclosed in the accounting statements. The companies act, 1956 makes it compulsory to provide all the information in the prescribed form. The accounting reports should disclose full and fair information to the proprietors, creditors, investors, and others. This convention is especially significant in the case of big businesses like Joint Stock Company where there is divorce between the owners and the managers.



- 2. Materiality concept:** Under this concept, the trader records important facts about commercial activities in the form of financial statements. If any unimportant information is to be given for the sake of clarity, it will be given as footnotes.
- 3. Consistency concepts:** The methods or principles followed in the preparation of various accounts should be followed in the years to come. It means that there should be consistency in the methods or principles followed. Or else, the results of one year cannot be conveniently compared with that of another. For example, a company may adopt straight-line method, written down value method, or any other method of providing depreciation on fixed assets. But it is expected that the company follows a particular method of depreciation consistently.
- 4. Conservatism concept:** This convention warns the trader not to take unrealized income into account. That is why the practice of valuing stock at cost or market price, whichever is lower is in vogue. This is the policy of “playing safe”. It takes into consideration all prospective losses to leaves all prospective profits. The convention of conservatism should be applied cautiously so that the results reported are not distorted. Some degree of conservatism is inevitable where objective data is not available.

## **UNIT-2- IMPORTANT QUESTION**

- ✓ Define accounting process. Elucidate the Accounting process/cycle
- ✓ How to prepare ledger, trial balance & final accounts explain with steps?
- ✓ How to post-adjustment items in final accounts:  
Outstanding expenses, b. Prepaid expenses, c. Depreciation, d. Interest on capital, e. Drawings.
- ✓ Briefly write about accounting principles or concepts & conventions.

**Problems:** JOURNAL, LEDGER, TRAIL BALANCE & FINAL ACCOUNTS(Trading & Profit & loss A/C, Balance sheet)


**JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY ANANTAPUR**

(Established by Govt. of A.P., ACT No.30 of 2008)

**ANANTHAPURAMU – 515 002 (A.P) INDIA**
**MASTER OF BUSINESS ADMINISTRATION  
MBA; MBA (General Management); MBA (Business Management)  
COMMON COURSE STRUCTURE**

Course Code	FINANCIAL ACCOUNTING FOR MANAGERS	L	T	P	C
21E00104		4	0	0	4
Semester		I			
Course Objectives:					
<ul style="list-style-type: none"><li>To introduce accounting , accounting rules, accounting process and preparation of financial statements.</li><li>To explain methods of valuation of assets,</li><li>To explore the meaning and interpretation of financial statements through ratio analysis technique.</li></ul>					
Course Outcomes (CO): Student will be able to					
<ul style="list-style-type: none"><li>Prepare the financial statements with accounting knowledge</li><li>Value the assets of the business organizations under different methods</li><li>Analyse the financial performance and position of the business organization and interpret the results from the point of company and investor</li></ul>					
UNIT - I	Lecture Hrs: 8				
Introduction to Accounting: Definition, Importance, Objectives and principles of accounting, uses of accounting and book keeping Vs Accounting, Single entry and Double entry systems, classification of accounts – rules of debit & credit. (Only theory)					
UNIT - II	Lecture Hrs: 12				
The Accounting Process: Overview, Books of Original Record; Journal and Subsidiary books, ledger, Trial Balance, Final accounts: Trading accounts- Profit & loss accounts- Balance sheets with adjustments. (Problems on Only Final Accounts)					
UNIT - III	Lecture Hrs:12				
Valuation of Assets: Introduction to Depreciation- Methods (Simple problems from Straight line method, Diminishing balance method and Annuity method). Inventory Valuation: Methods of inventory valuation (Simple problems from LIFO, FIFO).					
UNIT - IV	Lecture Hrs:12				
Financial Analysis -I Analysis and interpretation of financial statements from investor and company point of view, Liquidity, leverage, solvency and profitability ratios – Du Pont Chart (A Case study on Ratio Analysis).					
UNIT - V	Lecture Hrs:12				
Financial Analysis-II: Objectives of fund flow statement - Steps in preparation of fund flow statement, Objectives of Cash flow statement- Steps in Preparation of Cash flow statement – Analysis of Cash flow and Funds flow statements - Funds flow statement Vs Cash flow statement. (Only theory).					
Textbooks:					
<ul style="list-style-type: none"><li>Financial Accounting, Dr.S.N. Maheshwari and Dr.S.K. Maheshwari, Vikas Publishing House Pvt. Ltd.,</li><li>Accountancy .M P Gupta &amp;Agarwal ,S.Chand</li></ul>					
Reference Books:					
<ul style="list-style-type: none"><li>Financial Accounting ,P.C.Tulisan ,S.Chand</li><li>Financial Accounting for Business Managers, Asish K. Bhattacharyya, PHI</li><li>Financial Accounting Management An Analytical Perspective, Ambrish Gupta, Pearson Education</li><li>Accounting and Financial Management, Thukaram Rao, New Age Internationals.</li><li>Financial Accounting Reporting &amp; Analysis, Stice&amp;Stice, Thomson</li><li>Accounting for Management, Vijaya Kumar,TMH</li><li>Accounting for Managers, Made Gowda, Himalaya</li></ul>					



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**COMMON COURSE STRUCTURE & SYLLABI**

8. Accounting for Management ,N.P.Srinivasan, &M.ShakthivelMurugan, S.Chand

**Online Learning Resources:**

[https://onlinecourses.swayam2.ac.in/cec20\\_mg02/preview](https://onlinecourses.swayam2.ac.in/cec20_mg02/preview)  
[https://onlinecourses.swayam2.ac.in/imb19\\_mg06/preview](https://onlinecourses.swayam2.ac.in/imb19_mg06/preview)  
[https://onlinecourses.nptel.ac.in/noc19\\_mg37/preview](https://onlinecourses.nptel.ac.in/noc19_mg37/preview)  
<https://www.coursera.org/learn/wharton-accounting>

## UNIT-3

### VALUATION OF ASSETS

#### 3. INTRODUCTION TO DEPRECIATION

**3.1 Valuation of fixed assets:** The broad meaning of Valuation of fixed assets is Valuation of Land, Building, Plant and Machinery, etc.

Valuation of Fixed Assets is undertaken as per the client's requirement. Sometimes Financial Institutions, Banks & Customs authorities also need valuation reports for certain specific assets.

**Definition of 'Asset Valuation:** A method of assessing the worth of a company, real property, security, antique or other item of worth. Asset valuation is commonly performed prior to the sale of an asset or prior to purchasing insurance for an asset.

##### **3.1.1 What is the Difference between Tangible and Intangible Assets?**

- In the world of accounting, understanding the difference between tangible and intangible assets is very important to keep track of a company's property. A tangible asset is anything that has a physical existence, meaning that it can actually be seen or felt by a person. An intangible asset is anything that a company owns that does not have a physical existence, meaning things like information and company logos. Both types of assets are very important parts of a company, and accountants need to be able to recognize both types of these assets.
- One type of tangible assets are known as long-term assets. These are physical things that a company owns and expects to have for a long period of time. The most common examples of these types of assets include land, equipment, and buildings. Over time, all of these assets, except for land, have to be depreciated by an accountant working for the company. This means that they are not worth as much as time goes on as they were originally purchased for.
- Buildings and equipment used by the company are depreciated as time passes. Additionally, companies incur other costs that have to be factored in to their balance sheet. For example, some building costs include the original price of the purchase of the building, any taxes that the company had to pay when purchasing the building, any kind of fees for attorneys and realtors, and any potential costs of having to fix up



or maintain the building. Some equipment costs include the original price that the equipment was bought for, any taxes that had to be paid to purchase the equipment, the costs incurred for installing the equipment, and if the item was delivered, the cost for delivery.

- Land is different from other tangible assets in that it does not depreciate, but instead is held to its historical cost. This means that it remains at the same price on the balance sheet whether the appraisal value goes up or down. It also sees some of the same additional costs as buildings and equipment do. For example, in addition to the price that the land was purchased for, companies have to factor in any potential taxes and any potential fees for people involved with the purchase.

### **3.1.2 Concept of Depreciation:**

a) **Depreciable asset.** These are assets which

- i) are expected to be used during more than one accounting period: and
- ii) have a limited life ; and
- iii) are held by an enterprise for use in the production or supply of goods and services for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

b) **Useful life.** This is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production of similar units expected to be obtained from the use of the asset by the enterprise.

The useful life of a depreciable asset is shorter than its physical life and is:

- (i) pre-determined by legal or contractual limits such as the expiry dates of related lease ;
- (ii) directly governed by extraction or consumption ;
- (iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repairs and maintenance policy of the enterprise etc.,
- (iv) Reduced by obsolescence arising from such factors as technological changes, improvement in production methods, change in market demand for the product or service, output of the asset or legal or other restrictions.

**(c) Depreciable Amount.** The amount of depreciable asset is its historical cost, or other amount substituted for historical cost in financial statements, less the estimated residual value.

**(d) Residual Value.** Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset.

### 3.1.3 Cause of depreciation

The following are the main causes of depreciation:

- (i) **Physical Deterioration.** It is caused mainly from wear and tear when the asset is in use and from erosion, rust, rot and decay from being exposed to wind, rain sun and other elements of nature.
- (ii) **Economic Factors.** These may be said to be those that cause the asset to be put out of use even though it is in good physical condition. These arise due to obsolescence and inadequacy. *Obsolescence* means the process of becoming obsolete or out of date. An old machinery though in good physical condition may be rendered obsolete by the introduction of a new model which produces more than the old machinery.
- (iii) **Time factors.** There are certain assets with a fixed period of legal life such as lease, patents, and copyrights. For instance, a lease can be entered into for any period while a patent's life is for some years but on certain grounds this can be extended. Provision for the consumption of these assets is called amortization rather depreciation.
- (iv) **Depletion.** Some assets are of a wasting character perhaps due to the extraction of raw materials from them. These materials are then either used by the firm to make something else or are sold in their raw state to other firms. Natural resources such as mines, quarries and oil wells come under this heading. To provide for the consumption of an asset of a wasting character is called provision for depletion.
- (v) **Accident.** An asset may reduce in value because of meeting of an accident.

### 3.1.4 Difference between Depreciation, Depletion, Amortization and Dilapidations

- *Depreciation* applies to fixed assets, depletion to wasting assets, amortizations to intangible assets and dilapidation to damage due to a building or other property during tenancy. AICPA has given the difference between these terms in the following words:
- “*Depreciation* can be distinguished from other terms, with specialized meaning used by accountants to describe assets cost allocation procedures. Depreciation is concerned with charging the cost of man-made fixed assets to operations (and not with determination of asset value for the balance sheet). Depletion refers to cost allocations for natural resources such as oil and mineral deposits.
- *Amortization* relates to cost allocation for intangible assets such as patent and leaseholds. The use of the term depreciation should also be avoided in connection with the valuation procedures for securities and investments.”

### **3.2. METHODS OF DEPRECIATION:**

Different methods of calculating provision for depreciation are mainly accounting customs which may be used by different concerns taking into consideration their individual peculiarities. The following are the main methods of providing depreciation:

#### **3.2.1 Fixed Installment (or Fixed Percentage on Original Cost or Straight Line) Method**

Under method a fixed percentage of the original value of the asset is written off every year so as to reduce the asset account to nil or to its scrap value at the end of the estimated life of the asset. To ascertain the annual charge under this method all that is necessary is to divide the original value of the asset (minus its residual value, if any) by the number of years of its estimated life i.e.,

$$\text{Depreciation} = \frac{\text{Cost price of asset} - \text{Scrap Value}}{\text{Estimated life of asset}}$$

If, for example, a machine costing Rs. 11, 000/- is estimated to have a life of 10 years and the scrap value is estimated Rs. 1, 000/- at the end of its life, the amount of depreciation would be

$$\text{Rs. } \frac{11,000-1,000}{10} = \text{Rs. } 1,000$$

The amount of depreciation charged during each period of the asset's life is constant. If the charge of depreciation is plotted annually on a graph paper and the points joined together, then the graph will reveal a straight line that is why it is also called as straight line method.

This method is suggested in case of assets where in the service value declines as a function of time and that too at a uniform rate. The repairs, maintenance and revenue also remain more or less constant.

It should be noted carefully that if depreciation is given as some percentage per annum and if the asset is purchased during the accounting year, say on July 1<sup>st</sup> then depreciation for six months is to be charged, if the accounting year closes on 31<sup>st</sup> December.

### **3.2.1.1 Merits of Fixed Installment Method**

- i. This method is simple to understand and easy to apply.
- ii. It can write down an asset to zero at the end of its working life, if so desired.
- iii. This method is very suitable for those assets which have a fixed life e.g., furniture, fixtures, short leases, patents and copyright and other assets of a small intrinsic value, repair charges are less and the possibility of obsolescence also less.

### **3.2.1.2 Demerits of Fixed Installment Method**

- i. The charge for depreciation remains constant year after year. The expenses of repairs and maintenance are increasing as the asset grows older. The profit and loss account thus in the later years bears more than its share of valuation.
- ii. It becomes difficult to calculate the depreciation on additions made during year.
- iii. Under this method the depreciation charge remains the same from year to year irrespective of the use of the asset. Thus it does not take into consideration the effective utilization of the asset.
- iv. It is not taking into consideration the interest on capital invested in fixed assets.
- v. It does not provide funds replacement of assets.
- vi. This method tends to report an increasing rate of return on investment in the asset amount due to the fact that the net balance of the asset amount is taken. In spite of these drawbacks, this method is mostly used by firms in U.S.A Canada, U.K., and some firms in India.



**Example 1:** Calculate the rate of depreciation under straight line method (SLM) in each of the following alternative cases:

Case	Purchase Price of Machine (₹)	Expenses to be Capitalized (₹)	Estimated Residual Value (₹)	Expected Useful Life
(a)	80,000	20,000	40,000	4 years
(b)	17,000	3,000	2,000	10 years

**Solution:**

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

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

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

Case (b) = ₹17,000 + ₹3,000 = ₹20,000

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

$$\text{Amount of Depreciation} = \frac{\text{Total Cost of Asset} - \text{Estimated Residual Value}}{\text{Expected Useful Life}}$$

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

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

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

$$\text{Rate of Depreciation (under SLM)} = \frac{\text{Amount of Depreciation}}{\text{Total Cost of Asset}} \times 100$$

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

$$\text{Case (b)} = \frac{₹1,800}{₹20,000} \times 100 = 9\%$$

**Example 2:** On 1st January 2012, X Ltd. purchased a second-hand machine for ₹52,000 and spent ₹2,000 as shipping and forwarding charges, ₹5,000 as import duty, ₹500 as carriage inwards, ₹1,500 as repair charges, ₹500 as installation charges, ₹400 as brokerage of the middleman and ₹100 for an iron pad. It was estimated that the machine will have a scrap value of ₹2,000 at the end of its useful life which is 20 years. On 30th Sept 2012 repairs & renewals amounted to ₹2,000. On 1st July 2014, this machine was sold for ₹30,600.

**Required:** Prepare the machinery account for the first three years.

**Solution:**

Total Cost of Machinery = Purchase Price + Expenses to be capitalized  
 = ₹52,000 + ₹2,000 + ₹5,000 + ₹500 + ₹1,500 + ₹500 + ₹400 + ₹100  
 = ₹62,000

$$\begin{aligned} \text{Amount of Depreciation p.a.} &= \frac{\text{Total Cost of Machine} - \text{Estimated Scrap value}}{\text{Expected Useful Life}} \\ &= \frac{62,000 - 2,000}{20} = ₹3,000 \end{aligned}$$



Dr. Machinery Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹
01.01.12	To Bank A/c (Cost)	52,000	31.12.12	By Depreciation A/c	3,000
	To Bank A/c (Expenses)	10,000		By Balance c/d	59,000
		<b>62,000</b>			<b>62,000</b>
01.01.13	To Balance b/d	59,000	31.12.13	By Depreciation A/c	3,000
		<b>59,000</b>		By Balance c/d	56,000
01.01.14	To Balance b/d	56,000			<b>59,000</b>
		<b>56,000</b>	01.07.14	By Depreciation A/c	1,500
				By Bank A/c	30,600
				By P&L A/c (Loss)	23,900
					<b>56,000</b>

**Working Notes:**

i) Book Value as on date of sale = ₹56,000 – ₹1,500 = ₹54,500.

ii) Loss on sale = Book Value as on date of sale – Sale proceeds  
= ₹54,500 – ₹30,600 = ₹23,900.

iii) The amount spent on repairs and renewals on 30.09.2012 is of revenue nature and not of capital nature and hence, not debited to machinery account.

**Example 3:** Kumaran Brothers purchased a Machinery on 1.1.2012 for ₹5,00,000. On 1.1.2014 the machinery was sold for ₹4,00,000. The firm charges depreciation at the rate of 15% per annum on Straight Line Method. The books are closed on 31<sup>st</sup> March every year. Prepare Machinery account and Depreciation account.

**Solution:**

Dr. Machinery Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹
1-1-2012	To Bank A/c	5,00,000	31-3-2012	By Depreciation A/c	18,750
		<b>5,00,000</b>		By balance c/d	4,81,250
1-4-2012	To balance b/d	4,81,250			<b>5,00,000</b>
		<b>4,81,250</b>	31-3-2013	By Depreciation A/c	75,000
1-4-2013	To balance b/d	4,06,250		By balance c/d	4,06,250
		<b>4,06,250</b>			<b>4,81,250</b>
			1-1-2014	By Depreciation A/c	56,250
			"	By Bank A/c	3,50,000
					<b>4,06,250</b>

Dr. Depreciation Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹
31-3-2012	To Machinery A/c	18,750	31-3-2012	By Profit & Loss A/c	18,750
31-3-2013	To Machinery A/c	75,000	31-3-2013	By Profit & Loss A/c	75,000
1-1-2014	To Machinery A/c	56,250	1-1-2014	By Profit & Loss A/c	56,250

Calculation of Profit or Loss on Sale of Machinery		
Date	Particulars	₹
1.1.2012	Cost	5,00,000
31.3.2012	Depreciation $5,00,000 \times \frac{15}{100} \times \frac{3}{12}$	18,750
	Book Value	4,81,250
31.3.2013	Depreciation	75,000
	Book value	4,06,250
1.1.2014	Depreciation $5,00,000 \times \frac{15}{100} \times \frac{9}{12}$	56,250
	Book value	3,50,000
	Sales value	4,00,000
	Profit	50,000

### **3.2.2. Diminishing Balance (or Reducing Installment or Written Down Value) Method**

- Under this method, depreciation is calculated at a certain percentage each year on the balance of the asset which is brought forward from the previous year;
- The amount of depreciation charged in each period is not fixed but it goes on decreasing gradually as the beginning balance of the asset in each year will reduce.
- The charges in initial periods are higher than those in the later periods.
- Overall charges, i.e., amount of depreciation, repairs and maintenance taken together remains equal throughout the life of the asset.
- This method is justified in the cases where 1. there is much uncertainty of revenue in later years and 2.
- there is also increase in repairs and maintenance costs consequently decreasing efficiency and revenues in every succeeding period. It is usually adopted for plant and machinery.

#### **3.2.2.1 Merits of Diminishing Balance Method**

- i. It tends to give a fairly even charge of depreciation against revenue each year. Depreciation is generally heavy during the first few years and is counter – balanced by the repairs being light and in the later years when repairs are heavy this is counter – balanced by the decreasing charge for depreciation. This concept is based on the logic that as an asset grows older, the amount of depreciation goes on decreasing.
- ii. Fresh calculations of depreciation are not necessary as and when additions are made.
- iii. This method is recognized by the income tax authorities in India.
- iv. It does not provide for replacement of asset on the expiry of its useful life.
- v. This method is suitable for plant and machinery, building etc. Where the amount of repairs and renewals increase as the asset grows older and the possibilities of assets are more.

#### **3.2.2.2 Demerits of Diminishing Balance Method**

- i. The original cost of the asset is altogether lost sight of in subsequent years and the asset can never be reduced to zero.

- ii. This method does not take into consideration the asset as an investment and interest is not taken into consideration.
- iii. As compared to the first method, it is difficult to determine the suitable rate of depreciation.

### 3.2.3 DISTINCTION BETWEEN STRAIGHT LINE METHODS AND DIMINISHING BALANCE METHOD

Points of Distinction	Straight Line Method	Diminishing Balance Method
1.Change in Depreciation Amount	Throughout the life of the asset, the amount for depreciation remains to be equal.	Amount of depreciation is more during earlier years of the life of asset than later years and therefore amount is never equal.
2.Balance in Assets A/c	Assets A/c at the expiry of the expected life becomes nil.	The amount never becomes nil.
3.Overall Changes	The overall charge i.e., Depreciation and repairs taken together go on increasing from year to year. In other words the amount depreciation and repairs is relatively less during the earlier years of the life of the asset than later years become repairs go on increasing with use of asset.	Overall charge remains more or less same for every year throughout the life of the asset. Since depreciation goes on decreasing and amount of repairs goes on increasing.
4. Profits	Profits under this method are more during the earlier years of the life of the asset.	Profits are less during earlier years than the later years.



**Example 5:** On 1.1.2010 a machine was purchased for ₹1,00,000. On 30.9.2012 a new machine was purchased for ₹20,000 installation expenses being ₹5,000.

Show the Machinery Account up to 31<sup>st</sup> Dec. 2013 assuming that the rate of depreciation was 10% on written down value method.

**Solution:**

In the books of .....					
Dr.			Machinery Account		Cr.
Date	Particulars	₹	Date	Particulars	₹
2010			2010		
1 Jan.	To Bank A/c	1,00,000	31 Dec.	By Depreciation A/c	10,000
				By Balance c/d	90,000
		1,00,000			1,00,000
2011			2011		
1 Jan.	To Balance b/d	90,000	31 Dec.	By Depreciation A/c	9,000
				By Balance c/d	81,000
		90,000			90,000
2012			2012		
1 Jan.	To Balance b/d	81,000	31 Dec.	By Depreciation A/c	8,725
30 Sept.	To Bank A/c	20,000		(8,100+ 625)	
	To Bank A/c			By Balance c/d	97,275
	(Installation expenses)	5,000			
		1,06,000			1,06,000
2013			2013		
1 Jan.	To Balance b/d	97,275	31 Dec.	By Depreciation A/c	9,728
				By Balance c/d	87,547
		97,275			97,275
2014					
1 Jan.	To Balance b/d	87,547			

**Example 6:** On 1st January 2012, X Ltd. purchased a second-hand machine for ₹58,000 and spent ₹2,000 on its erection. On 1st July 2014, this machine was sold for ₹28,600.

**Required:** Prepare the machinery account of the first 3 years according to the written down value taking the rate of depreciation at 10% p.a.

Machinery Account					
Dr.			Cr.		
Date	Particulars	₹	Date	Particulars	₹
01.01.2012	To Bank A/c	58,000	31.12.2012	By Depreciation A/c	6,000
	To Bank A/c (Erection charges)	2,000		$\left[ 60,000 \times \frac{10}{100} \right]$	
		<b>60,000</b>		By Balance c/d	54,000
01.01.2013	To Balance b/d	54,000			<b>60,000</b>
			31.12.2013	By Depreciation A/c	5,400
				$\left[ 54,000 \times \frac{10}{100} \right]$	
		<b>54,000</b>		By Balance c/d	48,600
01.01.2014	To Balance b/d	48,600			<b>54,000</b>
			01.07.2014	By Depreciation A/c	2,430
				$\left[ 48,600 \times \frac{10}{100} \times \frac{6}{12} \right]$	
		<b>48,600</b>		By Bank A/c	28,600
				By P&L A/c (Loss)	17,570
					<b>48,600</b>

i) Book value as on date of sale = ₹ 48,600 -  $\left( 48,600 \times \frac{10}{100} \times \frac{6}{12} \right)$  = ₹ 46,170

ii) Loss on Sale = Book value - Sale proceeds = ₹ 46,170 - ₹ 28,600 = ₹ 17,570

**Example 7:** A company whose accounting year is the calendar year purchased on 1<sup>st</sup> April, 2011 machinery costing ₹ 30,000. It further purchased machinery on 1<sup>st</sup> October 2011 costing ₹ 20,000 and on 1<sup>st</sup> July 2012, costing ₹ 10,000. On 1<sup>st</sup> January 2013 one third of the machinery which was installed on 1<sup>st</sup> April became obsolete and was sold for ₹ 3,000.

Show how the machinery account would appear in the books of company. The depreciation to be charged at 10% p.a. on written down value method.

**Solution:**

Machinery Account					
Dr.			Cr.		
Date	Particulars	₹	Date	Particulars	₹
2011 April 1	To Bank A/c	30,000	2011 Dec. 31	By Dep. A/c (2,250 + 500)	2,750
Oct. 1	To Bank A/c	20,000	"	By Balance c/d	47,250
		<b>50,000</b>			<b>50,000</b>
2012 Jan. 1	To Balance b/d	47,250	2012 Dec. 31	By Dep. A/c (4,725 + 500)	5,225
July 1	To Bank A/c	10,000		By Balance c/d	52,025
		<b>57,250</b>			<b>57,250</b>
2013 Jan. 1	To Balance b/d	52,025	2013 Jan. 1	By Bank A/c	3,000
			Jan. 1	By P & L A/c	5,325
			Dec. 31	By Dep. A/c	4,370
			"	By Balance c/d	39,330
		<b>52,025</b>			<b>52,025</b>
2014 Jan 1	To Balance b/d	39,330			

### **3.3 ANNUITY METHOD**

1. The fixed Installment Method and the Reducing Balance method of charging depreciation ignore the interest factor.
2. The Annuity Method takes care of this factor. Under this method, the depreciation is charged on the basis that besides losing the original cost of asset, the business also losses interest on the amount used for buying the asset.
3. The terms “Interest” here means the interest which the business could have earned otherwise if the money used in purchasing the asset would have been invested in some other form of investment.
4. Thus, according to this method, such an amount is charged by the way of depreciation which taken into A/c not only the cost of the asset but also interest there on at an accepted rate.
5. The amount of interest is calculated on the book value of the asset, in the beginning of each year.
6. The amount of depreciation is uniform and is determined on the basis of annuity table.  
Follows:  $\text{Rs. } 5,000 \times 2.48685 = \text{Rs } 12,434$  or (say)  $\text{Rs } 12,500$ .



**Example 9:** A firm purchases a lease-hold property for period of five years for ₹10,000 on 1.1.2009. It decides to write off the lease by Annuity method presuming the rate interest at 5% p.a. The Annuity table shows that the annual amount necessary to write off ₹1 at 5% p.a. is ₹0.230976. You are required to prepare the Lease Hold Property Account for five years and show the net amount to be charged to the Profit and Loss account for these five years.

**Solution:**

Dr.			Lease Hold Property Account			Cr.
Date	Particulars	₹	Date	Particulars	₹	
<b>2009</b>			<b>2009</b>			
January 1	To Bank	10,000.00	December 31	By Depreciation	2,309.76	
December 31	To Interest	500.00	December 31	By Balance c/d	8,190.24	
		<b>10,500.00</b>			<b>10,500.00</b>	
<b>2010</b>			<b>2010</b>			
January 1	To Balance b/d	8,190.24	December 31	By Depreciation A/c	2,309.76	
December 31	To Interest	409.52	December 31	By Balance c/d	6,290.00	
		<b>8,599.76</b>			<b>8,599.76</b>	
<b>2011</b>			<b>2011</b>			
January 1	To Balance b/d	6,290.00	December 31	By Depreciation A/c	2,309.76	
December 31	To Interest	314.50	December 31	By Balance c/d	4,294.74	
		<b>6,604.50</b>			<b>6,604.50</b>	
<b>2012</b>			<b>2012</b>			
January 1	To Balance b/d	4,294.74	December 31	By Depreciation A/c	2,309.76	
December 31	To Interest	214.74	December 31	By Balance c/d	2,199.72	
		<b>4,509.48</b>			<b>4,509.48</b>	
<b>2013</b>			<b>2013</b>			
January 1	To Balance b/d	2,199.72	December 31	By Depreciation A/c	2,309.76	
December 31	To Interest	110.04				
		<b>2,309.76</b>			<b>2,309.76</b>	

**Statement Showing the Amount Chargeable to the Profit and Loss Account**

Year	Depreciation (Debited)	Interest (Credited)	Net Charge Against Profits
2009	2,309.76	500.00	1,809.76
2010	2,309.76	409.52	1,900.24
2011	2,309.76	314.50	1,995.26
2012	2,309.76	214.74	2,095.02
2013	2,309.76	110.04	2,199.72
	<b>11,548.80</b>	<b>1,548.80</b>	<b>10,000.00</b>

### **UNIT-3 IMPORTANT QUESTIONS**

- ✓ Explain Methods of Depreciation with merits & de-merits?

**Depreciation problems:** Straight Line, Diminishing Balance & annuity Method.



## UNIT-3

### VALUATION OF ASSETS

#### **3.4 INVENTORY VALUATION**

Inventory or stock is the resourceful but idle assets lying with the company at the end of the accounting period. It is one of the most significant assets of a company on its balance sheet. So inventory valuation is a very important factor in the accounting of a company.

According to Kohler's Dictionary for Accountants, inventory is defined as "Raw materials and supplies, goods finished and in process of manufacture and merchandise on hand, in transit and owned, in storage or consigned to other at the end of an accounting period.

Inventory forms a significant portion of the total assets of many enterprises and a lot of working capital is invested in this item. Inventories generally constitute the second largest item after fixed assets, in the financial statements, particularly of manufacturing concerns. This is why valuation of inventories has assumed significance in recent years. The values attached to inventories can materially affect the operating results as shown by trading and profit and loss account and the financial position of a business firm because closing inventory (stock in trade) is shown on the credit side of the trading account and this amount is also shown as current asset in the balance sheet. The closing inventory becomes the opening inventory in the next accounting period and shown on the debit side of trading account. Thus, the valuation of inventories does affect the operating results not only of the current accounting period but also of the subsequent period. Inventory valuation is purely subjective depending upon the policies and the different bases of valuing inventories used by different business and even by different undertakings with in the same trade or industry.

According to Accounting Standards - A (AS - 2) 'inventories' mean tangible property held.

- (1) For sale
- (2) In the process of production for sale
- (3) For computation in the production of goods or services for sale, inventories are normally Classified in the financial statements as current assets as under:
  - i. Raw materials and components
  - ii. Work- in-process
  - iii. Finished goods
  - iv. Stores and spares.

Thus, the term inventory includes stock of (I) finished goods, (ii) work in-progress and (iii) raw materials and components. In case of a trading concern inventory primarily consists of finished goods while in case of a manufacturing concern, inventory consists of raw materials, components, stores, work-in-process and finished goods.

### **3.4.1 OBJECTIVE OF INVENTORY VALUATION:**

1. **Determination of income:** The valuation of inventory is necessary for determining the net income earned by a business during a particular period. Gross profit is the excess of sales over cost of goods sold. Cost of goods sold is ascertained by adding opening inventory to and deducting closing inventory from purchases.
2. **Determination of financial position:** The inventory at the end of a period is to be shown as a current asset in the balance sheet of the business. In case the inventory is not properly valued; the balance sheet will not disclose the correct financial position of the business.
3. **Income Determination:** To calculate accurate profit or loss for a certain period, it is necessary to value inventory properly. Profit is the excess of sales over cost of sales. Cost of Sales is equal to Opening stock plus Purchases plus Direct Expenses minus closing stock. Hence, if stock is not valued correctly, profit will not be accurate.
4. **Presentation of Financial Position:** At the end of the accounting period, position of various assets and liabilities is presented in the Balance Sheet. Inventory is one of the items of assets shown in Balance Sheet. If inventory is not valued properly, correct financial position of the business will not be reflected in Balance Sheet.
5. **Location of Wastage:** Proper maintenance of inventory records helps a business firm to locate deficiencies, wastages, pilferages etc. Periodical checking of inventory records will enable the business to ascertain any difference between actual physical stock and stock as per books.
6. **Liquidity Position:** As inventory is classified as current asset, it is one of the constituents of net working capital which reveals the liquidity position of a business. Current ratio which reveals the relationship between current assets and current liabilities is significantly affected by value of inventory.

**3.4.2 METHODS OF VALUATION OF INVENTORIES:** The purchase prices of materials fluctuate on account of changes in the product prices, buying from different suppliers and on account of quality discounts. Because of price fluctuations, the stock may

include several lots of the same material purchased at different prices. When these materials are issued to production, it is important to consider the correct price at which these materials are charged to production. There are various methods in use. They are broadly classified under the following categories:

**3.4.2.1. First in First out (Commonly Called FIFO):** Under this method material is first issued from the earliest consignment on hand and priced at the cost at which that consignment was placed in the stores. In other words, materials received first are issued first. The units in the opening stock of materials are treated as if they are issued first, the units from the first purchase issued next, and so on until the units left in the closing stock of materials are valued at the latest cost of purchases. It follows that unit costs are apportioned to cost of production according to their chronological order of receipts in the store.

This method is most suitable in times of falling prices because the issue price of materials to jobs or works orders will be high (materials issued from the earliest consignments which were purchased at a higher rate) while the cost of replacement of materials will be low. But in case of rising prices this method is not suitable because the issue price of materials to production will be low while the cost of replacement of materials will be high.

**3.4.2.1.1 Advantages of FIFO Method:**

1. The main advantage of FIFO method is that it is simple to understand and easy to operate.
2. It is a logical method because it takes into consideration the normal procedure of utilizing first those materials which are received first. Materials are issued in order of purchases, so materials received first are utilized first.
3. Under this method, materials are issued at the purchase price; so the cost of jobs or work orders is correctly ascertained so far as cost of materials is concerned. Thus, the method recovers the cost price of the materials.
4. This method is useful when prices are falling.
5. Closing stock of materials will be valued at the market price as the closing stock under this method would consist of recent purchase of materials.
6. This method is also useful when transactions are not too many and prices of materials are fairly steady.

#### **3.4.2.1.2 Disadvantages of FIFO Method:**

1. This method increases the possibility of clerical errors, if consignments are received frequently at fluctuating prices as every time an issue of materials is made, the store ledger clerk will have to go through this record to ascertain the price to be charged.
2. In case of fluctuations in prices of materials, comparison between one job and the other job becomes difficult because one job started a few minutes later than another of the same nature may be issued materials at different prices, merely because the earlier job exhausted the supply of the lower priced materials in stock.
3. For pricing one requisition more than one price has often to be taken.
4. When prices rise, the issue price does not reflect the market price as materials are issued from the earliest consignments. Therefore, the charge to production is low because the cost of replacing the material consumed will be higher than the price of issue.

#### **3.4.2.2. Last In First Out (Commonly Called LIFO) Method:-**

As against the First In First Out method the issues under this method are priced in the reverse order of purchase i.e., the price of the latest available consignment is taken. This method is sometimes known as the replacement cost method because materials are issued at the current cost to jobs or work orders except when purchases were made long ago. This method is suitable in times of rising prices because material will be issued from the latest consignment at a price which is closely related to the current price levels. Valuing material issues at the price of the latest available consignment will help the management in fixing the competitive selling prices of the products. This method was first introduced in the U.S.A. during the Second World War to get the advantages of rising prices.

##### **3.4.2.2.1 Advantages of LIFO Method:**

1. Like FIFO method, this is simple to operate and is useful when transactions are not too many and the prices are fairly steady.
2. Like FIFO, this method recovers cost from production because actual cost of material is charged to production.
3. Production is charged at the recent prices because materials are issued from the latest consignment. Thus, effect of current market prices of materials is reflected in the cost of sales provided the materials are recently purchased.



4. In times of rising prices, LIFO method of pricing issues is suitable because materials are issued at the current market prices which are high. This method thus helps in showing a lower profit because of increased charge to production during periods of rising prices and lower profit reduces burden of income-tax.

#### **3.4.2.3 Disadvantages of LIFO Method:**

1. Like FIFO, this method may lead to clerical errors as every time an issue is made, the store ledger clerk will have to go through the record to ascertain the price to be charged.
2. Like FIFO, comparison between one job and the other job will become difficult because one job started a few minutes after another of the same type may bear a different charge for materials consumed, merely because the earlier job exhausted the supply of the lower priced or higher priced materials in stock.
3. For pricing a single requisition, more than one price has often to be adopted.

The stock in hand is valued at price which does not reflect current market price. Consequently, closing stock will be understated or overstated in the Balance Sheet.

#### **3.4.2.4. Highest In First Out (HIFO) Method:**

This method is based on the assumption that the closing stock of materials should always remain at the minimum value; so the issues are priced at the highest value of the available consignments in the store. The method is not popular as it always undervalues the stock which amounts to creating a secret reserve. The method is mainly used in case of cost plus contracts or monopoly products as it is helpful in increasing the price of the contract or products.

**Example 17:** From the following transactions prepare a Stores Ledger Account, showing pricing of materials on LIFO basis.

Year 2014					
1 July	Opening stock				500 units @ ₹20 each
4 July	Purchased	GRN	574		400 units @ ₹21 each
6 July	Issued	SR	251		600 units
8 July	Purchased	GRN	578		800 units @ ₹24 each
9 July	Issued	SR	258		500 units
13 July	Issued	SR	262		300 units
24 July	Purchased	GRN	584		500 units @ ₹25 each
28 July	Issued	SR	269		400 units

GRN = Goods Received Notes

SR = Stores Requisition

**Solution:**

**LIFO Method  
Stores Ledger Account**

Date	Receipts				Issues				Balance		
	Ref. GRN	Qty. Units	Rate (₹)	Amount (₹)	Ref. SR	Qty. Units	Rate (₹)	Amount (₹)	Qty. Units	Rate (₹)	Amount (₹)
2014 1 July	—	—	—	—	—	—	—	—	500	20	10,000
4 July	574	400	21	8,400	—	—	—	—	500 400	20 21	10,000 8,400
6 July	—	—	—	—	251	400 200	21 20	8,400 4,000	300	20	6,000
8 July	578	800	24	19,200	—	—	—	—	300 800	20 24	6,000 19,200
9 July	—	—	—	—	258	500	24	12,000	300 300	20 24	6,000 7,200
13 July	—	—	—	—	262	300	24	7,200	300	20	6,000
24 July	584	500	25	12,500	—	—	—	—	300 500	20 25	6,000 12,500
28 July	—	—	—	—	269	400	25	10,000	300 100	20 25	6,000 2,500

**Example 18:** XYZ Inc. had the following inventory balance as of June 30, 2014.

June 3 order of 400 units @ Rs. 10.50	₹4,200
June 8 order of 100 units @ Rs. 11.00	1,100
June 19 order of 200 units @ Rs. 11.50	2,300
	₹. 7,600

On July 1, 2014, the company sold 240 units at ₹16.00 per unit. On July 10, 2014, a competitor announced a new model which resulted in the cost of Murray inventory dropping to the new replacement cost, which was ₹10.75. XYZ Inc. uses a perpetual inventory system.

What is the balance in the inventory account on July 9, 2014, if XYZ Inc. uses:

- 1) FIFO
- 2) LIFO



**Solution:**

**FIFO Method**  
**Stores Ledger Account**

Date	Receipts			Issues			Balance		
	Quantity (Units)	Rate (₹)	Amount (₹)	Quantity (Units)	Rate (₹)	Amount (₹)	Quantity (Units)	Rate (₹)	Amount (₹)
June 3, 2014	400	10.50	4,200	—	—	—	400	10.50	4,200
June 8, 2014	100	11	1,100	—	—	—	400 100	10.50 11	4,200 1,100
June 19, 2014	200	11.50	2,300	—	—	—	400 100 200	10.50 11 11.50	4,200 1,100 2,300
July 1, 2014	—	—	—	240	10.50	2,520	160 100 200	10.50 11 11.50	1,680 1,100 2,300
July 9, 2014	—	—	—	—	—	—	460	—	5,080

**Notes:**

- 1) Value of Inventory on July 9, 2014 is ₹5,080 and in unit 460
- 2) Cost of goods sold = ₹2,520
- 3) Profit = Sales – Cost of goods sold  
= 3,840 - 2,520 = ₹1,320

**LIFO Method**  
**Stores Ledger Account**

Date	Receipts			Issues			Balance		
	Quantity (Units)	Rate (₹)	Amount (₹)	Quantity (Units)	Rate (₹)	Amount (₹)	Quantity (Units)	Rate (₹)	Amount (₹)
June 3, 2014	400	10.50	4,200	—	—	—	400	10.50	4,200
June 8, 2014	100	11	1,100	—	—	—	400 100	10.50 11	4,200 1,100
June 19, 2014	200	11.50	2,300	—	—	—	400 100 200	10.50 11 11.50	4,200 1,100 2,300
July 1, 2014	—	—	—	200 40	11.50 11	2,300 440	400 60	10.50 11	4,200 660
July 9, 2014	—	—	—	—	—	—	460	—	4,860

**Notes:**

- 1) Value of Inventory on July 9, 2014 is ₹4,860 and in unit 460
- 2) Cost of goods sold = ₹2,740 (2,300+440)
- 3) Profit = Sales – Cost of goods sold = 3,840 - 2,740 = ₹1,100

### 3.4.2.5 Average Cost Method:

The principle on which the average cost method is based is that all of the materials in store are so mixed up that an issue cannot be made from any particular lot of purchases and, therefore, it is proper if the materials are issued at the average cost of materials in store.

Average may be of two types:

- (i) Simple Arithmetic Average
- (ii) Weighted Arithmetic Average.

**3.4.2.5.1 Simple Arithmetic Average:** "A price which is calculated by dividing the total of the prices of the materials in the stock from which the material to be priced could be drawn by the number of the prices used in that total".

Simple average price is calculated by dividing the total of unit purchase prices of different lots in stock on the date of issue by the number of prices used in the calculation and quantity of different lots is ignored. This method may lead to over-recovery or under-recovery of cost of materials from production because quantity purchased in each lot is ignored.

Simple average price is not to be followed because this method of calculating issue price does not recover the cost price of the materials from the production.

**3.4.2.5.2 Weighted Average Price:** "A price which is calculated by dividing the total cost of materials in the stock from which the materials to be priced could be drawn by the total quantity of materials in that stock".

It is better to issue the material at weighted average price method because it recovers the cost price of the materials from production.



**Example 20:** From the following information, prepare a Stores Ledger adopting simple average price method:

November	1	Opening stock 500 units @ ₹. 2/unit
	2	Purchased 400 units @ ₹2.10/unit
	5	Issued 600 units
	7	Purchased 800 units @ ₹. 2.40/unit
	9	Issued 500 units
	12	Returned 200 units from 5 <sup>th</sup> issue
	17	Purchased 400 units @ 2.50/unit
	25	Issued 600 units

**Solution:**

**Store Ledger Account**

Date	Receipts			Issues			Balance		
	Qty. Units	Rate (₹)	Amount (₹)	Qty. Units	Rate (₹)	Amount (₹)	Qty. Units	Rate (₹)	Amount (₹)
1	—	—	—	—	—	—	500	2.00	1,000
2	400	2.10	840	—	—	—	500		1,000
							400		840
5	—	—	—	600	2.05	1230	300		610
7	800	2.40	1920	—	—	—	300		610
							800		1,920
9	—	—	—	500	2.25	1125	600		1,405
12	200	2.05	410	—	—	—	600		1,405
							200		410
17	400	2.50	1000	—	—	—	600		1,405
							200		410
							400		1,000
25	—	—	—	600	2.31	1386	600		1,429

$$\text{Issue Price} = (1) 5 \text{ Nov.} = \frac{2.00 + 2.10}{2} = 2.05$$

$$(2) 9 \text{ Nov.} = \frac{2.10 + 2.40}{2} = 2.25$$

$$(3) 25 \text{ NOV.} = \frac{2.40 + 2.05 + 2.50}{3} = 2.31$$

- 2) **Weighted Average Price Method (WAPM):** It is based on the assumption that each issue of goods consists of a due proportion of the earlier lots. It uses a weighted average price for pricing the issue of materials until a new lot is purchased when a new weighted average price will be calculated.

Weighted Average Price is calculated as follows:

$$\text{Weighted Average Price} = \frac{\text{Total Cost of Materials in stock}}{\text{Total Quantity of Materials in stock}}$$

It is useful when the quantity of materials in each lot purchased is not uniform.

- i) **Periodic Weighted Average Method (PWAM):** In this method, the weighted average price is calculated at the end of each period, say, a month, by dividing the total cost of purchases during the period by the quantity purchased., i.e.,

$$\text{Periodic weighted average price} = \frac{\text{Total cost of materials purchased during the period}}{\text{Total quantity purchased during the period}}$$



- ii) **Moving Weighted Average Method:** In this method, the price is calculated by dividing the total of the periodic weighted average prices of a given number of periods by the number of periods. This method gives more accurate results as it considers quantity as well as prices for arriving at weighted average. The advantages and disadvantages are similar to those of simple average price method.

**Example 21:** From the following transaction pertaining to material. 'C' prepare stores ledger account using Weighted average method of Pricing materials.

Date	Unit Purchased	Cost Price per kg
2014 January 2	200	102
7	300	105
10	200	108
20	100	110

There were 100kg in stock on January 1, 2014 which were valued at Rs. 100 per kg Quantities issued from stores during the month were 200kg January 5 – 250kg, January 13 – 200kg, January 18 – 200kg January 25 – 150kg.

**Solution:**

Stores Ledger									
Date		Receipts		Issues			Balance		
2014	Qty. Units	Rate (₹)	Amount (₹)	Qty. Units	Rate (₹)	Amount (₹)	Qty. Units	Rate (₹)	Amount (₹)
1 Jan							100	100	10,000
2 Jan	200	102	20,400	–	–	–	300	101.33	30,400
5 Jan				250	101.33	25,333	50	101.33	5,067
7 Jan	300	105	31,500				350	104.48	36,567
10 Jan	200	108	21,600				550	105.75	58,167
13 Jan				200	105.76	21,152	350	105.75	37,015
18 Jan				200	105.76	21,152	150	105.75	15,863
20 Jan	100	110	11,000				250	107.45	26,863
25 Jan				150	107.45	16,117.8	100	107.45	10,745

**Example 22:** From the following transactions, prepare a stores ledger account, showing pricing of materials on LIFO basis:

Year 2014					
1 July	Opening stock			500 units @ ₹20 each	
4 July	Purchased	GRN	574	400 units @ ₹21 each	
6 July	Issued	SR	251	600 units	
8 July	Purchased	GRN	578	800 units @ ₹24 each	
9 July	Issued	SR	258	500 units	
13 July	Issued	SR	262	300 units	
24 July	Purchased	GRN	584	500 units @ ₹25 each	
28 July	Issued	SR	269	400 units	

**Solution:**

olution:

Weighted Average Method  
Stores Ledger Account

Date 2014	Receipts				Issues				Balance		
	Ref. GRN	Qty. Units	Rate (₹)	Amount (₹)	Ref. SR	Qty. Units	Rate (₹)	Amount (₹)	Qty. Units	Rate (₹)	Amount (₹)
1 July	—	—	—	—	—	—	—	—	500	20.000	10,000
4 July	574	400	21	8,400	—	—	—	—	900	20.444	18,400
6 July	—	—	—	—	251	600	20.444	12,267	300	20.444	6,133
8 July	578	800	24	19,200					1,100	23.030	25,333
9 July	—	—	—	—	258	500	23.030	11,515	600	23.030	13,818
13 July	—	—	—	—	262	300	23.030	6,909	300	23.030	6,909
24 July	584	500	25	12,500	—	—	—	—	800	24.261	19,409
28 July	—	—	—	—	269	400	24.261	9,705	400	24.261	9,704

**Note:** The issue prices are calculated as follows:

On 4 July ₹18,400 ÷ 900 units = 20.444

On 8 July ₹25,333 ÷ 1,100 units = 23.030

On 24 July ₹19,409 ÷ 800 units = 24.261



the following information, prepare a Stores Ledger under (a) Simple Average (b) Weighted Average Method.

Date	Units	Price
Receipts :		₹
2.3.11	200	2.00
10.3.11	300	2.40
18.3.11	250	2.60
Issues :		
15.3.11	250	
20.3.11	300	

(a) Simple Average Method

Date	Receipts			Issues			Balance	
	Quantity	Unit cost	Total cost	Quantity	Unit cost	Total cost	Quantity	Total cost
		₹	₹		₹	₹		₹
March 2	200	2.00	400	—	—	—	200	400
March 10	300	2.40	720	—	—	—	500	1,120
March 15	—	—	—	250	2.20	550	250	570
March 18	250	2.60	650	—	—	—	500	1,220
March 20	—	—	—	300	2.50	750	200	470

March 15<sup>th</sup> : Issue price :  $(2 + 2.40)/2 = ₹ 2.20$

March 20<sup>th</sup> Issue price :  $(2.40 + 2.60)/2 = ₹ 2.50$

b) Weighted Average Method

Date	Receipts			Issues			Balance		
	Quantity	Unit cost	Total cost	Quantity	Unit cost	Total cost	Quantity	Unit cost	Total cost
		₹	₹		₹	₹		₹	₹
March 2	200	2.00	400	—	—	—	200	2.00	400
March 10	300	2.40	720	—	—	—	500	2.24	1,120
March 15	—	—	—	250	2.24	560	250	2.24	560
March 18	250	2.60	650	—	—	—	500	2.42	1,210
March 20	—	—	—	300	2.42	726	200	2.42	484

## **4. VALUATION OF GOODWILL**

Goodwill is an intangible asset but not fictitious. Although it is not tangible asset like plant and machinery, buildings etc., nevertheless it contributes to the profit earnings capacity of the business. Goodwill is valuable asset if the business concern is profitable, but if the business is suffering from continuous losses, it is valueless.

Goodwill is defined as an element arising in which enables it to earn greater profits than the return normally to be expected in the capital represented by the net tangible assets employed in the business.

According to Kohler "goodwill is the current value of expected future income in excess of a normal return on investment in net tangible assets."

It is treated as an intangible asset in accounts. It is sometimes described as a momentum or a push that keeps the business going without further effort like the momentum of a body that continues its motion against a retarding force till it comes to rest gradually.

### **4.1 Features of Goodwill:**

- a.** Goodwill is incapable of realization separately from business as a whole i.e., goodwill is realizable only if the business is disposed.
- b.** Value of goodwill has no relationship to any costs which might have been incurred to build it.
- c.** The value of goodwill may be positive or negative. It is positive when the value of business is more than the value of its net separable assets and negative when the value of business is less than the value of its net separable assets.
- d.** The value of goodwill fluctuates from time to time due to internal and external factors.
- e.** It is not possible to value separately each of the intangible factors contributing to goodwill.
- f.** Assessment of the value of goodwill is highly subjective and differs from value to value.
- g.** Goodwill may be inherent or purchased goodwill. Inherent goodwill is internally generated. It is not shown in financial statement. It is not included in purchased ' consideration and its valuation depend on the subjective judgment of the value.



## **4.2 Under What Circumstances Goodwill Is Valued and Recorded (or) Need for Valuation of Goodwill:**

The need for valuation of goodwill depends upon the form of business organization. In case of sole trading concern it is usually valued at the time of selling the business. In case of Partnership concerns, the necessity arises in the following cases.

- a. When a new partner is admitted
- b. When a partner retires or dies
- c. When- there is a change in profit sharing ratio among the partners
- d. When the firm sells its business to a company

### **In case of Joint Stock Company it is valued**

- a. When two or more companies amalgamate.
- b. When one company takes over another company
- c. When a company wants to acquire controlling interest in other company and
- d. When government takes over the business.

## **4.3. Factors affecting valuation of goodwill:**

The main factors affecting the goodwill are:

- a. Profits expected to be earned by the concern. Profitability of a concern depends upon several factors such as nature of business, favorable location or site, skill of management, possession of trademarks, patents and copy rights, future competition, money market conditions etc.,
- b. Capital requirement
- c. Possibility of transfer of goodwill etc.,

## **5. METHODS OF VALUATION OF GOODWILL**

The various methods of valuation of Goodwill are

1. Average profit method
2. Weight average profit method
3. Super profit method
4. Capitalization method

**5.1 Average Profit Method:** In this method the value of goodwill is calculated on the basis of average for the past few years multiplied by the no. of years in which anticipated profit will be available.

$$\text{Average Profit} = \frac{\text{Total Profits}}{\text{No. of years}}$$

**Example:** From the following information calculate Goodwill.

Years	Profit
1995	10,000
1996	16,000
1997	12,000
1998	16,000
1999	5,000

Goodwill is 2 years of purchase.

**Solution:-**

**Calculating Goodwill**

$$\begin{aligned}\text{Average Profit} &= \text{Total of Profits/ No. of years} \\ &= 59,000/5 = 11,800\end{aligned}$$

$$\text{Average Profit} = 11800 \times 2 \text{ years purchase}$$

$$\text{Goodwill} = 23,600.$$

**5.2 Weighted Average Profit Method:** In this method Goodwill is calculated by weights.

If weights are not given assume weights

Ex: 1year, weight =1,2 year weight = 2, 3 year weight = 3

This method is used when profits are continuously increased or continuously decreased.

$$\text{Weighted Avg. Profit} = \frac{\text{Total amount of weights}}{\text{Total no. of weights}}$$

**Example:** From the following information calculate Goodwill Amount

Years	Profit
1985	6,000
1986	9,000
1987	10,000
1988	12,000
1989	15,000

Goodwill is 3 years of purchase.

**Solution:-**

$$\text{Weighted Avg. Profit} = \frac{\text{Total amount of weights}}{\text{Total No. of weights}}$$

Year	Profit	Weights	Amount of Weight
1985	6000	1	6,000
1986	9000	2	18,000
1987	10000	3	30,000
1988	12000	4	48,000
1989	15000	5	75,000
			<b>1,77,000</b>

Weighted Average Profit =  $1,77,000/15=11,800$

**Good Will:-**

G.W. = Weighted Average Profit x 3 year purchase

G.W. =  $11,800 \times 3 = 35,400$ .

**5.3 Super Profit Method :** In this method the future maintainable profits of the firm whose goodwill is for sale are compared with normal profits, if the estimated future profit are more than the normal profit then the difference is known as Super Profit. This is the measure of

extra profit earned by the firm. Goodwill is found by multiplying the Super Profit by no. of years in which the Super Profit is expected in future.

**Step1:** Ascertain capital employed and Average Capital employed.

**Step2:** Find the normal profit on the basis of normal rate of return, there is no uniformity of treatment in this regard; some authors calculate normal profit on capital employed. While other calculate on average employed. However, it is preferable to calculate normal profit on average capital employed.

**Step 3:** Ascertain future maintainable profits of the concern

**Step 4:** Calculate super profit deducting normal profit from the future maintainable profit.

**Step 5:** Find out goodwill by multiplying super profit by the no. of years they are expected to be earned.

**5.4 Capitalization Method:** Under this method, the value of goodwill is calculated by capitalizing the super profit at the normal rate of return. This method attempts to determine the amount of capital needed for earning super profits. The value of goodwill is calculated by the following formula:

$$= \frac{\text{Average Annual Super Profit}}{\text{Normal Rate of Return}} \times 100$$

**5.5 Simple Profit method:** In this method goodwill is valued on the basis of a certain number of years' purchases of the average profits of the past few years. For example, if the average annual profits of a business for the past 5 years are Rs 10,000 and goodwill is to be valued on the basis of 2 years' purchase of such average annual profits, the value of goodwill will be Rs20,000.

In case of Super profit method, goodwill is based on the average annual super profit earned by the business. The term super profit means the profit over and above the normal profit. This method is most popular for valuation of goodwill in case of joint stock companies. However, in case of this method, goodwill can also be valued by any of the following methods:

**a) Purchase of super profit method.** According to this method, the value of goodwill is ascertained as follows:

**Average Annual Super Profit x Number of years**



**For example**, if the amount of average annual super profit is Rs 3,000, and it is expected that the purchaser of the business will be in a position to maintain this profit for three years (only on account of old reputation of the business), the value of the goodwill will be Rs 9,000.

**b) Sliding Scale Valuation of Super Profit:** This method of valuation of goodwill is a slight variation of the purchase of super profit method. It has been advocated by A.E. Cutforth. The method is based on the theory that the greater the amount of super profits the more difficult, it would be to maintain it. The super profit in this case is divided into two or three divisions. Each of these divisions is multiplied by a different number of years, purchase in descending order from first division.

**For example**, if the amount of super profit is estimated at Rs.6,000 the value of the goodwill it will be calculated as under: First Rs. 2,000 at (say) 3 years purchase 6,000 Second Rs, 2,000 at (say) 2 years purchase 4,000  
Third Rs. 2,000 at (say) 1 years purchase 2,000  
Total value of goodwill **Rs. 12,000 .**

**c) Annuity Method of Super Profit:** This method is based on the logic that the purchaser should pay not for goodwill only the present value of super profits calculated at a proper rate of interest. In other words, goodwill in case of this method is the discounted value of the total amount calculated as per purchase of super profit method. The value of goodwill in case of this method is ascertained as follows:

**Average Annual Super profit x Annuity Rate**

**Example:** Average annual super profit Rs. 5,000, Rate of Interest 10% In case goodwill is to be valued at 3 years purchase of the average annual super profit reference will have to be made to the annuity table for finding out the present value of one rupee paid annually for 3 years at 10% interest. Reference to annuity table shows that Rs. 2.48685 is the present value of an annuity of Re 1 for three years. The value of goodwill will, therefore, be ascertained as follows: Rs. 5,000 x 2.48685 = Rs 12,434 or (say) Rs 12,500.

### **UNIT-3 IMPORTANT QUESTIONS**

- ✓ Explain Methods of Inventory Valuation? Merits & de-merits?
- ✓ Explain Methods of good will Valuation? Merits & de-merits?

**Problems:** LIFO, FIFO SIMPLE & WEIGHTED AVERAGE.


**JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY ANANTAPUR**

(Established by Govt. of A.P., ACT No.30 of 2008)

**ANANTHAPURAMU – 515 002 (A.P) INDIA**
**MASTER OF BUSINESS ADMINISTRATION  
MBA; MBA (General Management); MBA (Business Management)  
COMMON COURSE STRUCTURE**

Course Code	FINANCIAL ACCOUNTING FOR MANAGERS	L	T	P	C
21E00104		4	0	0	4
Semester		I			
Course Objectives:					
<ul style="list-style-type: none"><li>To introduce accounting , accounting rules, accounting process and preparation of financial statements.</li><li>To explain methods of valuation of assets,</li><li>To explore the meaning and interpretation of financial statements through ratio analysis technique.</li></ul>					
Course Outcomes (CO): Student will be able to					
<ul style="list-style-type: none"><li>Prepare the financial statements with accounting knowledge</li><li>Value the assets of the business organizations under different methods</li><li>Analyse the financial performance and position of the business organization and interpret the results from the point of company and investor</li></ul>					
UNIT - I	Lecture Hrs: 8				
Introduction to Accounting: Definition, Importance, Objectives and principles of accounting, uses of accounting and book keeping Vs Accounting, Single entry and Double entry systems, classification of accounts – rules of debit & credit. (Only theory)					
UNIT - II	Lecture Hrs: 12				
The Accounting Process: Overview, Books of Original Record; Journal and Subsidiary books, ledger, Trial Balance, Final accounts: Trading accounts- Profit & loss accounts- Balance sheets with adjustments. (Problems on Only Final Accounts)					
UNIT - III	Lecture Hrs:12				
Valuation of Assets: Introduction to Depreciation- Methods (Simple problems from Straight line method, Diminishing balance method and Annuity method). Inventory Valuation: Methods of inventory valuation (Simple problems from LIFO, FIFO).					
UNIT - IV	Lecture Hrs:12				
Financial Analysis -I Analysis and interpretation of financial statements from investor and company point of view, Liquidity, leverage, solvency and profitability ratios – Du Pont Chart (A Case study on Ratio Analysis).					
UNIT - V	Lecture Hrs:12				
Financial Analysis-II: Objectives of fund flow statement - Steps in preparation of fund flow statement, Objectives of Cash flow statement- Steps in Preparation of Cash flow statement – Analysis of Cash flow and Funds flow statements - Funds flow statement Vs Cash flow statement. (Only theory).					
Textbooks:					
<ul style="list-style-type: none"><li>Financial Accounting, Dr.S.N. Maheshwari and Dr.S.K. Maheshwari, Vikas Publishing House Pvt. Ltd.,</li><li>Accountancy .M P Gupta &amp;Agarwal ,S.Chand</li></ul>					
Reference Books:					
<ul style="list-style-type: none"><li>Financial Accounting ,P.C.Tulisan ,S.Chand</li><li>Financial Accounting for Business Managers, Asish K. Bhattacharyya, PHI</li><li>Financial Accounting Management An Analytical Perspective, Ambrish Gupta, Pearson Education</li><li>Accounting and Financial Management, Thukaram Rao, New Age Internationals.</li><li>Financial Accounting Reporting &amp; Analysis, Stice&amp;Stice, Thomson</li><li>Accounting for Management, Vijaya Kumar,TMH</li><li>Accounting for Managers, Made Gowda, Himalaya</li></ul>					



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**COMMON COURSE STRUCTURE & SYLLABI**

8. Accounting for Management ,N.P.Srinivasan, &M.ShakthivelMurugan, S.Chand

**Online Learning Resources:**

[https://onlinecourses.swayam2.ac.in/cec20\\_mg02/preview](https://onlinecourses.swayam2.ac.in/cec20_mg02/preview)  
[https://onlinecourses.swayam2.ac.in/imb19\\_mg06/preview](https://onlinecourses.swayam2.ac.in/imb19_mg06/preview)  
[https://onlinecourses.nptel.ac.in/noc19\\_mg37/preview](https://onlinecourses.nptel.ac.in/noc19_mg37/preview)  
<https://www.coursera.org/learn/wharton-accounting>

Subject:  
**FINANCIAL ACCOUNTING  
FOR MANAGERS**



**Tools of Financial Analysis**

Comparative Financial Statements

Common-size Financial Statements

Trend Percentages

Ratio Analysis

Fund Flow Statement

Cash Flow Statement





## **UNIT-4**

### **FINANCIAL ANALYSIS – I**

#### **4.1. ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS FROM INVESTOR AND COMPANY POINT OF VIEW**

##### **1.1 NATURE OF FINANCIAL STATEMENTS:**

Financial statements are the basic and formal means through which the corporate management communicates financial information to various external users. Financial statements are primarily directed towards the needs of owners and incidentally to the needs of other external parties which include investors, tax authorities, governments, employees etc. the following definitions bring out the meaning of financial statements.

According to American Institute of Certified Public Accountants (AICPA), “Financial statements are prepared for the purpose of presenting a periodical review or report on progress made by the management and deal with the status of investment in the business and the results achieved during the period under review.

##### **4.1.2 TYPES OF FINANCIAL STATEMENTS:**

Financial statements generally include two statements known as income statement and balance sheet. The prime attention of accounting process is paid on distinguishing between the revenue items from capital items. Revenue items include both revenue receipts as well as revenue payments. They are of nominal nature, hence need to be matched and net results are to be identified. The statement, which takes care of this process, is known as income statement. After matching the revenue receipts with that of revenue payments, the remaining balances are of capital nature. They include items, which have potential uses and future obligations known as assets and liabilities. The statement, which shows total of assets and liabilities, is known as balance sheet. As per generally accepted accounting principles financial statements are as follows:

- i) Balance sheet
- ii) Income statement
- iii) Statement changes in owners' account
- iv) Statement of changes in financial position

The two basic or major financial statements known as balance sheet and income statement are required for external reporting and also for internal needs of the management like planning, decision making and control. These two basic statements are supported by number schedules, annexure, supplementing the data contained in the balance sheet and income statement. Apart from these two basic financial statements, there is a need to know about movements of funds and changes in the financial position of the company. A statement of retained earnings and the statement of changes in financial position help in this direction.

#### **4.1.3 USES AND IMPORTANCE OF FINANCIAL STATEMENTS:**

Financial statements, which are prepared depicting true, relevant, easily understandable, comparable, analytically represented and promptly presented financial position, help the users in their economic decisions. The users of financial statements include management, investors, shareholders, creditors, government, bankers, employees and public at large. They provide not only information about the performance of the management to the various parties interested in the organization but also help in taking appropriate decisions. The uses and importance of financial statements are presented below:

- a) **Report on stewardship function:** Financial statements report on the performance of the policies of the management to the shareholders. The gaps in the management and ownership can be understood with the help of financial statements.
- b) **Basis for fiscal policies:** the fiscal policies particular taxation policies of the government are related with the financial performance of corporate undertakings. Thus financial statements provide basic input for industrial and taxation and other socio-economic policies of the government.
- c) **Basis for dividend policies:** the dividend policies of the corporate sector are linked with the government regulations and financial performance of the undertaking. Hence, financial statements form basis for dividend policies of companies.
- d) **Basis for granting of credit:** corporate undertakings have to borrow funds from banks and other financial institutions for different purposes. Credit granting institutions take decisions based on the financial performance of the undertakings. Thus financial statements form basis for granting of credit.
- e) **Basis for prospective investors:** the investors include both short term and long term investors. Their prime considerations in their investment decisions are security and liquidity of their investment with reasonable profitability. Financial statements help

the investors to assess long term and short term solvency as well as the profitability of the concern.

- f) **Guide to the value of the investment already made:** shareholders of companies are interested in knowing the status, safety and return on their investment. They may also need information to take decision about continuation or discontinuation of their investment in the business. Financial statements provide information to the shareholders in taking such important decisions.
- g) **Aids government in policy framework:** the government studies the financial statements of corporate undertakings to assess the role of corporate undertakings in the economic development of the country. It also studies the economic situation of the country from these statements in terms of industrial production, employment, technological development etc. these statements enable the government to know whether business is following various rules and regulations or not. These statements also form a base for framing and amending various laws for the regulation of the business.
- h) **Helps trade associations in helping their members:** trade associations may analyze the financial statements for the purpose of providing service and protection to the members. They may develop standard ratios and design uniform system of accounts.
- i) **Helps stock exchanges:** financial statements help the stock exchanges to understand the extent of transparency in reporting on financial performance and enables them to call for required information to protect the interest of investors. The financial statements enable the stock brokers to judge the financial position of different concerns and take decisions about the prices to be quoted.

#### **4.1.4 LIMITATIONS OF FINANCIAL STATEMENTS:**

Though utmost care is taken in the preparation of financial statements to be useful to the users, they suffer from the following limitations:

- 1) Net profit is ascertained on the basis of historical cost. If profits are adjusted to changing price levels, it may lead to loss and consequently dividends may be paid out of capital.
- 2) Accounting is done on the basis of certain conventions; eg: the assets are valued on the going concern basis. Some of the assets may not realize the stated values, if the liquidation is forced on the company. Assets shown in the balance sheet reflect merely unexpired or unamortized cost.

- 3) The balance sheet is prepared at a point of time and the accounting year may be deliberately chosen in such a manner that it gives favorable picture.
- 4) Financial statements are the outcome of recorded facts, concepts and conventions used and value judgments made in different situations by the accountants. Hence, bias may be observed in the results.
- 5) Financial statements show aggregate information but not specific information. Hence they may not satisfy the users in decision making unless modified suitably.
- 6) Balance sheet does not disclose information relating to changes in management, loss of markets and cessation of agreements, which have vital bearing on the enterprise.
- 7) Financial statements contain only monetary information but not qualitative information like industrial relations, industrial climate, labor relations, quality of work and labor etc.
- 8) Profit and loss account discloses only interim profits but not final profits. Final profits can be known only when enterprise is liquidated.

#### **4.1.5 ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS :**

The process of critical examination of the financial information contained in the financial statements in order to understand and make decisions regarding the operations of the firm is called "financial statement analysis". It is basically a study of the relationship among various financial facts and figures as given in a set of financial statements.

#### **4.1.6 OBJECTIVES OF FINANCIAL STATEMENT ANALYSIS**

- 1) To provide adequate information about the source of finance and obligations of the finance firm.
- 2) To provide reliable information about the financial performance and financial soundness of the concern.
- 3) To provide sufficient information about results of operations of business over a period of time.
- 4) To provide useful information about the financial conditions of the business and movement of resources in and out of business.
- 5) To provide necessary information to enable the users to evaluate the earning performance of resources or managerial performance in forecasting the earning potentials of business.



#### **4.1.7 CHARACTERISTIC & FUNCTIONS OF FINANCIAL STATEMENT ANALYSIS**

- 1) **Understandability:** The information must be readily understandable to users of the financial statements. This means that information must be clearly presented, with additional information supplied in the supporting footnotes as needed to assist in clarification.
- 2) **Relevance:** The information must be relevant to the needs of the users, which is the case when the information influences the economic decisions of users. This may involve reporting particularly relevant information, or information whose omission or misstatement could influence the economic decisions of users.
- 3) **Reliability:** The information must be free of material error and bias, and not misleading. Thus, the information should faithfully represent transactions and other events, reflect the underlying substance of events, and prudently represent estimates and uncertainties through proper disclosure.
- 4) **Comparability:** The information must be comparable to the financial information presented for other accounting periods, so that users can identify trends in the performance and financial position of the reporting entity.

#### **4.1.8 TYPES OF ANALYSIS AND INTERPRETATION:**

As you have already learnt, various users of financial statements study them from different angles for different purposes. However, the 'modus operandi' and the material used are identified by Man Mohan and Goyal as two common bases used for classification.

**I) Modus operandi:** on the basis of number of years, financial statements used for analysis and interpretation, the analysis may be classified into vertical and horizontal analysis.

**a. Vertical analysis:** when the analysis of financial statements of an organization is made for only one accounting period, it is called as vertical analysis. For instance, analyzing and interpreting the performance of a company for the year 2004 with the help of profit and loss account of that company for the year ending 31<sup>st</sup> December, 2004 and the balance sheet of that company so on that date.

**Balance sheet of XYZ Company as on 31.12.2004**

	Amount	Amount
<b>Uses of Funds</b>	Rs	Rs
Fixed Assets		
Land & Building	XXX	
Plant & Machinery	XXX	
Furniture & Fixtures	XXX	XXX
<b>Current Assets</b>		
Stock-in-trade	XXX	
Sundry Debtors	XXX	
Bills Receivables	XXX	
Cash at bank	XXX	
Cash in hand	XXX	
	XXX	
<b>Current Liabilities</b>		
Sundry Creditors	XXX	
Bills payable	XXX	
Outstanding Expenses	XXX	
	XXX	XXXXXX
<b>Net working capital (CA-CL)</b>		XXXXXX
<b>Total net Assets</b>		
<b>Sources of funds</b>		
<b>Owners Funds</b>		
Equity Share Capital		
Reserves & Surplus		
Long Term liabilities		
Total		<u>XXXXXX</u>

**b. Horizontal analysis:** When the analysis of financial statements of an organization is made for two or more years, it is called as 'horizontal analysis'. Since the data for more than one year are used, it is possible to compare the performance of the company during a year with that of the previous year. This helps to identify the trend in various indicators of performance such as improved profitability of an organization, its solvency, liquidity, etc.,

over the years. For instance, comparison of performance of an undertaking for the year 2004 with that of 2003, can be taken as horizontal analysis.

Capital & Liabilities	Amount	Assets & Property	Amount
<b>Capital:</b> Equity share capital Preference share capital Reserves & Surplus <b>LONG TERM LAIBILITIES</b> Debentures Loan Mortgage  <b>Current Liabilities'</b> Creditors Bills Payables Bank Loan Outstanding Expenses		Fixed Assets Good will Land & Building Plant & Machinery Furniture & Fixtures Investments  Current Assets Stock in trade Debtors Bills Receivable Cash at bank Cash in hand	
	<u>XXXX</u>		<u>XXXX</u>

## II) Material used:

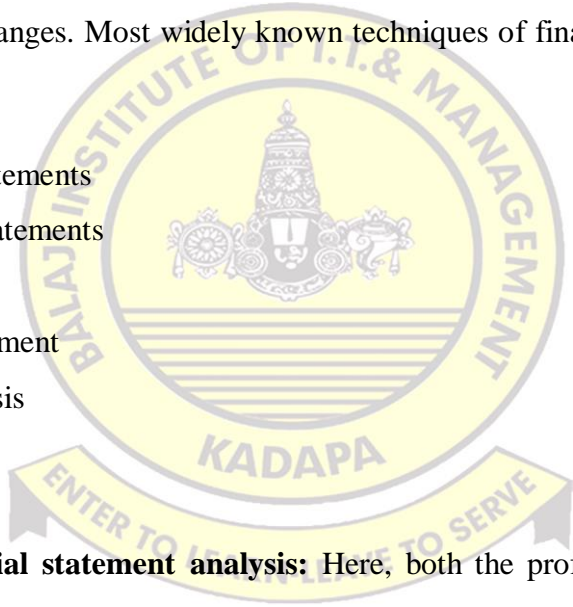
Analysis and interpretation of Financial Statement maybe external or internal depending upon the material or information used.

**a. External Analysis:** The financial statements are prepared and presented to out sides including shareholders and employees. Normally, external people do not have an easy access to the detailed accounting records of the organization. The outsiders have to rely on the figures in the financial statements and other supplement in the annual reports of the purpose of analysis and interpretation to form an idea about the financial health of the company and to take appropriate decisions. Such type of analysis by the people external to the organization is called 'external analysis. Due to this reason of non-availability of detailed information, this type of analysis serves only a very limited purpose.

**b. Internal analysis:** when the financial statements of an organization are analyzed and interpreted by the people internal to the organization and who have an easy access to the detailed accounting records for the purpose of assisting the material personal to take correct measures and appropriate decisions, is called “internal analysis”. As complete set of information is available to the analyst, he can analyze the performance of the organization clearly stating the reasons for improvements or decreasing trends in various indicators of performance.

#### **4.1.9 TECHNIQUES OF FINANCIAL ANALYSIS:**

Financial statement analysis is done to emphasize the comparative and relative importance of data presented and at the same time evaluate the position of the firm. This purpose of financial data analysis is satisfied by using various suitable techniques. The techniques show the relationships and changes. Most widely known techniques of financial statement analysis are:

- 
- 1) Comparative statements
  - 2) Common size statements
  - 3) Trend analysis
  - 4) Funds flow statement
  - 5) Cash flow analysis
  - 6) Ratio analysis

**1) Comparative financial statement analysis:** Here, both the profit and loss account and balance sheet are prepared by providing columns to the figures for both, the current year as well as for the previous year and for the changes during the year both, in absolute and relative terms. As a result, it is possible to find out not only the balances of account as on different dates and summarized of different operational activities of different periods, but also the extent of their increase or decrease between these dates. The figures in the comparative statements can be used for identifying the direction of changes and also the trends in different indicators of performance of an organization.

**2) Common size financial statement analysis:** Common size statement is a financial tool for studying the key changes and trends in the financial position (balance sheet) and financial result (profit and loss account) of a company. Here each item in the statement is stated as a



percentage of totals of which that item is a part. Thus, each percentage exhibits the relation of the individual item to its respective total.

First, state the total of the statement 100% and then compute the ratio of each statement item to the statement total.

Inter-firm comparison or comparison of the company's position with the related industry as a whole is possible with the help of vertical common size statement analysis. Horizontal common size statement analysis facilitates trend analysis of the financial result and financial position of the statement of the company over the past several years.

**3)Trend analysis:** The financial statements may be analyzed by computing trends of series of information. Trend analysis determines the direction upwards or downwards and involves the computation of the percentage relationship that each statements item bears to the same item in the base year.

**Procedure for calculating trends:**

One year is taken as base year. Generally the first or the last year is taken as base year. The figures of base year are taken as 100. The trend percentages are calculated in relation to base year. If a figure in other year is less than the figure in base year, the trend percentage will be less than 100 and it will be more than 100 if figure is more than the base year figure. Each year's figure is divided by the base year figure.

$$\text{Trend ratio} = \text{present year value} / \text{base year value} * 100$$

The base period should be carefully selected. The base period should be a normal period. The accounting procedures and conventions used for collecting data and preparation of financial statements should be similar; otherwise the figures will not be comparable.

The interpretation of trend analysis involves a cautious study. The mere increase or decrease in trend percentage may give misleading results. For example, an increase of 20% in current assets may be treated favorable. If this increase in current assets is accompanied by an equivalent increase in current liabilities, then this increase will be unsatisfactory. The increase in sales may not increase profits if cost of production has gone up.

**4) Funds flow statement:** As the name implies statement of sources and uses of funds depicts the sources from which funds are obtained and uses to which they are put.

According to Foulke defined funds flow statement as “A statement of sources and application of funds is a technical device designed to analyze the changes in the financial conditions of a business enterprise between two dates”.

**Preparation of funds flow statement:**

The preparation of funds flow statement is divided into two parts viz.,

- a)Statement of changes in working capital and
- b)Statement of Sources and Uses of funds.

**5) Cash Flow Statement:** A statement of changes in the financial position of firm on cash basis is called a cash flow statement ..A cash flow statement summarizes the causes of changes in cash position of business enterprises between dates of two balance sheets. It is called a cash flow out flow (uses) of cash.

**Preparation of cash Flow statement:**

The cash flows shown in the statement are grouped in to three main categories of cash inflows and cash outflows viz., Cash flows from operating activities , cash flows investing activities and cash flows from financing activities. A brief description of these items is discussed below:

- A) Cash flows from operating activities
- B) Cash flows from investing activities
- C) Cash flows from financing activities

**6) Ratio Analysis:** Single most important technique of financial analysis in which quantities are converted into ratios for meaningful comparisons, with past ratios and ratios of other firms in the same or different industries. Ratio analysis determines trends and exposes strengths or weaknesses of a firm.-*Bust Noon*

**4.2. RATIO ANALYSIS:**

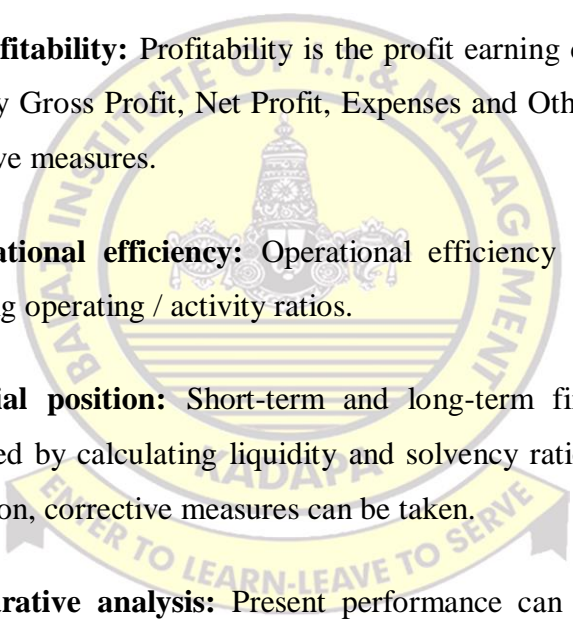
Ratio Analysis is a form of Financial Statement Analysis that is used to obtain a quick indication of a firm's financial performance in several key areas. The ratios are categorized as Short-term Solvency Ratios, Debt Management Ratios, Asset Management Ratios, Profitability Ratios, and Market Value Ratios.

Ratio Analysis as a tool possesses several important features. The data, which are provided by financial statements, are readily available. The computation of ratios facilitates the

comparison of firms which differ in size. Ratios can be used to compare a firm's financial performance with industry averages. In addition, ratios can be used in a form of trend analysis to identify areas where performance has improved or deteriorated over time.

Because Ratio Analysis is based upon Accounting information, its effectiveness is limited by the distortions which arise in financial statements due to such things as Historical Cost Accounting and inflation. Therefore, Ratio Analysis should only be used as a first step in financial analysis, to obtain a quick indication of a firm's performance and to identify areas which need to be investigated further.

#### **4.2.1 OBJECTIVES OF RATIO ANALYSIS:**

- 
- (1) Measuring the profitability:** Profitability is the profit earning capacity of the business. This can be measured by Gross Profit, Net Profit, Expenses and Other Ratios. If these ratios fall we can take corrective measures.
  - (2) Determining operational efficiency:** Operational efficiency of the business can be determined by calculating operating / activity ratios.
  - (3) Measuring financial position:** Short-term and long-term financial position of the business can be measured by calculating liquidity and solvency ratios. In case of unhealthy short or long-term position, corrective measures can be taken.
  - (4) Facilitating comparative analysis:** Present performance can be compared with past performance to discover the plus and minus points. Comparison with the performance of other competitive firms can also be made.
  - (5) Indicating overall efficiency:** Profit and Loss Account shows the amount of net profit and Balance Sheet shows the amount of various assets, liabilities and capital. But the profitability can be known by calculating the financial ratios.
  - (6) Budgeting and forecasting:** Ratio analysis is of much help in financial forecasting and planning. Ratios calculated for a number of years work as a guide for the future. Meaningful conclusions can be drawn for future from these ratios.

#### **4.2.2 ADVANTAGES OF RATIO ANALYSIS**

- 1. Performance over time:** Ratio analysis is a strong indicator of the financial performance of a company over time. An analyst can calculate the same ratio across different time periods to identify particular components of a company's financial performance that may be improving or declining. Ratio analysis uses relative percentages rather than dollar amounts, allowing for ease of comparison across periods. Ratio analysis may help distinguish between firms that may fail and firms that are profitable. Through the careful use of financial ratio analysis, an analyst may be able to detect financial troubles up to five years before a firm fails.
- 2. Performance against competitors:** Ratio analysis can be used to assess the performance of a company against other competitors that operate within the same industry. Companies that operate in the same industry generally exhibit similar financial profiles. Thus, a calculated ratio that is significantly above or below the industry average may indicate a particularly strong or particularly weak performance by the company in certain areas.

#### **4.2.3 DISADVANTAGES OF RATIO ANALYSIS**

- 1. Narrow Focus:** Ratio analysis may lead to a narrow focus on certain elements of a company's financial performance. It is important to consider all ratios in relation to one another.
- 2. Accounting Methodologies:** Certain ratios may be adversely affected by a company's accounting methodologies.

#### **4.2.4 TOOLS FOR RATIO ANALYSIS (OR) TYPES RATIO :**

- 1) Liquidity Ratios:** They measure the firm's ability to meet current obligations. Current ratio, cash ratio, quick ratio, net working capital ratio it measures the firm's ability to meet current obligations
- 2) Leverage Ratios:** These ratios show the proportion of debt and equity in financing the firm's assets. Debt ratio, debt equity ratio capital employed to net worth ratio it shows the proportions of debt and equity in financing the firm's assets



- 3) **Activity Ratios:** They reflect the firm's efficiency in utilizing the assets. Inventory turnover ratio, debt turnover ratio, collection period, total assets turnover ratio, fixed and current assets turnover ratio, creditor turnover ratio, working capital ratio etc, Activity ratio reflect the firms efficiency in utilizing its assets
- 4) **Profitability Ratios:** These ratios measure overall performance and effectiveness of the firm. Gross profit, net profit, operating, return on equity, return on investment .it measures overall performance and effectiveness of the firm.

### **4.3. DUPONT CHART**

The DuPont analysis also called the DuPont model is a financial ratio based on the return on equity ratio that is used to analyze a company's ability to increase its return on equity. In other words, this model breaks down the return on equity ratio to explain how companies can increase their return for investors.

The DuPont analysis looks at three main components of the ROE ratio.

- ❖ Profit Margin
- ❖ Total Asset Turnover
- ❖ Financial Leverage

The DuPont Corporation developed this analysis in the 1920s. The name has stuck with it ever since

Based on these three performances measures the model concludes that a company can raise its ROE by maintaining a high profit margin, increasing asset turnover, or leveraging assets more effectively.

#### **4.3.1Formula**

The Dupont Model equates ROE to profit margin, asset turnover, and financial leverage. The basic formula looks like this.

#### **DuPont Analysis**

$$\text{Return on Equity} = \text{Profit Margin} \times \text{Total Asset Turnover} \times \text{Financial Leverage}$$

Since each one of these factors is a calculation in and of itself, a more explanatory formula for this analysis looks like this.

DuPont Analysis					
	Profit Margin	x	Total Asset Turnover	x	Financial Leverage
Return on Equity =	<u>Net Income</u>		<u>Net Sales</u>		<u>Total Assets</u>
	Net Sales		Average Total Assets		Total Equity

Every one of these accounts can easily be found on the financial statements. Net income and sales appear on the income statement, while total assets and total equity appear on the balance sheet.

#### 4.3.2 USE OF DUPONT ANALYSIS

Using the modified equation of Return on Equity, one can make a more informed decision and understand the company position better. If the Return on Equity either increases due to increase in operating efficiency or improved asset utilization, it is a good sign for investors. It would imply that either company is making higher margins on its sales or the company is making better use of its assets or both.

On the other hand, if the Return on Equity increases on account of financial leverage, it would imply that the profit is due to the financial strategy of the company rather than good operations of it. Too higher a debt ratio also makes a company riskier proposal for investment.

In essence, a manager should try increasing the ROE by way of either higher operating efficiency or better asset utilization. There is no reservation for using the third parameter also i.e. financial leverage, but it will increase the risk of bankruptcy in case the lenders asks for the large sum of money.

#### Example Explaining DuPont Analysis

Consider a hypothetical scenario of companies X and Y with below numbers.

	X	Y
1. Operating profit margin ratio	0.20	0.12
2. <a href="#">Asset turnover ratio</a>	0.30	0.30
3. Financial Leverage or Equity multiplier	2.00	3.33
ROE (1*2*3)	0.12	0.12



# FINANCIAL ACCOUNTING.

①

## Types of Ratio:

### 1. Liquidity Ratio :-

a) current ratio =  $\frac{\text{current Assets}}{\text{current liabilities}}$ .

### b) Quick (or) Acid test (or) liquidity Ratio.

=  $\frac{\text{Liquid/Quick Assets}}{\text{current liabilities}}$ .

#### \* current Assets:-

1. sundry debtors.
2. Bills Receivables
3. cash in hand.
4. cash at bank.
5. closing stock.
6. prepaid Expenses.
7. Marketable Securities.

#### current liabilities:-

1. sundry creditors.
2. bills payables.
3. Outstanding Expenses.
4. Bank over draft.
5. provision for taxation.

### Quick Assets (or) Acid test (or) liquidity Ratio:-

\*current Assets - Inventory - prepaid Expenses.

cash Ratio =  $\frac{\text{cash} + \text{Bank} + \text{Marketable Securities}}{\text{current liabilities}}$ .

#### problem:

1. From the following Information calculate current, Quick and cash Ratio.



Liabilities	Amount	Assets	Amount
Equity share capital	1,00,000	Land and Building	3,60,000.
80% preference capital	1,10,000	plant and Machinery	5,00,000.
Reserves	40,000	Furniture and Fixtures	1,00,000.
profit and loss A/c	2,10,000	stock	95,000.
15% Debentures	8,00,000	Debitors	2,00,000.
Trade creditors	40,000	Marketable securities	80,000.
Bills payable	30,000	cash	50,000.
out standing Expenses	20,000	Bills Receivable	5,000
Bank over draft	5,000	prepaid Expenses	5,000.
provision for taxation	40,000	preliminary Expenses	60,000.

### Current Ratio:

$$\text{Current Ratio} = \frac{\text{current Assets}}{\text{Current liabilities.}}$$

$$= \text{Sundry Debtors} + \text{Bills}$$

Receivables + stock + cash in hand + cash at bank + prepaid Expenses + Market securities.

---

Sundry creditors + Bills payable + out standing Expenses + Bank over draft + provision for taxation.



$$= 20,000,00 + 5000 + 95000 + 50,000 + 0 + 5000 + 80,000$$

$$40,000 + 30,000 + 20,000 + 5000 + 40000$$

$$= \frac{4,35,000}{1,35,000}$$

$$= 3.22 : 1$$

2) Quick Ratio:

$$\text{Quick Ratio} = \frac{\text{current Assets} - \text{Inventory} - \text{prepaid Expenses}}{\text{current liabilities.}}$$

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{current liabilities}}$$

$$= \frac{\text{current Assets} - \text{Inventory} - \text{prepaid Expenses}}{\text{current liabilities.}}$$

$$= \frac{4,35,000 - 95,000 - 5000}{13,50,000}$$

$$= \frac{33,5000}{13,50,000}$$

$$= 2.48 : 1$$

3) Cash Ratio:-

$$\text{Cash Ratio} = \frac{\text{cash} + \text{Bank} + \text{Marketable Securities}}{\text{current liabilities.}}$$

$$= 50,000 + 0 + 80,000$$

$$\underline{1,35,000}$$

$$= \frac{1,30,000}{1,35,000}$$

$$\underline{1,35,000}$$

$$= 0.9631$$

2) Leverage Ratio :—

$$1. \text{ Debt-Equity Ratio} = \frac{\text{Total long term Debt}}{\text{share holders Fund.}}$$

(OR)

External Equities.

Internal Equities.

Where, Total long term debt = Debenture + long term loans + term loans + loan on Mortgage + loans from financial Institutions + Redineable preference share capital.  
Share holders Fund :—

Share holders Fund = Equity share capital + Irredenable preference capital + capital Reserves + Retained earnings + any other Surplus provisions — Fictitious Assets.

1) From the following Information calculate debt equity ratio.

Debt debentures	1,40,000.
long term loan	60,000.
Bank balance	30,000.
Debtors	70,000
general Reserves	40,000
creditors	66,000
share capital	1,20,000.
bills payable	14,000.

$$\text{debt equity ratio} = \frac{\text{Total long term debts}}{\text{Share holders Funds.}}$$

$$= \frac{\text{Debt debentures} + \text{long term loan}}{\text{share capital} + \text{general Reserves.}}$$

$$= \frac{1,40,000 + 60,000}{12,0000 + 40,000}$$

$$= \frac{2,00,000}{1,60,000}$$

$$= 1.25:1$$

Proprietary / Equity Ratio:-

$$\text{P.E.R} = \frac{\text{Proprietary Funds (share holders Funds)}}{\text{Total Assests.}}$$

2) Proprietor Funds are 6,00,000.

Building 2,00,000.

Machinery 1,00,000.

Furniture 2,50,000

land 50,000.

$$\text{Proprietor Funds} = \frac{\text{Share holders Funds (or) P.F.}}{\text{Total Assets.}}$$

$$= \frac{6,00,000}{2,00,000 + 1,00,000 + 2,50,000 + 50,000}$$

$$= \frac{6,00,000}{6,00,000}$$

$$= 1:1$$

3) Interest Coverage Ratio:-

$$\text{debt Service Ratio} = \frac{\text{Net profit before Interest and tax.}}{\text{Interest on long term debt.}}$$

1) The Net profit after tax of a firm is 75,000. and its fixed Interest charges on long term borrowings are 30,000. The Rate of Income tax is 50%. calculate Interest coverage ratio.



Net profit (After tax) = 75,000

Tax 50% = 75,000.

Interest = 30,000.

Interest (Net profit before tax and Interest) = 1,80,000

Interest = 30,000

1,50,000

75,000

75,000

Tax 50% and Interest

Net profit After tax.

Interest coverage Ratio =  $\frac{1,80,000}{30,000}$

= 6:1

capital gearing Ratio:

capital gearing Ratio =  $\frac{\text{Equity share capital}}{\text{Reserves and surplus.}}$

preference share capital + long term debt bearing Fixed Interest.

1) From the following Information find out capital gearing ratio.

Particulars	2001-02	2002-03.
1. Equity share capital	6,00,000	4,00,000.
2. Reserves and surplus.	3,00,000	2,00,000.
3. 8% preference share capital	2,50,000	4,00,000.
4. 6% debentures	2,50,000	4,00,000.
5. Fixed Assets	2,00,000	4,00,000.

capital gearing ratio =

Equity share capital + Reserves and surplus

preference share capital + long term debt bearing fixed interest.

$$2001-02 = \frac{6,00,000 + 3,00,000}{2,50,000 + 2,50,000}$$

$$= \frac{9,00,000}{50,0000}$$

$$= 1.8 : 1$$

$$2002-2003 = \frac{4,00,000 + 2,00,000}{4,00,000 + 4,00,000}$$

$$= \frac{6,00,000}{8,00,000}$$

$$= 0.75 : 1$$

2) particulars

Year  
(2001-02)

year  
(2002-03)

1. Equity share capital

606000

404000

2. Reserves and surplus

303000

202000

3. 8% preference share capital

252500

404000

4. 6% debentures

252500

404000

5. Fixed Assets	202000	404000.
6. Outstanding Expenses	10100	15150.

Capital gearing ratio =  $\frac{\text{Equity share capital} + \text{Reserves and surplus.}}{\text{preference share capital} + \text{long term debt bearing fixed interest.}}$

$$\begin{aligned} 2001-02 &= \frac{606000 + 303000}{252500 + 252500} \\ &= \frac{909000}{505000} \end{aligned}$$

$$= 1.8:1$$

$$\begin{aligned} 2002-03 &= \frac{404000 + 202000}{404000 + 404000} \\ &= \frac{606000}{808000} \end{aligned}$$

$$= 0.75:1$$

3) Activity Ratio:-

a) Fixed Assets turnover Ratio:-

$$= \frac{\text{Net sales}}{\text{Net fixed Assets}}$$

Where, Net sales = total sales - sales Returns.

Net Fixed Assets = Gross fixed Assets - depreciation.



1) ABC company has gross fixed Assets of Rs 5,00,000 and Accumulated depreciation is 2,00,000. Sales over the last 1 year was 9,00,000/- calculate fixed Assets turnover Ratio.

Fixed Assets turnover Ratio

= Net sales

Net Fixed Assets

=  $\frac{9,00,000}{5,00,000 - 2,00,000}$

=  $\frac{9,00,000}{3,00,000}$

= 3 times //

Stock (Inventory) turn over ratio:-

=  $\frac{\text{cost of goods sold}}{\text{Average Inventory}}$

Where, cost of goods sold = sales - gross profit.  
(or)

cost of goods sold = opening stock + purchases  
+ Direct Expenses - closing stock.

Average Inventory =  $\frac{\text{opening stock} + \text{closing stock}}{2}$



(08)

$$\text{Stock turn over ratio} = \frac{\text{Net sales}}{\text{Average stock}}$$

$$\text{Inventory conversion period Ratio :}$$

$$= \frac{365 \text{ days}}{\text{Inventory turn over Ratio}}$$

Inventory turn over Ratio

1) Mr. Ravi and co. supplies the following Information for the year ending 31-Dec-2013.

$$\text{Credit sales} = 1,75,000/-$$

$$\text{cash sales} = 2,50,000/-$$

$$\text{sales Returns} = 25,000/-$$

$$\text{Opening stock} = 25,000/-$$

$$\text{closing stock} = 35,000/-$$

$$\text{Stock turn over ratio} = \frac{\text{cost of goods sold}}{\text{Average Inventory}}$$

$$= \frac{15,000}{30,000}$$

$$= 0.5 \text{ times}$$

$$\text{Cost of good sold} = \text{sales} - \text{gross profit}$$

$$= 1,75,000 + 2,50,000 - 4,10,000$$

$$\Rightarrow 4,25,000 - 4,10,000$$

$$= 15,000.$$

$$\begin{aligned}
 \text{Average Inventory} &= \frac{\text{opening stock} + \text{closing stock}}{2} \\
 &= \frac{25,000 + 35,000}{2} \\
 &= \frac{60,000}{2} \\
 &= 30,000/-
 \end{aligned}$$

$$\begin{aligned}
 \text{Inventory conversion period} &= \frac{365}{0.5} \\
 &= 730 \text{ days.}
 \end{aligned}$$

Debtors turn over Ratio:—

$$= \frac{\text{Net credit sales}}{\text{Average Account Receivables}}$$

$$\text{Avg Receivables} = \frac{\text{opening Receivables} + \text{closing Receivables}}{2}$$

$$\begin{aligned}
 \text{debtors collection period (or) debtors Velocity} \\
 &= \frac{\text{Average trade debtors}}{\text{Net sales}} \\
 &\quad \text{No. of working days.}
 \end{aligned}$$

3) calculate debtors turn over ratio and Avg debt collection period from the year 2012 to 2013.

Particulars	2012	2013
Sundry debtors	15,000	45,000
Bills Receivables	5,000	15,000
provision for doubtful debts	15,000	4,500

Total sales — 2,20,000/-

Sales Return — 20,000/-

cash sales — 40,000/-

Debtors turnover Ratio.

=  $\frac{\text{Net Credit Sales}}{\text{Average Account Receivables (or) Avg Debtors}}$

Average Account Receivables (or) Avg Debtors

$$= \frac{1,60,000}{40,000}$$

= 4 times.

$$\begin{aligned} \text{Net credit sales} &= 2,20,000 - 20,000 \\ &= 2,00,000. \end{aligned}$$

$$\begin{aligned} \text{Credit sales} &= 2,00,000 - 40,000 \\ &= 1,60,000. \end{aligned}$$

$$\begin{aligned} \text{Avg Debtors} &= \frac{\text{Opening Debtors} + \text{Opening Bills Receivables} \\ &\quad + \text{c. Debtors} + \text{closing Bills Receivables}}{2} \end{aligned}$$

$$= \frac{15,000 + 5,000 + 45,000 + 15,000}{2}$$

$$= 80,000$$

Debtors collection period =  $\frac{365}{4} = 91$  days.

Formula, =  $\frac{365}{\text{Debt turnover Ratio}}$

Creditors turnover Ratio (or) payable turnover Ratio.

=  $\frac{\text{Net credit purchases}}{\text{Average trade creditors.}}$

Where, Net credit purchases = gross credit purchases  
- purchase Returns.

Average trade creditors =  $\frac{\text{creditors} + \text{bills payable}}{2}$   
(or)

Average trade creditors =  $\frac{\text{opening trade creditors} + \text{closing trade creditors.}}{2}$   
(or)

Average trade creditors =  $\frac{\text{Total purchases}}{\text{closing creditors.}}$

1) calculate creditor turnover ratio and debt payment period from the following Information.



cash purchases - 1,00,000/-

opening sundry creditors - 25,000/-

closing sundry creditors - 30,000/-

opening bills payable - 20,000/-

closing bills payable - 25,000/-

Total purchases - 407000/-

purchase Returns - 7,000/-

$$\begin{aligned}\text{Credit Turn over Ratio} &= \frac{\text{Net credit purchases}}{\text{Average trade creditors.}} \\ &= \frac{3,00,000}{50,000} \\ &= 6 \text{ times.}\end{aligned}$$

$$\begin{aligned}\text{Net credit purchases} &= 40,7000 - 7000 - 1,00,000 \\ &= 3,00,000.\end{aligned}$$

$$\begin{aligned}\text{Average creditors} &= \frac{\text{opening creditors} + \text{opening} \\ &\quad \text{Bills Receivable} + \text{closing creditor} \\ &\quad + \text{closing Bills Receivables.}}{2}\end{aligned}$$

$$= \frac{25,000 + 20,000 + 30,000 + 25,000}{2}$$

$$= \frac{1,00,000}{2}$$

$$= 50,000.$$

Creditors collection period

$$= \frac{365}{6}$$

$$= \frac{365}{6}$$

$$= 61 \text{ days}$$

#### 4. profitability Ratio:-

$$\text{Gross profit Ratio} = \frac{\text{gross profit}}{\text{Net sales}} \times 100.$$

Where, gross profit = net sales - cost of goods sold.

\* cost of goods sold = opening stock + net purchases + direct Expenses - closing stock.

\* Net sales = Total sales - Sales Returns.

$$2) \text{ Net profit Ratio} = \frac{\text{Net profit}}{\text{Net sales}} \times 100.$$

$$3) \text{ operating Ratio} = \frac{\text{cost of goods sold} + \text{operating Expenses}}{\text{Net sales}} \times 100.$$

$$4) \text{ Operating profit Ratio} = \frac{\text{operating profits}}{\text{Net sales}} \times 100.$$

$$5) \text{ Expenses Ratio} = \frac{\text{Amount of Expenses}}{\text{Net sales}} \times 100.$$

6) Return on capital Employed = 
$$\frac{\text{Net Income before Interest and tax}}{\text{capital Employed.}}$$

7) Return on share holders Funds  
$$= \frac{\text{Net profit after Interest and tax}}{\text{share holders Funds}} \times 100.$$

where,

share holders Funds = Fixed Assests + current Assests - current and long term liabilities.

8) Earning per share:-

$$\text{EPS} = \frac{\text{Net profit after tax, Interest and preference dividend}}{\text{No. of Equity shares.}}$$

9) price Earning Ratio:-

$$(\text{PE}) \cdot \text{Ratio} = \frac{\text{Market price per share}}{\text{Earnings per equity share}}$$

1) Trading and profit and loss A/c. of the Reliance company.



Dr

Cr

particulars	Amount	particulars	Amount
To opening stock	40,000	By sales	2,00,000
To purchases	1,00,000	By closing stock	20,000
To gross profit	80,000		
Total	2,20,000		2,20,000
To Administrative Expenses	15,000	By gross profit	80,000
To selling Expenses	20,000		
To Financial Expenses	5,000		
To Non-operating Expenses	10,000		
To Net profit	30,000		
Total	80,000		80,000

calculate i) gross profit Ratio.

ii) Net profit Ratio.

iii) operating Ratio.

iv) operating profit Ratio.

v) cost of goods sold Ratio

vi) Administrative Expenses Ratio.

vii) Financial Ratio.



$$1. \text{ Gross profit Ratio} = \frac{\text{Gross profit}}{\text{Net sales}} \times 100.$$

$$= \frac{80,000}{2,00,000} \times 100$$

$$= 40\%.$$

$$2. \text{ Net profit Ratio} = \frac{\text{Net profit}}{\text{Net sales}} \times 100$$

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

$$= 15\%$$

$$3. \text{ Operating Ratio} = \frac{\text{Cost of goods sold} + \text{Operating Expenses}}{\text{Net sales}} \times 100$$

$$= \frac{2,00,000 - 80,000 + 12,000 + 15,000 + 20,000 + 5,000}{2,00,000} \times 100$$

$$= 80\%.$$

$$4. \text{ Operating profit Ratio} = \frac{\text{O.P}}{\text{Net sales}} \times 100.$$

$$\text{O.P.R} = \text{Net sales} - \text{cost of goods sold} + \text{Admin. Exp} + \text{selling and distribution} + \text{Financial Expenses}.$$

$$= 2,00,000 - 1,20,000 + 15,000 + 20,000 + 5,000$$

$$= 2,00,000 - 1,60,000$$

$$= 40,000.$$

$$= \frac{40,000}{2,00,000} \times 100$$

$$= 20\%$$

O.P.R = 100 - operating Ratio.

$$= 100 - 80$$

$$= 20\%$$

5) cost of good sold Ratio = cost good sold

$$\frac{\text{Ratio}}{\text{Net sales}} \times 100.$$

$$= \frac{2,00,000 - 80,000}{2,00,000}$$

$$= \frac{1,20,000}{2,00,000} \times 100$$

$$= 60\%$$

6) Administrative Expenses Ratio

$$= \frac{\text{A.d Expenses}}{\text{Net sales}} \times 100.$$

$$= \frac{15000}{200000} \times 100$$

$$= 7.5\%$$

7) Financial Ratio =  $\frac{\text{Financial Expenses}}{\text{Net sales}} \times 100.$

$$= \frac{5000}{200000} \times 100$$

$$\begin{aligned}
 \text{Selling Expenses Ratio} &= \frac{\text{Selling Expenses}}{\text{Net sales}} \times 100 \\
 &= \frac{20000}{200000} \times 100 \\
 &= 10\%
 \end{aligned}$$

2) P, Q, R corporation has Earnings before Interest and tax. Rs 10,00,000, total Assets Rs 45,00,000 and current liabilities of Rs 1,00,000. calculate Return on capital Employed.

$$\text{Returns on capital Employed} = \frac{\text{Net Income before Interest and tax}}{\text{capital Employed}}$$

$$\begin{aligned}
 \text{capital Employed} &= \text{G.C} - \text{current liabilities} \\
 &= 45,00,000 - 1,00,000 \\
 &= 44,00,000
 \end{aligned}$$

$$\begin{aligned}
 \text{R.O.C.E} &= \frac{1,0,00,000}{44,00,000} \times 100 \\
 &= 22.72\%
 \end{aligned}$$

3) calculate Return on share holders Funds.

Particulars	Amount
I A) Net profit after Interest and tax	4,40,000
B) less: preference dividend (1,00,000 x $\frac{18}{100}$ )	18,000
	<u>4,22,000</u>

c) Net profit after Interest, tax and preference dividend.

II calculation of Equity share holders Funds.

1) Net Fixed Assets	12,00,000.
2) Trade Investment	1,00,000.
3) current Assets	4,40,000.
4) Total Assets	17,40,000.
less: current liabilities	3,40,000.
Capital Employed	14,00,000.
less: long term debt	↳ 8,00,000
share holders Fund	← 6,00,000
less: preference share capital	↳ 1,00,000
Equity share holders Funds	5,00,000

Return on share holders Fund

$$= \frac{\text{Net profit After Interest and tax}}{\text{share holders Fund.}}$$

$$= \frac{4,22,000}{5,00,000} \times 100$$

$$= 84.4\%$$



4) calculate Earning per share

1. 10,000 equity shares of Rs 10/- each

$$(10,000 \times 10 = 1,00,000)$$

2) 1,00,000 , 10% preference share of Rs 10/- each

$$(10,000 \times 10 = 1,00,000)$$

3) Net profit before paying dividend to preference shares 50,000/-

$$\text{Earning per share} = \frac{\text{net profit after dividend on preference shares}}{\text{No. of equity shares.}}$$

$$10,000 @ 10 = 1,00,000.$$

$$10,000 @ 10\% \text{ Interest } @ 10 = 1,00,000.$$

Net profit Before paying dividend to preference share = 50,000.

(-) preference Dividend

$$1,00,000 \times \frac{10}{100}$$

$$= \frac{10,000}{40,000}$$

→ Net profit After paying preference. D.

$$= \frac{40,000}{10,000}$$

$$= 4/-$$

Price Earning Ratio:-

= Market price per share

Earning per Equity shares.

5) The capital of ABC Ltd. Is as follows

80,000 Equity shares of Rs 10/- = 8,00,000

10/-, 30,000 preference shares of each Rs 10/-  
is, 3,00,000.

Net profit after tax at 60% is, 2,70,000/-

Depreciation = 60,000/-

Equity dividend paid = 20%.

Market price of equity shares Rs 40/-

price Earning = Market price per share  
Earning per Equity share.

Equity preference share

= Net profit after dividend on  
preference shares

No. of Equity shares.

= 2,70,000 - 30,000  
80,000

= 3.

preference share Divident

preference share Divident =

$$30,00,000 \times \frac{10}{100}$$
$$= 30,000.$$

price Earning =  $\frac{\text{Market price per share}}{\text{Earning per Equity shares.}}$

$$= \frac{40}{3}$$
$$= 13.3$$
$$= .$$

Written by,  
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1st MBA.

## **IMPORTANT QUESTIONS**

### **UNIT-4**

- ✓ What is ratio analysis? Explain types of ratio with formulas?
- ✓ Importance (or) Advantages & disadvantages of Ratio analysis?
- ✓ What is financial analysis? Explain Du Pont chart analysis ?

**Problems:** RATIO ANALYSIS MOST IMPORTANT.






**JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY ANANTAPUR**

(Established by Govt. of A.P., ACT No.30 of 2008)

**ANANTHAPURAMU – 515 002 (A.P) INDIA**
**MASTER OF BUSINESS ADMINISTRATION  
MBA; MBA (General Management); MBA (Business Management)  
COMMON COURSE STRUCTURE**

Course Code	FINANCIAL ACCOUNTING FOR MANAGERS	L	T	P	C
21E00104		4	0	0	4
Semester		I			
Course Objectives:					
<ul style="list-style-type: none"><li>To introduce accounting , accounting rules, accounting process and preparation of financial statements.</li><li>To explain methods of valuation of assets,</li><li>To explore the meaning and interpretation of financial statements through ratio analysis technique.</li></ul>					
Course Outcomes (CO): Student will be able to					
<ul style="list-style-type: none"><li>Prepare the financial statements with accounting knowledge</li><li>Value the assets of the business organizations under different methods</li><li>Analyse the financial performance and position of the business organization and interpret the results from the point of company and investor</li></ul>					
UNIT - I	Lecture Hrs: 8				
Introduction to Accounting: Definition, Importance, Objectives and principles of accounting, uses of accounting and book keeping Vs Accounting, Single entry and Double entry systems, classification of accounts – rules of debit & credit. (Only theory)					
UNIT - II	Lecture Hrs: 12				
The Accounting Process: Overview, Books of Original Record; Journal and Subsidiary books, ledger, Trial Balance, Final accounts: Trading accounts- Profit & loss accounts- Balance sheets with adjustments. (Problems on Only Final Accounts)					
UNIT - III	Lecture Hrs:12				
Valuation of Assets: Introduction to Depreciation- Methods (Simple problems from Straight line method, Diminishing balance method and Annuity method). Inventory Valuation: Methods of inventory valuation (Simple problems from LIFO, FIFO).					
UNIT - IV	Lecture Hrs:12				
Financial Analysis -I Analysis and interpretation of financial statements from investor and company point of view, Liquidity, leverage, solvency and profitability ratios – Du Pont Chart (A Case study on Ratio Analysis).					
UNIT - V	Lecture Hrs:12				
Financial Analysis-II: Objectives of fund flow statement - Steps in preparation of fund flow statement, Objectives of Cash flow statement- Steps in Preparation of Cash flow statement – Analysis of Cash flow and Funds flow statements - Funds flow statement Vs Cash flow statement. (Only theory).					
Textbooks:					
<ol style="list-style-type: none"><li>Financial Accounting, Dr.S.N. Maheshwari and Dr.S.K. Maheshwari, Vikas Publishing House Pvt. Ltd.,</li><li>Accountancy .M P Gupta &amp;Agarwal ,S.Chand</li></ol>					
Reference Books:					
<ol style="list-style-type: none"><li>Financial Accounting ,P.C.Tulisan ,S.Chand</li><li>Financial Accounting for Business Managers, Asish K. Bhattacharyya, PHI</li><li>Financial Accounting Management An Analytical Perspective, Ambrish Gupta, Pearson Education</li><li>Accounting and Financial Management, Thukaram Rao, New Age Internationals.</li><li>Financial Accounting Reporting &amp; Analysis, Stice&amp;Stice, Thomson</li><li>Accounting for Management, Vijaya Kumar,TMH</li><li>Accounting for Managers, Made Gowda, Himalaya</li></ol>					



**JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY ANANTAPUR**  
(Established by Govt. of A.P., ACT No.30 of 2008)  
**ANANTHAPURAMU – 515 002 (A.P) INDIA**

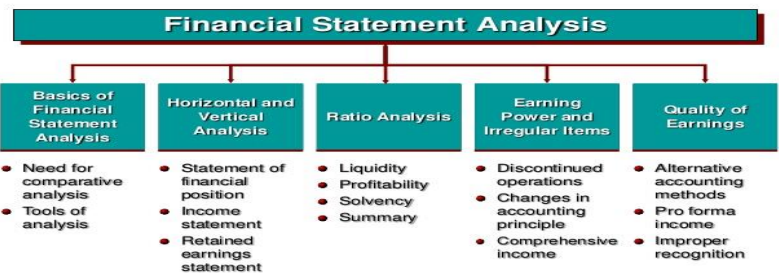
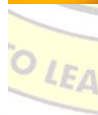
**MASTER OF BUSINESS ADMINISTRATION**  
**MBA; MBA (General Management); MBA (Business Management)**  
**COMMON COURSE STRUCTURE & SYLLABI**

8. Accounting for Management ,N.P.Srinivasan, &M.ShakthivelMurugan, S.Chand

**Online Learning Resources:**

[https://onlinecourses.swayam2.ac.in/cec20\\_mg02/preview](https://onlinecourses.swayam2.ac.in/cec20_mg02/preview)  
[https://onlinecourses.swayam2.ac.in/imb19\\_mg06/preview](https://onlinecourses.swayam2.ac.in/imb19_mg06/preview)  
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## I SEMESTER FINANCIAL ACCOUNTING FOR MANAGERS **Unit-V** **FINANCIAL ANALYSIS -II**



## UNIT-5

### FINANICAL ANALYSIS – II

#### **5.1. FUNDS FLOW STATEMENT**

**INTRODUCTION:** The profit and loss account and the balance sheet are the two important financial statements of a business organization. The profit and loss account reports the revenues generated and expenses incurred during a particular period of time. The balance sheet contains information relating to assets and liabilities of an organization as on a particular date. Both the statements do not contain sufficient information to assess about the funds position of an organization by the users.

In order to analyze the fund moments in a business organization, it is necessary to prepare a statement which is known as “statement of sources and uses of funds” or simply funds flow statement. It is also called “statement of changes in financial position”.

**5.1.1 Concept of fund:** It refers to all the financial resources of the company, which includes cash, and equivalents

Fund means working capital. **Working capital=current Assets –current Liabilities**

\*The excess of current assets over current liabilities is called working capital.

Flow: It refers to the statement of sources and applications.

**5.1.2 Flow to fund:** the flow of fund refers to transfer of economic values from one asset equity to another. When fund means working capital, flow of funds refers to movement of funds which cause a change in working capital of an organization. To understand, the concept of flow of funds we have to first of all be clear about the difference between current and non-current assets.

#### **5.1.3 Meaning and definition of funds flow statement:**

As the name implies statement of sources and uses of funds depicts the sources from which funds are obtained and uses to which they are put.

According to Foulke defined funds flow statement as “A statement of sources and application of funds is a technical device designed to analyze the changes in the financial conditions of a business enterprise between two dates”.

**Funds flow statement**\_ a statement prepared to ascertain the increase/ decrease in various items of fixed assets, long term liabilities and share capital between two balance sheet dates

#### **5.1.4. OBJECTIVES, USES, SIGNIFICANCE OF FUND FLOW STATEMENT:**

A funds flow statement is an essential tool for the financial analysis and is of primary objective is to the financial management. Now-a-days, it is being widely used by the financial



analysis, credit granting institutions and financial managers. The basic purpose of a funds flow statement is to reveal the changes in the working capital on the two balance sheet dates. It also describes the sources from which additional working capital has been financed and the uses to which working capital has been applied. Such a statement is particularly useful in ascertaining the growth of the firm, its resulting financial needs and in determining the best way of financing these needs. By making use of projected funds flow statements, the management can come to know the adequacy or inadequacy of working capital even in advance. One can plan the intermediate and long-term financing of the firm, repayment of long – term debts expansion of the business, allocation of resources, etc.

1. Fund flow statement reveals clearly the changes in items of financial position between two different balance sheet dates showing clearly the different sources and applications of funds. Thus, it summarizes the financing and investing activities of the enterprise.

2. It also reveals how much of the total funds is being collected by disposing of fixed assets, how much from issuing shares or debentures, how much from long-term or short-term loans, and how much from normal operational activities of the business.

3. It also provides information about the specific utilization of such funds i.e., how much has been used for acquiring fixed assets, how much for redemption of preference shares, debentures or short-term loans as well as payment of tax, dividend etc.

4. It helps the management in depicting all inflows and outflows of funds which cause a change in working capital of a business organisation.

5. The projected fund flow statement helps management to exercise budgetary control and capital expenditure control in the enterprise.

6. The financial statements reveal the net effect of various transactions on the operational and financial position of a concern. The balance sheet gives a static view of the resources of a business and the uses to which these resources of a business and the uses to which these resources have been put at a certain point of time. But it does not disclose the causes for changes in the assets and also the effect of these changes on the liquidity position of the economy. Sometimes a concern may operate profitably and yet its cash position may become more and worse. The funds flow statement gives a clear answer to situation explaining what has happened to, the profits of the profits of firm.

It throws light on many perplexing questions of general interest which otherwise may be answered, such as

(a) Why were the net current assets lesser in spite of higher profits and vice-versa?

b) Why more dividends could not be declared in spite of available profits?

c) How was it possible to distribute more dividends than the present earnings?

- d) What happened to the net profit? Where did they go?
  - e) What happened to the proceeds of sale of fixed assets or issue of shares, debentures, etc?
  - f) What are the sources of repayment of debt?
  - g) How was the increase in working capital financed and how will it be financed in future?
7. Sometimes a firm has sufficient profits available for distribution as dividend but yet it may not be advisable to distribute dividend for lack of liquid or cash resources. In such cases, a funds flow statement helps in the formation of a realistic dividend policy.
8. The resources of a concern are always limited and it wants to make the best use of these resources. A projected funds flow statement constructed for the future helps in making managerial decisions. The firm can plan the deployment of its resources and allocate them among various applications.
9. The projected funds flow statement also act as a guide for future to the management. The management can come to know the various problems it is going to face in near future for want of funds. The firm's future needs of funds can be projected well in advance and also the timing of these needs. The firm can arrange to finance these needs more effectively and avoid future problems.
10. The funds flow statement helps in explaining how efficiently the management has used its working capital and also suggests way to improve working capital position of the firm.
11. the financial institutions and banks such as State financial institutions industrial development corporation, industrial finance corporation of India, Industrial development bank of India, etc., all ask for funds flow statement constructed for a number of year before granting loans to know the credit worthiness and paying capacity of the firm. Hence, a firm seeking financial assistance from these institutions has no alternative but to prepare funds flow statements.

#### **5.1.5. LIMITATIONS OF FUNDS FLOW STATEMENTS:**

- 1) It should be remembered that a funds flow statement is not a substitute of an income statement or a balance sheet. It provides only some additional information as regards changes in working capital.
- 2) It is not original statement but simply re-arrangement of data given in the financial statement.
- 3) It is essentially historic in nature and projected funds flow statement can't be prepared with much accuracy. Changes in cash are more important and relevant for financial management than the working capital.

NOTE: The term 'financial analysis' includes both 'analysis and interpretation'.

## **5.2. STEPS IN PREPARATION OF FUNDS FLOW STATEMENT:**

a) Statement of changes in working capital

b) Statement of Sources and Uses of funds

**a) Statement of changes in working capital:** the primary objective of this statement is to arrive at the net change in working capital between the dates of two balance sheets which should be shown in the funds flow statement. The increase in working capital between the two balance sheet dates is treated as use of fund and the decrease in working capital is treated as sources of funds.

The statement finally discloses the difference in working capital at the end of two years either as an increase or decrease in working capital. While, ascertaining the increase or decrease in individual items of current assets and current liabilities and its impact on working capital the following rules are to be observed:

- Increase in the items of current assets will increase the working capital.
- Decrease in the items of current assets will decrease the working capital.
- Increase in the items of current liabilities will decrease the working capital.
- Decrease in the working of current liabilities will increase the working capital.

**Note:** we observe that there is positive relationship between current assets and working capital. On other hand, there is an inverse relationship between changes in current liabilities and working capital

### **PROFORMA OF STATEMENT OF CHANGES IN WORKING CAPITAL**

Particulars	Beginning of the year	End of the year	Changes in working capital	
			Increase(+)	Decrease(-)
<b><u>Current Assets :</u></b>				
Cash				
Cash at Bank				
Bills Receivable				
Debtors				
Stock				
Short-term investments				
Prepaid Expenses				
Other Current Assets				
<b>Total Current Assets(A)</b>	<b>XXX</b>	<b>XXX</b>		
<b><u>Current Liabilities:</u></b>				
Creditors				
Bills payable				
Outstanding Expenses				
Bank Overdraft				
Short-term Loans				
Proposed dividend				
Provision for taxation				
Other Current Liabilities				
<b>Total Current liabilities(B)</b>	<b>XXX</b>	<b>XXX</b>		
<b>Working capital (C) (current Assets-Current Liabilities) C=A-B</b>	<b>XXX</b>	<b>XXX</b>		
<b>Net Increase (Or) Decrease in working capital</b>	<b>XXX<sup>1</sup></b>	<b>XXX<sup>2</sup></b>	<b>XXX<sup>2</sup></b>	<b>XXX<sup>1</sup></b>
<b>Total</b>	<b>XXX</b>	<b>XXX</b>	<b>XXX</b>	<b>XXX</b>

**Note:** 1 and 2 denote net increase and net decrease in working capital respectively.

**b ) statement of sources and uses funds/funds flow statement:** This is the second but most important step in the preparation of funds flow statement. It is prepared on the basis of changes in fixed assets, share capital and long term liabilities that took place between the dates of two balance sheets. If any additional information is available it must also be considered.

Increase in fixed assets is use of funds and decrease in fixed assets in sources of fund (On account of sale only and not on account of depreciation or writing off the values of assets).

Increase in long term liabilities is a source of fund and decrease in long term liabilities is use of fund (including share capital). The following is the format of statement of sources and Application of funds with the probable items of sources and uses of funds.

### PROFORMA OF FUNDS FLOW STATEMENT

Sources	Amount	Applications	Amount
Funds from operation	XXX	Funds lost in operation	XXX
Issue of share capital	XXX	Redemption of preference share	
Issue of debentures	XXX	capital	XXX
Raising long-term loan	XXX	Redemption of Debentures	XXX
Receipt from party paid shares, called up	XXX	Repayment of long term loans	XXX
Sale of fixed assets	XXX	Purchase of fixed assets	XXX
Non-trading receipts such as dividend	XXX	Purchase of long-term	
Sale of long term investments	XXX	investments	XXX
Net decrease in working capital	XXX	Non-Trading payments	XXX
		Payment of dividend	XXX
		Payment of tax	XXX
<b>Total</b>	<b>XXX</b>	<b>Total</b>	<b>XXX</b>

**\*Note:** These two items appear as an application of funds only when these items are treated as non-current liability.

#### 5.2.1 FUNDS FROM TRADING ACTIVITIES OF OPERATING PROFIT:

The profit or loss disclosed by profits and loss account doesn't indicate the funds generate by trading activities, because it contains a variety of write offs and adjustments, which do not involve any corresponding movement of funds. Therefore appropriate adjustments are to be making to loss as arrive at the funds from business operations. For this purpose items debited to profit, which do not belong trading activities.

**Operating profit = Net profit + Non –operating Expenses – Non –operating Income**



### **CALCULATION OF FUNDS FROM OPERATIONS**

<b>Particulars</b>	<b>Amount Rs.</b>	<b>Amount Rs.</b>
<b>Net profit</b>	XXX	
<u>Add:</u> Non –Operating items debited to P&L a/c		
Depreciations	XXX	
Write off depreciation on non tangible assets	XXX	
Discount on issue of share and debentures	XXX	
Loss on sale of non current assets	XXX	
Provision for income tax	XXX	
Proposed dividend	XXX	
All transfers to reserves	XXX	
Provision for doubtful debts	XXX	
	<b>XXX</b>	<b>XXX</b>
<u>Less:</u> Non operating terms credited to P&L a/c		XXX
Profit on sale of Non –current assets		XXX
Dividend and interest received		XXX
Non –operating income		XXX
Gain on evaluation of non – current assets		XXX
<b>Funds from Operations</b>		<b>XXX</b>

### Schedule of changes in Working Capital :

This statement is prepared from the current items of Balance Sheet, i.e., current assets and current liabilities in order to calculate the increase or decrease in working capital. Non-current items are ignored as working capital is the difference between current assets and current liabilities. In order to know whether there is an increase or decrease in working capital, the following rules must be followed :

1. An increase in a current asset between two Balance Sheet dates results in an increase in the working capital and a decrease in a current asset would result in a decrease in working capital.
2. An increase in a current liability, between two Balance Sheet dates, decreases working capital whereas a decrease in a current liability would increase the working capital.

The following illustrations will make the above rules clear.

#### Illustration 1 :

Prepare a schedule of changes in working capital from the given consolidated Balance Sheet.

<i>Liabilities</i>	<i>31.03.08</i> ₹	<i>31.03.09</i> ₹	<i>Assets</i>	<i>31.03.08</i> ₹	<i>31.03.09</i> ₹
Share Capital	80,000	95,000	Fixed Assets	90,000	1,00,000
Reserves	20,000	25,000	Current Assets	30,000	50,000
Current Liabilities	20,000	30,000			
	<u>1,20,000</u>	<u>1,50,000</u>		<u>1,20,000</u>	<u>1,50,000</u>
	-----	-----		-----	-----

#### Schedule of Changes in Working Capital

<i>Particulars</i>	<i>31.03.08</i> ₹	<i>31.03.09</i> ₹	<i>Change in Working Capital</i>	
			<i>Increase (+)</i> ₹	<i>Decrease (-)</i> ₹
Current Assets	30,000	50,000	20,000	--
Current Liabilities	20,000	30,000	--	10,000
			<u>20,000</u>	<u>10,000</u>
Increase in Working Capital			--	10,000
			<u>20,000</u>	<u>20,000</u>

**Note :** Though there is an increase in both current assets and current liabilities, the increase in current assets is more than the increase in current liabilities, thus resulting in an increase in working capital.



**Illustration 2 :**

The following are the particulars of A Ltd. for 31.03.08 and 31.03.09.

<i>Particulars</i>	<i>31.03.08</i> ₹	<i>31.03.09</i> ₹
Fixed Assets	5,90,000	5,20,000
Current Assets	4,10,000	3,80,000
	<u>10,00,000</u>	<u>9,00,000</u>
Equity Capital	5,00,000	5,00,000
Reserves	2,75,000	2,00,000
Current Liabilities	2,25,000	2,00,000
	<u>10,00,000</u>	<u>9,00,000</u>

Prepare a statement of changes in working capital.

**Solution :****Schedule of changes in working capital**

<i>Particulars</i>	<i>31.03.08</i> ₹	<i>31.03.09</i> ₹	<i>Change in Working Capital</i> <i>Increase (+)</i> ₹	<i>Decrease (-)</i> ₹
Current Assets	4,10,000	3,80,000	--	30,000
Current Liabilities	2,25,000	2,00,000	25,000	--
			<u>25,000</u>	<u>30,000</u>
Decrease in Working Capital			5,000	--
			<u>30,000</u>	<u>30,000</u>

**Illustration 3 :**

The following are the summarized balance sheets of X and Y Co., as on 31.03.08 and 31.03.09.

**Balance Sheets**

<i>Particulars</i>	<i>31.03.08</i> ₹	<i>31.03.09</i> ₹	<i>Particulars</i>	<i>31.03.08</i> ₹	<i>31.03.09</i> ₹
Capital :					
Equity Shares	80,000	80,000	Fixed Assets	60,000	50,000
Preference Shares	--	20,000	Debtors	80,000	48,000
General Reserve	4,000	4,000	Stocks	20,000	70,000
Profit & Loss Account	8,000	10,800	Prepaid expenses	2,600	1,000
Debentures	22,000	25,600	Cash	400	7,000
Creditors	24,000	26,000			
Bank Overdraft	25,000	9,600			
	<u>1,63,000</u>	<u>1,76,000</u>		<u>1,63,000</u>	<u>1,76,000</u>

You are required to prepare a schedule showing changes in working capital.



**Solution :**

**Schedule of changes in Working Capital**

Particulars	31.03.08 ₹	31.03.09 ₹	Changes in Working Capital	
			Increase (+) ₹	Decrease (-) ₹
<b>Current Assets</b>				
Debtors	80,000	48,000	--	32,000
Stocks	20,000	70,000	50,000	--
Prepaid Expenses	2,600	1,000	--	1,600
Cash	400	7,000	6,600	--
<b>Current Liabilities</b>				
Creditors	24,000	26,000	--	2,000
Bank Overdraft	25,000	9,600	15,400	--
			72,000	35,600
Increase in Working Capital			--	36,400
			72,000	72,000

The preparation of Schedule of changes in Working Capital, to ascertain the increase or decrease in working capital between two Balance Sheet dates, constitutes the first step in the preparation of Fund Flow Statement on working capital basis. The remaining two steps are (a) ascertaining funds from operations and (b) preparation of Funds Flow Statement.

**Sources and Application of Funds :**

'Funds' are interpreted, to mean Working Capital (Net Working Capital). As net working capital is excess of current assets over current liabilities, funds represent that portion of current assets which are not financed by current liabilities (i.e., financed from the long-term/Non-current sources).

**Sources of Funds :**

The sources of funds can be classified as external sources and internal sources. External sources of funds are those sources which are raised from outside the business, to augment the funds. The external sources are (a) additional capital raised (b) increase in long term borrowings.

As opposed to external sources, internal sources consist of resources raised within the organization internally. Every profitable sale brings in funds in excess of the cost of goods sold. Thus, profit generated by the business is an important internal source of funds. In determining profit, revenues during the period are matched against the expenses, whether involves the use of funds or not, during the current period. Thus, the amount of profit requires adjustment in respect of transactions that do not involve the use of funds - e.g., Depreciation, amortization of expenses etc.

Surplus or worn out assets could be sold and this also constitutes an internal source of funds.



**Illustration 5 :**

Prepare a Funds Flow Statement from the following information.

**Comparative Balance Sheet**

	31-03-08 ₹	31-03-09 ₹		31-03-08 ₹	31-03-09 ₹
Capital	80,000	1,00,000			
Reserves	30,000	45,000	Fixed Assets:		
Accumulated Depreciation on Machinery	10,000	15,000	Machinery	60,000	70,000
			Furniture	40,000	40,000
Current Liabilities:			Current Assets:		
Creditors	25,000	30,000	Stocks	20,000	30,000
Bills Payable	10,000	2,000	Debtors	15,000	25,000
Expenses Payable	20,000	8,000	Cash	40,000	35,000
	1,75,000	2,00,000		1,75,000	2,00,000

Net profit for the year ₹ 15,000.

**Solution :**

**Schedule of Changes in Working Capital**

	31-03-08 ₹	31-03-09 ₹	Changes in Working Capital	
			Increase (₹)	Decrease (₹)
Current Assets:				
Stocks	20,000	30,000	10,000	---
Debtors	15,000	25,000	10,000	---
Cash	40,000	35,000	---	5,000
Current liabilities:				
Creditors	25,000	30,000	---	5,000
Bills Payable	10,000	2,000	8,000	---
Expenses Payable	20,000	8,000	12,000	---
Increase in Working Capital			40,000	10,000
			---	30,000
			40,000	40,000



Dr.		Accumulated Depreciation Account		Cr.
	₹			₹
		By Balance b/d		10,000
		By Depreciation Charged		5,000
To Balance c/d	15,000	(Balancing Figure)		
	15,000			15,000

Dr.		Machinery Account		Cr.
	₹			₹
To Balance b/d	60,000	By Balance c/d		70,000
To Cash Purchases	10,000			
(Balancing Figure)	70,000			70,000

Dr.		Share Capital Account		Cr.
	₹			₹
To Balance c/d	1,00,000	By Balance b/d		80,000
		By Cash		20,000
	1,00,000	(Balancing Figure)		
				1,00,000

Dr.		Reserves Account		Cr.
	₹			₹
To Balance c/d	45,000	By Balance b/d		30,000
		By Net Profit		15,000
	45,000			45,000

#### Funds from Operations

	₹
Net Profit	15,000
Add: Depreciation Charged	5,000
Funds from Operations	20,000

#### Funds Flow Statement for the year ended 31-03-2009

	₹
A. Sources :	
Funds from Operations	20,000
Issue of Share Capital	20,000
	40,000
B. Applications :	
Purchase of Machinery	10,000
Increase in Working Capital	30,000
	40,000



**Illustration 7 :**

From the following Balance Sheets, prepare Funds Flow Statement.

**Comparative Balance Sheet**

	31-03-08 ₹	31-03-09 ₹		31-03-08 ₹	31-03-09 ₹
Share capital	90,000	1,10,000	Land	80,000	1,00,000
Profit and Loss A/c	80,000	95,000	Plant and Machinery	40,000	66,000
General Reserve	40,000	50,000	<b>Current Assets :</b>		
<b>Current Liabilities :</b>			Stocks	40,000	60,000
Creditors	51,000	25,000	Debtors	40,000	35,000
Provision for Doubtful Debts			Cash	50,000	20,000
Debts	4,000	2,000	Preliminary Expenses	25,000	15,000
Bills Payable	20,000	18,000	Discount on Issue of Shares	10,000	4,000
	<u>2,85,000</u>	<u>3,00,000</u>		<u>2,85,000</u>	<u>3,00,000</u>

**Solution :****Schedule of Changes in Working Capital**

	31-03-08 ₹	31-03-09 ₹	Changes in Working Capital	
			Increase (₹)	Decrease (₹)
<b>Current Assets:</b>				
Stocks	40,000	60,000	20,000	--
Debtors	40,000	35,000	--	5,000
Cash	50,000	20,000	--	30,000
<b>Current Liabilities:</b>				
Creditors	51,000	25,000	26,000	--
Provision for Doubtful Debts	4,000	2,000	2,000	--
Bills Payable	20,000	18,000	2,000	--
			<u>50,000</u>	<u>35,000</u>
Increase in Working Capital			--	15,000
			<u>50,000</u>	<u>50,000</u>

Dr.	Land Account		Cr.
	₹		₹
To Balance b/d	80,000	By Balance c/d	1,00,000
To Bank	<u>20,000</u>		
(Balancing Figure)	<u>1,00,000</u>		<u>1,00,000</u>



Dr. Preliminary Expenses Account		Cr.	
	₹		₹
To Balance b/d	25,000	By P & L Account (Balancing Figure)	10,000
		By Balance c/d	<u>15,000</u>
	<u>25,000</u>		<u>25,000</u>

Dr. Machinery Account		Cr.	
	₹		₹
To Balance b/d	40,000		
To Cash A/c (Purchase)	<u>26,000</u>	By Balance c/d	<u>66,000</u>
(Balancing Figure)	<u>66,000</u>		<u>66,000</u>

Dr. Discount on Issue of Shares Account		Cr.	
	₹		₹
To Balance b/d	10,000	By P & L Account (Balancing Figure)	6,000
		By Balance c/d	4,000
	<u>10,000</u>		<u>10,000</u>

Dr. General Reserve Account		Cr.	
	₹		₹
		By Balance b/d	40,000
To Balance c/d	50,000	By P & L Account (Balancing Figure)	10,000
	<u>50,000</u>		<u>50,000</u>

Dr. Adjusted Profit and Loss Account		Cr.	
	₹		₹
To Preliminary Expenses	10,000	By Balance b/d	80,000
To Discount on Shares	6,000		
To General Reserve	10,000	By Funds From Operations (Balancing Figure)	41,000
To Balance c/d	<u>95,000</u>		
	<u>1,21,000</u>		<u>1,21,000</u>



Funds Flow Statement for the year ended 31-03-2009	
	₹
<b>A. Sources</b>	
Funds from Operations	41,000
Issue of Shares (1,10,000 - 90,000)	<u>20,000</u>
	61,000
<b>B. Application</b>	
Purchase of Land	20,000
Purchase of Machinery	<u>26,000</u>
	46,000
Increase in Working Capital (A - B)	<u>15,000</u>

### **5.3. CASH FLOW STATEMENT**

**Introduction and meaning:** Cash plays very important role in the entire economic life of a business. Cash flow statement provides information about the cash receipts and payments of a firm for a given period of time. This statement provides useful information which compliments profit and Loss Account and Balance Sheet. Based on the information about the cash flows of the firm, it is possible to assess the ability of the firm to generate cash and cash equivalents and the firm to utilize these cash flows.

A firm needs cash to make payments to its supplies, to incur day to day expenses and to pay salaries, wages, interests and dividend etc., It is very essential for a business to maintain an adequate balance of cash.

**3.1 Definition:** 'A statement of changes in the financial position of firm on cash basis is called a cash flow statement'.

A cash flow statement summarizes the causes of changes in cash position of business enterprises between dates of two balance sheets. It is called a cash flow out flow (uses) of cash.

#### **5.3.2 OBJECTIVES OF CASH FLOW STATEMENT**

(a) **Measurement of Cash:** Inflows of cash and outflows of cash can be measured annually which arise from operating activities, investing activities and financial activities.

(b) **Generating Inflow of Cash:** Timing and certainty of generating the inflow of cash can be known which directly helps the management to take financing decisions in future.

(c) **Classification of Activities:** All the activities are classified into: operating activities, investing activities and financial activities which help a firm to analyze and interpret its various inflows and outflows of cash.

(d) Prediction of Future: A Cash Flow Statement, no doubt, forecasts the future cash flows which helps the management to take various financing decisions since synchronization of cash is possible.

(e) Assessing Liquidity and Solvency Position: Both the inflows and outflows of cash and cash equivalent can be known, and, as such, liquidity and solvency position of a firm can also be maintained as timing and certainty of cash generation is known, i.e. it helps to assess the ability of a firm to generate cash.

(f) Evaluation of Future Cash Flows: Whether the cash flow from operating activities are quite sufficient in future to meet the various payments e.g. payment of expenses/debts/dividends/taxes.

(g) Supply Necessary Information to the Users: A Cash Flow Statement supplies various information relating to inflows and outflows of cash to the users of accounting information in the following ways:

(i) To assess the ability of a firm to pay its obligations as soon as it becomes due;

(ii) To analyze and interpret the various transactions for future courses of action;

(iii) To see the cash generation ability of a firm;

(iv) To ascertain the cash and cash equivalent at the end of the period.

(h) Helps the Management to Ascertain Cash Planning: No doubt a cash flow statement helps the management to prepare its cash planning for the future and thereby avoid any unnecessary trouble.

#### **5.4. PREPARATION OF CASH FLOW STATEMENT:**

The cash flows shown in the statement are grouped in to three main categories of cash inflows and cash outflows viz., Cash flows from operating activities , cash flows investing activities and cash flows from financing activities. A brief description of these items is discussed below:

A) Cash flows from operating activities

B) Cash flows from investing activities

C) Cash flows from financing activities

**A) CASH FLOWS OPERATING ACTIVITIES:** Operating activities of a firm are the main revenue producing activities of the firm and other activities that are not investing and financial activities. Operating activities include cash effects of those transactions and events that enter into the determination of net profit or loss. Following are the items which generate cash flows from operating activities of a firm.

- i) Cash receipts from the sale of goods and the rendering of services.
- ii) Cash receipts from royalties, fees, commission, and other revenue.
- iii) Cash payments to suppliers for goods and services.
- iv) Cash payments to and on behalf of employees.
- v) Cash receipts and payments of an insurance enterprise for premium and claims, annuities and other policy benefits.
- vi) Cash payments or refunds of income – taxes unless they can be specifically identified with financing and activities.
- vii) Cash receipts and payments relating to future contracts , forward contracts , options contracts , and swap contracts when the contracts are held for dealing or trading purpose,etc.,

### Calculation of cash from operations (traditional method)

Particulars	Amount	Amount
<b>Funds from operations</b>		
<b>Add:</b> Increase in Current liabilities(excluding bank overdraft)	XXX	XXX
Decrease in current assets(excluding cash and bank balances)	XXX	XXX
<b>Less:</b> Increase in current assets(excluding cash and bank balances)	XXX	XXX
Decrease in current liabilities(excluding bank overdraft)	XXX	XXX
Cash from operations		<b>XXX</b>

**B) CASH FLOW FROM INVESTING ACTIVITIES:** Investing activities include acquisition and disposal of long term assets and other investments which are not included in cash equivalents. Investing activities include transactions that involve the purchase and sale of long-term assets such as land and buildings, plant and machinery etc., which are not held for re-sale and other investment purpose. Following are the items of cash flows arising from investing activities.

- i) Cash payments to acquire fixed assets( including intangibles) these payments include those relating to capitalized research and development costs and self-constructed fixed assets.
- ii) Cash receipts from disposal of fixed assets(including intangibles)
- iii) Cash payments to acquire shares, warrants, or debt instruments of other enterprises and interest in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purpose)



- iv) Cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interest in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes)
- v) Cash advances and loans made to third parties (other than advances and loans made by a financial enterprise).
- vi) Cash receipts and payments relating to future contracts, forward contracts, option contracts, and swap contracts except when the contracts are held for dealing or trading purposes.

**C) CASH FLOWS FROM FINANCING ACTIVITIES:** Financing activities are those activities that result in changes in the sizes and composition of owner's capital and borrowings of a firm. Following are the items of cash flows arising from financial activities:

- i) Cash proceeds from issuing of shares
- ii) Cash proceeds from issuing of debentures, loans, bonds and other short-term borrowings.
- iii) Cash repayments of borrowings
- iv) Payment of dividend.

#### **5.4.1 USES OF CASH FLOWS STATEMENT:**

- i) Cash flow statement helps efficient cash management. A projected cash flow statement enables the management to plan and co-ordinate the financial operations of a business efficiently.
- ii) The cash flow analysis helps the management in exploring possibility of repayments of long-term debts. The cash flow statement discloses the increase or decrease in cash and reasons thereof.
- iii) A comparison between actual and budget cash flow statement discloses the failure or success of the management in managing cash resources and necessary remedial measures to be taken in case of deviation.
- iv) Projected cash flow statement helps the management to determine the estimate the likely inflows and outflows of cash operations and the amount of cash to be raised from other sources for the future needs of the firm.
- v) Cash flow analysis supplements the analysis provided by funds flow statement.

#### **5.4.2 LIMITATIONS OF CASH FLOW STATEMENT:**

- i) It is difficult to precisely define the term 'cash'. There are controversies over a number of items like stamps, postal orders to be included in cash.
- ii) A cash flow statement reveals the inflow and outflow of cash but the exclusion of near cash items from cash obscures the true reporting of the firm's liquidity position.
- iii) Working capital being a wider concept of funds, a funds flow statement present a more complete picture than cash flow statement.

2. Cash Flow Analysis is more useful as a tool in short range planning whereas Funds Flow Analysis is more useful in long range planning.
3. An increase in a current liability or a decrease in a current asset (other than cash) will result in an increase in cash. Whereas, such changes will result in decrease in working capital. Similarly, a decrease in a current liability or an increase in a current asset (other than cash) will result in a decrease in cash, whereas such changes would increase the working capital.

### Procedure for preparing a Cash Flow Statement :

Cash Flow Statement is not a substitute of Income Statement, i.e., a Profit and Loss Account, and a Balance Sheet. It provides additional information and explains the reasons for changes in cash and cash equivalents, derived from Financial Statements at two points of time. The procedure for preparing a Cash Flow Statement is different from the procedure followed in respect of Profit and Loss Account and Balance Sheet. It is prepared with the help of Financial Statements. **The basic information required for the preparation of a Cash Flow Statement is obtained from the following three sources :**

- (i) Comparative Balance Sheets at two points of time, i.e. in the beginning and at the end of the accounting period.
- (ii) Income Statement of the current accounting period or the Profit and Loss Account.
- (iii) Some selected additional data to extract the hidden transactions.

The preparation of a Cash Flow Statement involves the following steps :

- Step 1.** Compute the net increase or decrease in cash and cash equivalents by making a comparison of these accounts given in the comparative Balance Sheets.
- Step 2.** Calculate the net cash flow provided from (used in) Operating Activities by analyzing the Profit and Loss Account, Balance Sheet and Additional Information. There are two methods of converting net income into net cash flows from Operating Activities : the Direct Method and the Indirect Method.
- Step 3.** Calculate the net cash flow from Investing Activities (Cash Inflows – Cash Outflows).
- Step 4.** Calculate the net cash flow from Financing Activities (Cash Inflows – Cash Outflows).
- Step 5.** Prepare a formal Cash Flow Statement highlighting the net cash flow from (used in) Operating, Investing and Financing Activities separately.
- Step 6.** Make an aggregate of net cash flows from the above three activities and ensure that the total net cash flow is equal to the net increase or decrease in cash and cash equivalents as calculated in Step 1.
- Step 7.** Report significant non-cash transactions that did not involve cash or cash equivalents in a separate schedule to the Cash Flow Statement e.g., purchase of Machinery against issue of share capital or redemption of debentures in exchange for share capital.



**Illustration 2 :**

From the following information prepare a Cash Flow Statement of XYZ Ltd for the year ended 2007. (Direct Method)

**Balance sheet**

(₹ in '000)

<i>Liabilities</i>	<i>March 2006 (₹)</i>	<i>March 2007 (₹)</i>	<i>Assets</i>	<i>March 2006 (₹)</i>	<i>March 2007 (₹)</i>
Issued & paid up Capital	2,000	2,000	Long-term Assets (Net)	1,500	2,500
Profit & Loss A/c	200	250	Closing stock	400	800
Mortgage Loan	---	1,000	Prepaid Administrative Expenses	100	200
Tax unpaid	50	100	Trade Debtors	200	250
Trade Creditors	500	1,000	Cash	550	600
	<u>2,750</u>	<u>4,350</u>		<u>2,750</u>	<u>4,350</u>

**Statement of Profit for the year ended March 31, 2007**

(₹ in '000)

<i>Particulars</i>	<i>Rs.</i>	<i>Rs.</i>
Sales		5,000
Opening Stock	400	
Add: Purchase	<u>3,500</u>	
	3,900	
Less: Closing stock	<u>800</u>	
Cost of Goods Sold	<u>3,100</u>	<u>3,100</u>
Gross profit		1,900
Less: Administration Expenses	1,300	
Depreciation	250	
Provision for tax	<u>150</u>	<u>1,700</u>
Net Profit		200
Less: Payment of Dividends		<u>150</u>
Current Year Profit		50
Add: Profit & Loss A/c (2006)		<u>200</u>
Balance on 31 March 2007		<u>250</u>

You are also informed that a new Building was purchased on 15 June 2007 for ₹ 14,50,000/-



**Solution :**

**Cash Flow Statement for the year ended on 31 March 2007 (₹ in '000)**

	Rs.	Rs.
<u>Cash flows from Operating Activities :</u>		
Cash receipts from customers	4,950	
Cash paid to suppliers and employees	(4,200)	
Cash generated from operations	750	
Income tax paid	(100)	
Net cash generated from operating activities		650
<u>Cash flows from Investing Activities :</u>		
Purchase of new building	(1,450)	
Net cash used in Investing Activities		(1,450)
<u>Cash flows from Financing Activities :</u>		
Raising of mortgage loan	1,000	
Dividend paid	(150)	
Net cash provided by Financing Activities		850
Net increase in cash and cash equivalents		50
<u>Add : Cash and cash equivalents at the beginning of the period</u>		<u>550</u>
Cash and cash equivalents at the end of the year		<u>600</u>

**Working Notes :**

(₹ in '000)

**(1) Calculation of cash receipts from customers :**

Sales for the year as per profit statement	5,000
<u>Add : Trade Debtors as an 31 March 2006</u>	<u>200</u>
	5,200
<u>Less : Trade Debtors as on 31 March 2007</u>	<u>250</u>
Cash receipts from customers	<u>4,950</u>

**(2) Calculation of cash paid to supplier and employees :**

A. Purchases for the year as per statement of profit	3,500
<u>Add : Trade creditors as on 31 March 2006</u>	<u>500</u>
	4,000
<u>Less : Trade creditors as on 31 March 2007</u>	<u>1,000</u>
Cash paid to creditors for purchase of goods (A)	<u>3,000</u>
B. Administrative expenses as per statement of profit	1,300
<u>Add : Prepaid expenses as on 31 March 2006</u>	<u>100</u>
	1,400
<u>Less : Prepaid expenses as on 31 March 2007</u>	<u>200</u>
Cash paid to services (B)	<u>1,200</u>
Cash paid to supplier and employees (A + B)	<u>4,200</u>

(3) Calculation of tax paid :	
Opening balance of tax unpaid	50
<u>Add</u> : Provision made during the year	<u>150</u>
	200
<u>Less</u> : Closing balance of tax unpaid	<u>100</u>
Tax paid during the year ✓	<u>100</u>

### **5.5. DIFFERENCE BETWEEN FUNDS FLOW STATEMENT & CASH FLOW STATEMENT**

Basis of difference	Funds flow statement	Cash flow statement
1. Basis of concept	It is based on a wider concept of funds, i.e., working capital.	It is based on a narrow concept of funds, i.e., cash.
2. Basis of accounting	It is based on accrual basis of accounting.	It is based on cash basis of accounting.
3. Schedule of changes in working capital	Schedule of changes in working capital is prepared to show the changes in current assets and current liabilities.	No such schedule of changes in working capital is prepared.
4. Method of preparing.	Funds flow statement reveals the sources and applications of funds. The net difference between sources and applications of funds represents net increase or decrease in working capital.	It is prepared by taking the opening balance of cash, adding to this all the inflows of cash deducting the outflows of cash from the total, the difference represents the closing balance of cash.
5. Basis of usefulness.	It is useful in planning intermediate and long –term financing.	It is more useful for short-term analysis and cash planning of the business.

### **UNIT-5 –IMPORTANT QUESTIONS**

- ✓ Objectives & uses of funds flow & cash flow statement?
- ✓ How to prepare funds flow & cash flow statement steps in preparation of funds flow statement?
- ✓ Funds flow statement Vs cash flow statement?

**Problems:** FUNDS FLOW AND CASH FLOW ANALYSIS.



MBA I Semester Regular Examinations May 2022

**FINANCIAL ACCOUNTING FOR MANAGERS**

(Common to all)

(For students admitted in 2021 only)

Time: 3 hours

Max. Marks: 60

All questions carry equal marks

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**SECTION – A**

(Answer the following: 05 X 10 = 50 Marks)

- 1 (a) Explain the objectives of accounting. 5M  
(b) Mention and explain the principles of accounting. 5M
- OR**
- 2 (a) Differentiate book keeping and accounting. 5M  
(b) Give explanation for single entry system. 5M
- OR**
- 3 (a) What are final accounts? Elaborate. 5M  
(b) Give a brief note on trading accounts. 5M
- OR**
- 4 (a) Briefly examine the purpose of profit and loss accounts. 5M  
(b) Explain the need of balance sheets. 5M
- OR**
- 5 (a) Give a brief note on any one of methods of valuation of depreciation. 5M  
(b) M/s. Bharat and sons purchased a machine on 1 Apr 2015 for Rs.400000 from ABC & Co. and paid Rs.100000 on its installation. The useful life of the machine is 3 years and its estimated residual value is Rs.40000. On 31st March 2018, M/s. Bharat and sons sell the machinery for 250000. Charge depreciation as per the Diminishing value method @10% p.a. Prepare the necessary ledger accounts in the books of Anil for the year ending 31st December every year. 5M
- OR**
- 6 (a) A Ltd. purchased a 5 years lease on 1 April 2013 for Rs.500000. It is decided to write off depreciation on lease using the Annuity method. The rate of interest is presumed to be 6% p.a. The annuity for Rs.1 for 5 years at 6% interest is 0.237396. Prepare the Lease A/c for 5 years. 5M  
(b) Give the advantages and disadvantages of diminishing balance method of depreciation. 5M
- OR**
- 7 (a) Differentiate the advantages and disadvantages of vertical analysis and horizontal analysis of financial statements. 5M  
(b) List out the ratios for financial statement analysis and briefly explain them. 5M
- OR**
- 8 (a) Give a brief note on Du Pont chart. 5M  
(b) Explain the elements of financial statements for interpreting them. 5M

Contd. in page 2



- 9 (a) What are the steps involved in preparation of fund flow statement? 5M  
 (b) What are the objectives of cash flow statement? 5M

OR

- 10 (a) What are the objectives of fund flow statement? 5M  
 (b) What are the steps involved in preparation of cash flow statement? 5M

### SECTION – B

(Compulsory question, 01 X 10 = 10 Marks)

#### 11 Case Study/Problem:

AXE Corp, a publically traded NASDAQ company (symbol JAL), is a manufacturer of cabinets. Its main headquarters is based in Miami, Florida and the company has been operating since 1981. The company sells its products on the worldwide retail market. The primary compound in JAL's leading products is found only in the rainforests of Central America. Its major customer is Wal-Mart. Its stock sells at 45 US dollars per share, and its 52 week price range is between 37.75 and 67.85 US Dollars, with a market cap of 10.2 billion dollars. The financial statements presented below for the Year Ending December 31, 2011 have been prepared using US GAAP. JAL's controller, Mercedes, would like to see the effect of using IFRS on the statement of cash Flows. The company would like to adapt IFRS by as early as next year as it is considering a new stock issue in Costa Rica, which requires IFRS compliance. You have been assigned the task of converting this cash flow financial statement from US GAAP to IFRS. 10M

#### AXE CORP.

#### Cash Flow Statement (Direct method) under US GAAP 1/1/2011-12/31/2011

##### Cash Flow From Operations

Cash collections from sales	\$ 266,000
Cash paid to suppliers	(183,000)
Cash paid for operating expenses	(29,000)
Cash paid for interest expense	(4,000)
Cash paid for income taxes	(9,000)
Cash flow provided from operating activities	41,000

##### Cash Flow from Investing

Purchase of equipment	(13,000)
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##### Cash Flow from Financing Activities

Cash dividends paid	(3,000)
Net Increase in cash for the Year 2011	25,000
Beginning cash balance	28,000
Ending cash balance 12/31/2011	\$ 53,000

#### ADDITIONAL INFORMATION:

- (i) AXE Corp. uses the LIFO method to account for its inventory. The LIFO reserve was \$15,000 at the beginning of the year and \$19,000 as of year-end. The effective tax rate for JAL is 25 percent. The company pays all tax liabilities when accrued.
- (ii) Management has established that there is an increase in the Fair market value of Property, Plant and Equipment as of 12/31/11 of \$6,000 above book value.
- (iii) In 2011, the company spent \$4,000 on internally feasible development costs, which relates to their pipeline of pharmaceutical drugs.

Contd. in page 3

(iv) AXE leased specialized machinery manufactured by the lessor, Jones Corp. The lease term is for 3 years with a lease payment made to lessor in the amount of \$5,000. Payment is due on December 31 of each year, with the first payment due on December 31, 2011. At the end of the lease term, ownership reverts back to lessor. There is no option to buy the equipment.

(a) The estimated useful life of the lease is 54 months; 4 and 1/2 years.

(b) The fair market value of the equipment is \$15,000.

(c) The interest rate implicit in the lease is 6 percent, and this is known to the lessee, Axe.

(d) The incremental borrowing rate of Axe is 7 percent.

(e) This lease is treated as an operating lease under US GAAP, and the US GAAP prepared cash flow statement reflects this.

(f) Under IFRS, this lease is treated as a capital/financing lease.

(v) Assume that AXE has elected to treat interest expense as a cash flow from operations activity, thereby being consistent with the US GAAP prepared statement.

**REQUIRED:**

(i) For items 1-4, identify whether there will be a change in cash flow under IFRS, a reclassification of cash flows, or no effect on cash flow.

(ii) For items 1-4, identify where applicable, the reclassification of cash flow among operating, investing and financing activities.

(iii) Make the necessary changes on the worksheet presented.

(iv) Prepare an IFRS Compliance Cash Flow Statement for the period 1/1/11 to 12/31/11.

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MBA I Semester Supplementary Examinations October 2022

**FINANCIAL ACCOUNTING FOR MANAGERS**

(Common to all)

(For students admitted in 2021 only)

Time: 3 hours

Max. Marks: 60

All questions carry equal marks

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**SECTION – A**

(Answer the following: 05 X 10 = 50 Marks)

- |   |     |   |    |
|---|-----|---|----|
| 1 | (a) | Explain single entry and double entry systems.                  | 5M |
|   | (b) | Describe the uses of accounting and book keeping Vs accounting. | 5M |

**OR**

- |   |     |  |    |
|---|-----|--|----|
| 2 | (a) | Describe the classification of accounts. | 5M |
|   | (b) | Explain the rules of debit and credit.   | 5M |

- |   |     |   |    |
|---|-----|---|----|
| 3 | (a) | For the year ended 31 December 2021, the profit of Kerbs Ltd. before changing depreciation on fixed assets and managerial commission amounted to \$300,000. | 5M |
|---|-----|---|----|

Depreciation for the year amounted to \$60,000 and a commission of 10% of the profits (before charging such commission) was payable to the manager.

The paid-up capital of the company consisted of \$1,000,000 divided into 5,000 6% preference shares of \$100 each, along with 50,000 equity shares of \$10 each. Interim dividend @ \$0.50 per share was paid during the year.

Brought from the previous year, the credit balance in the profit and loss account was \$35,000. Also, the following appropriations were proposed by the board of directors and subsequently passed at the company's annual general meeting:

- a. To pay the year's dividend on preference shares
- b. To pay a final dividend on equity shares at \$0.50 per share to make a total dividend of \$1 per share for the year
- c. To provide for taxation @ 50% on the net profit
- d. To transfer \$25,000 to the general reserve
- e. To carry forward the balance

Show the profit and loss appropriation account.

**Contd. in page 2**



(b)

Balance	Amount (\$)	Balance	Amount (\$)
Purchases	12,000	Carriage	250
Sales	25,000	Commission	350
Discount	1,200	Rent and Rates	600
Salaries	2,500	Building	6,000
Wages	10,000	Machinery	5,000
Cash in Hand	975	Delivery Van	4,000
Cash at Bank	13,500	Capital	20,000
Repairs & Maintenance	870	Accounts Payable	3,200
Sundry Expenses	350	Accounts Receivable	4,500
Mortgage	14,000	Closing Stock	5,750
Mortgage Interest	250	Opening Stock	2,450
Traveling Expenses	100	Returns Inward	300
Insurance	150	Reserve for doubtful Debts	800
Notes Payable	2,745	Notes Receivable	400

5M

Prepare a Trial Balance.

**OR**

- 4 (a) Explain journal subsidiary books, ledger, trial balance and final accounts. 5M  
 (b) Describe the accounting Process: Overview, Books of Original Record. 5M

- 5 (a) Explain the methods of inventory valuation. 5M  
 (b) Explain the methods of valuation of assets. 5M

**OR**

- 6 (a) Describe the straight line method of depreciation. 5M  
 (b) The Delta company uses a periodic inventory system. The beginning balance of inventory and purchases made by the company during the month of July, 2021 are given below: 5M  
 July 01: Beginning inventory, 500 units @ \$20 per unit.  
 July 18: Inventory purchased, 800 units @ \$24 per unit.  
 July 25: Inventory purchased, 700 units @ \$26 per unit.  
 The Delta company sold 1,400 units during the month of July.  
 Required: Compute inventory on July 31, 2021 and cost of goods sold for the month of July using following inventory costing methods:  
 (i) First in, first out (FIFO) method.  
 (ii) Last in, first out (LIFO) method.

- 7 (a) Explain Solvency Ratios and Liquidity Ratios and what's the difference. 5M  
 (b) Describe the tools for analysis of Financial Statements. 5M

**OR**

- 8 (a) Describe the DuPont system of ratio analysis. 5M  
 (b) Give the procedure for Analysis and Interpretation of Financial Statements. 5M

- 9 (a) Explain the steps in preparation of fund flow statement. 5M  
 (b) Describe the analysis of Cash flow and Funds flow statements. 5M

**OR**

- 10 (a) Explain the Steps in Preparation of Cash flow statement. 5M  
 (b) Evaluate the Funds flow statement Vs Cash flow statement. 5M

**SECTION – B**

(Compulsory question, 01 X 10 = 10 Marks)

- 11 **Case Study/Problem:** 10M

Prepare Trading and Profit and Loss Account and Balance Sheet from the following balances relating to the year ended 31<sup>st</sup> March, 2021:

	Rs.		Rs.
Capital	1,00,000	Wages	50,000
Creditors	12,000	Bank	10,000
Returns Outward	5,000	Repairs	500
Sales	1,64,000	Stock on 1st April, 2017	20,000
Bills Payable	5,000	Rent	4,000
Plant and Machinery	40,000	Manufacturing Expenses	8,000
Sundry Debtors	24,000	Trade Expenses	7,000
Drawing	10,000	Bad Debts	2,000
Purchases	1,05,000	Carriage	1,500
Returns Inward	3,000	Fuel and Power	1,000

Additional Information:

- (i) Closing stock was valued at Rs.14,500.  
 (ii) Depreciate Plant and Machinery by Rs.4,000.  
 (iii) Write off Bad Debts Rs.4,000.  
 (iv) A sum of Rs.400 is due for repairs.

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MBA I Semester Supplementary Examinations October 2020

**FINANCIAL ACCOUNTING FOR MANAGERS**

(For students admitted in 2017, 2018 & 2019 only)

Time: 3 hours

Max. Marks: 60

All questions carry equal marks

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**SECTION – A**

(Answer the following: 05 X 10 = 50 Marks)

- 1 Explain the importance of financial accounting.

**OR**

- 2 What are the primary objectives of accounting? Explain.

- 3 What are the accounting concepts and conventions? Explain in brief.

**OR**

- 4 From the following trial balance of M/s Sri Lakshmi&Co. Prepare Trading and Profit&Loss A/c for the year ending 31<sup>st</sup> March 2013.

Particulars	Debit ₹	Credit ₹	Particulars	Debit ₹	Credit ₹
Capital		62,000	Advertisement	1,500	
Opening stock	23,000		Interest received		800
Purchases & Sales	32,000	53,700	Debtors & Creditors	28,000	32,000
Returns	2,000	1,500	Cash in hand	1,200	
Wages	1,800		Salaries	2,500	
Land & Buildings	52,000		Other expenses	2,000	
Freight & Carriage	2,700				
Trade expenses	1,300				

- 5 What is FIFO method of inventory valuation? What are its merits and demerits?

**OR**

- 6 M/s Sairam Industries Ltd., purchased a plant on 1<sup>st</sup> April, 2010 for ₹4,50,000 and incurred installation charges of ₹50,000. On 30<sup>th</sup> September, 2010 it purchased second hand plant for ₹1,00,000. On 1<sup>st</sup> October, 2012 it sold the 1<sup>st</sup> plant purchased on 1<sup>st</sup> April, 2010 for ₹3,65,000. On 30<sup>th</sup> September, 2013 it sold the second plant purchased on 30<sup>th</sup> September, 2010 for ₹75,000 and purchased another plant for ₹1,50,000. Depreciation was provided at the rate of 10% on original cost on 31<sup>st</sup> March each year. Show the plant A/c for the period 2010-11 to 2013-14.

Contd. in page 2



7 Which are the financial ratios useful from the point of investors? Explain.

**OR**

8 A business furnishes you with the following details:

- (i) opening stock ₹50,000
- (ii) closing stock ₹70,000
- (iii) sales: credit ₹2,10,000, cash ₹1,50,000
- (iv) gross profit ₹60,000
- (v) year end debtors ₹20,000
- Less: provision for doubtful debts ₹2,000
- 
- 18,000

(vi) year end bills receivable ₹15,000

An year may be taken to be of 360 days. You are asked to:

Work out stock turnover ratio and debtors turnover ratio.

9 Explain the steps involved in preparation of funds flow statement.

**OR**

10 From the following particulars prepare cash flow statement of Ms.Sumana.

Assets/liabilities	1 <sup>st</sup> Jan 2018 (₹)	31 <sup>st</sup> Dec 2018(₹)
Cash	5,000	4,000
Debtors	40,000	45,000
Stock	30,000	25,000
Land	30,000	40,000
Buildings	50,000	55,000
Machinery	70,000	80,000
Total	2,25,000	2,49,000
Current liabilities	35,000	40,000
Loan from Mr.Shankar	--	25,000
Bank loan	40,000	30,000
Capital	1,50,000	1,54,000
Total	2,25,000	2,49,000

During the year, Sumana brought additional capital of ₹10,000 and her drawings during the year were ₹31,000.

Provision for depreciation on machinery: opening balance ₹30,000 and closing balance ₹44,000.

No depreciation need be provided for other assets.

### SECTION – B

(Compulsory question, 01 X 10 = 10 Marks)

11 **Case Study:**

From the following information, prepare a Balance Sheet with as many details as possible:

- (i) current ratio=2.5
- (ii) liquid ratio=1.5
- (iii) proprietary ratio(fixed assets/proprietary fund)=0.75
- (iv) working capital=₹1,20,000
- (v) reserves& surplus=₹80,000
- (vi) bank overdraft=₹20,000
- (vii) there are no long-term loans and fictitious assets.

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**FINANCIAL ACCOUNTING FOR MANAGERS**

(For students admitted in 2017, 2018 & 2019 only)

Time: 3 hours

Max. Marks: 60

All questions carry equal marks

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**SECTION – A**

(Answer the following: 05 X 10 = 50 Marks)

- 1 Who are the users of accounting information? Explain.

**OR**

- 2 How do you classify accounts? What are the rules for debit and credit? Explain with examples.

- 3 Write a detailed note on purchase book and three column cash book.

**OR**

- 4 Prepare the Trading and Profit & Loss A/c and Balance Sheet for Mr.Sriram from the following balances extracted from his accounting records on 31-12-2012.

	₹		₹
Capital account	9,000	Purchases	15,000
Furniture	800	Carriage outwards	200
Creditors	1,600	Salaries	2,000
Premises	13,000	Rent received	18,000
Bad debts	80	Discount allowed	800
Cash	40	Loan	180
Drawings	900	Reserve for bad debts	4,000
Overdraft at bank	905	Expenses	100
Debtors	1,500		705

Adjustments: (i) Make provision for bad debts @3%.

(ii) Salary due ₹200.

(iii) Stock on 31-12-2012 ₹3,500.

(iv) Write off 10% from furniture for depreciation.

(v) Rent due from tenants ₹100.

- 5 Explain in detail about the methods of goodwill valuation.

**OR**

- 6 On 1<sup>st</sup> January 2011 Sri Krishna Ltd purchased a machine for ₹1,50,000 and on 1<sup>st</sup> July 2011 it acquired additional machinery at a cost of ₹40,000. On 1<sup>st</sup> April 2012, it sold the machinery purchased on 1<sup>st</sup> July 2011 for ₹32,500, and bought a new machinery for ₹50,000. Depreciation is provided at a rate of 15% per annum using written down value method. Show the machinery account up to 31<sup>st</sup> December 2014.

Contd. in page 2

7	Share capital (20,000 equity shares of ₹10 each) = ₹2,00,000	
	Sales for the year	= ₹4,00,000
	Credit sales	= ₹3,00,000
	Stock	= ₹2,00,000
	Debtors	= ₹1,50,000
	Total assets	= ₹6,00,000
	Net profit	= ₹1,00,000
	Market price of share	= ₹20

From the above information compute:

- Stock turnover ratio.
- Debtors turnover ratio.
- Net profit to total assets ratio.
- Price earnings ratio.
- Earnings per share.

**OR**

- 8 Explain in detail about the limitations of accounting ratios.
- 9 What is funds flow statement? What are its objectives? Explain.

**OR**

- 10 The Balance Sheets of Srinivas Ltd as on 31-12-2013 and 31-12-2014.

Liabilities	2013(₹)	2014(₹)	Assets	2013(₹)	2014(₹)
Share capital	70,000	74,000	Cash	9,000	7,800
Debentures	12,000	6,000	Debtors	14,900	17,700
Reserve for doubtful debts	700	800	Stock	49,200	42,700
Trade creditors	10,360	11,840	Land	20,000	30,000
P&L A/c	10,040	10,560	Goodwill	10,000	5,000
Total	103,100	1,03,200		1,03,100	1,03,200

In addition, you are given:

- Dividend paid total ₹3,500.
- Land was purchased for ₹10,000.
- Amount provided for amortization of goodwill ₹5,000.
- Debentures paid off ₹6,000.

Prepare cash flow statement.

### SECTION – B

(Compulsory question, 01 X 10 = 10 Marks)

- 11 **Case Study:**

From the following information make out a balance sheet with as many details as possible:

Gross profit turnover ratio = 25%

Debtors velocity = 3 months

Creditors velocity = 2 months

Stock velocity = 8 times

Capital turnover ratio = 2.5 times

Fixed assets turnover ratio (based on cost of capital) = 8 times.

Gross profit for year ended on 31<sup>st</sup> December 2018 was ₹ 80,000. There was no long-term loan or overdraft. Reserves & surplus amounted to ₹28,000. Liquid assets were ₹ 97,333. Closing stock of the year was ₹2,000 more than the opening stock. Bills receivable and Bills payable were ₹5,000 and ₹2,000 respectively.

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