MALLA REDDY COLLEGE OF ENGINEERING & TECHNOLOGY
(Autonomous Institution - UGC, Govt. of India)

DEPARTMENT OF BUSINESS MANAGEMENT

DIGITAL NOTES

Financial Accounting and Analysis

(R20MBA03)

Course Instructor

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FINANCIAL ACCOUINTING AND ANALYSIS

Course Aim/s:

- To provide the information that is needed for sound economic decision making.
- To provide information about firm's performance to external parties such as investors, creditors, bankers, researchers and Government Agencies.

Learning Outcome/s:

- To prepare, understand, interpret and analyze financial statements with confidence.
- To appreciate and use financial statements as means of business communication.
- To use the analytical techniques and arriving at conclusions from financial information for the purpose of decision making.

Unit-I: Introduction to Accounting

Introduction to Accounting: Importance - Objectives – Principles. GAAP: Accounting Concepts and Conventions. Accounting System: Double Entry System - Recording Business Transactions - Classification of Accounts - Accounting Cycle - Users of Accounting Information.

Unit-II: The Accounting Process

Overview: Accounting Process. Books of Original Record: Journal - Ledger - Trial Balance (Problems) - Classification of Capital and Revenue Expenses - Final Accounts with Adjustments (Problems) - Cash Book and other Subsidiary books. (Only Theory)

Unit-III: Depreciation and Shares and Debentures

Depreciation: Concept - Methods of Depreciation: their impact on measurement of business Accounting - Straight Line Method (Problems) - Written down Value Method (Problems). Shares and Debentures: Entries for Issue of shares (Problems) - Forfeiture (Problems) - Issue of shares at Discount and premium (Problems) - Issue and Redemption of Debentures. (Problems)

Unit-IV: Financial Analysis-I

Working Capital: Statement of Changes in Working Capital - Funds from Operations - Paid Cost and Unpaid Costs. Financial Analysis: Introduction to Funds Flow Statement - Cash Flow Statement vs. Funds Flow Statement - Preparation and Analysis of Cash Flow Statement (Problems)

Unit-V: Financial Analysis-II

Financial Statement Analysis: Analysis and Interpretation of Financial Statements from Investor and Company point of view - Horizontal Analysis and Vertical Analysis of Company Financial Statements - Liquidity - Leverage - Solvency and Profitability Ratios. (Problems) Techniques: Du Pont Chart - Window Dressing - Limitations of Financial Statements. Accounting Standards (AS) Issued by ICAI-IFRS. Case Study on Financial Reporting & Analysis (FRAs).

REFERENCES:

- Dhanesh K. Khatri, Financial Accounting & Analysis, TMH, New Delhi.
- PK Jain and K. L. Narang, Financial Accounting & Analysis, Kalyani Publications.
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UNIT 1: INTODUCTION TO ACCOUNTING

INTRODUCTION

Accounting has rightly been termed as the language of the business. The basic function of a language is to serve as a means of communication. Accounting also serves this function. It communicates the results of business operations to various parties who have some stake in the business viz., the proprietor, creditors, investors, Government and other agencies. Though accounting is generally associated with business but it is not only business which makes use of accounting. Persons like housewives, Government and other
individuals also make use of a accounting. For example, a housewife has to keep a record of the money received and spent by her during a particular period. She can record her receipts of money on one page of her "household diary" while payments for different items such as milk, food, clothing, house, education etc. on some other page or pages of her diary in a chronological order. Such a record will help her in knowing about:

(i) The sources from which she received cash and the purposes for which it was utilized.
(ii) Whether her receipts are more than her payments or vice-versa?
(iii) The balance of cash in hand or deficit, if any at the end of a period.

ORIGIN AND GROWTH OF ACCOUNTING

Accounting is as old as money itself. However, the act of accounting was not as developed as it is today because in the early stages of civilization, the number of transactions to be recorded were so small that each businessman was able to record and check for himself all his transactions. Accounting was practiced in India twenty three centuries ago as is clear from the book named "Arthashastra" written by Kautilya, King Chandragupta's minister. This book not only relates to politics and economics, but also explain the art of proper keeping of accounts.

However, the modern system of accounting based on the principles of double entry system owes it origin to Luco Pacioli who first published the principles of Double Entry System in 1494 at Venice in Italy. Thus, the art of accounting has been practiced for centuries but it is only in the late thirties that the study of the subject 'accounting' has been taken up seriously.

MEANING OF ACCOUNTING

The main purpose of accounting is to ascertain profit or loss during a specified period, to show financial condition of the business on a particular date and to have control over the firm's property. Such accounting records are required to be maintained to measure the income of the business and communicate the information so that it may be used by managers, owners and other interested parties. Accounting is a discipline which records, classifies, summarizes and interprets financial information about the activities of a concern so that intelligent decisions can be made about the concern. *The American Institute of Certified Public Accountants* has defined the Financial Accounting as "the art of recording, classifying and summarizing in as significant manner and in terms of money transactions and events which in part, at least of a financial character, and interpreting the results thereof". *American Accounting Association* defines accounting as "the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.

From the above the following attributes of accounting emerge :
(i) **Recording :** It is concerned with the recording of financial transactions in an orderly manner, soon after their occurrence In the proper books of accounts.

(ii) **Classifying :** It Is concerned with the systematic analysis of the recorded data so as to accumulate the transactions of similar type at one place. This function is performed by maintaining the ledger in which different accounts are opened to which related transactions are posted.

(iii) **Summarizing :** It is concerned with the preparation and presentation of the classified data in a manner useful to the users. This function involves the preparation of financial statements such as Income Statement, Balance Sheet, Statement of Changes in Financial Position, Statement of Cash Flow, Statement of Value Added.

(iv) **Interpreting :** Nowadays, the aforesaid three functions are performed by electronic data processing devices and the accountant has to concentrate mainly on the interpretation aspects of accounting. The accountants should interpret the statements in a manner useful to action. The accountant should explain not only what has happened but also (a) why it happened, and (b) what is likely to happen under specified conditions.

OBJECTIVES OF ACCOUNTING

The following are the main objectives of accounting:

To keep systematic records

To protect business properties

To ascertain the operational profit or loss

To ascertain the financial position of the business

To facilitate rational decision making

Information System

1. **To keep systematic records :** Accounting is done to keep a systematic record of financial transactions. In the absence of accounting there would have been terrific burden on human memory which in most cases would have been impossible to bear.

2. **To protect business properties :** Accounting provides protection to business properties from unjustified and unwarranted use. This is possible on account of accounting supplying the following information to the manager or the proprietor:
(i) The amount of the proprietor's funds invested in the business.
(ii) How much the business have to pay to others?
(iii) How much the business has to recover from others?
(iv) How much the business has in the form of (a) fixed assets, (b) cash in hand, (c) cash at bank, (d) stock of raw materials, work-in-progress and finished goods?

Information about the above matters helps the proprietor in assuring that the funds of the business are not necessarily kept idle or under-utilized.

3. **To ascertain the operational profit or loss :** Accounting helps in ascertaining the net profit earned or loss suffered on account of carrying the business. This is done by keeping a proper record of revenues and expense of a particular period. The Profit and Loss Account is prepared at the end of a period and if the amount of revenue for the period is more than the expenditure incurred in earning that revenue, there is said to be a profit. In case the expenditure exceeds the revenue, there is said to be a loss. Profit and Loss Account will help the management, investors, creditors, etc. in knowing whether the business has proved to be remunerative or not. In case it has not proved to be remunerative or profitable, the cause of such a state of affairs will be investigated and necessary remedial steps will be taken.

4. **To ascertain the financial position of the business :** The Profit and Loss Account gives the amount of profit or loss made by the business during a particular period. However, it is not enough. The businessman must know about his financial position i.e. where he stands ?, what he owes and what he owns? This objective is served by the Balance Sheet or Position Statement. The Balance Sheet is a statement of assets and liabilities of the business on a particular date. It serves as barometer for ascertaining the financial health of the business.

5. **To facilitate rational decision making :** Accounting these days has taken upon itself the task of collection, analysis and reporting of information at the required points of time to the required levels of authority in order to facilitate rational decision-making. The American Accounting Association has also stressed this point while defining the term accounting when it says that accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information. Of course, this is by no means an easy task. However, the accounting bodies all over the world and particularly the International Accounting Standards Committee, have been trying to grapple with this problem and have achieved success in laying down some basic postulates on the basis of which the accounting statements have to be prepared.

6. **Information System :** Accounting functions as an information system for collecting and communicating economic information about the business enterprise. This information helps the management in taking appropriate decisions. This function, as stated, is gaining tremendous importance these days.

ROLE AND IMPORTANCE OF ACCOUNTING

Accounting plays an important and useful role by developing the information for providing answers to many questions faced by the users of accounting information :

(1) How good or bad is the financial condition of the business?
(2) Has the business activity resulted in a profit or loss ?
(3) How well the different departments of the business have performed in the past?
(4) Which activities or products have been profitable?
(5) Out of the existing products which should be discontinued and the production of which commodities should be increased?
(6) Whether to buy a component from the market or to manufacture the same?
(7) Whether the cost of production is reasonable or excessive?
(8) What has been the impact of existing policies on the profitability of the business?
(9) What are the likely results of new policy decisions on future earning capacity of the business?
(10) In the light of past performance of the business how should it plan for future to ensure desired results?

Above mentioned are few examples of the types of questions faced by the users of accounting information. These can be satisfactorily answered with the help of suitable and necessary information provided by accounting.

Besides, accounting is also useful in the following respects:

a. Increased volume of business results in large number of transactions and no businessman can remember everything. Accounting records obviate the necessity of remembering various transactions.
b. Accounting records, prepared on the basis of uniform practices, will enable a business to compare results of one period with another period.
c. Taxation authorities (both income tax and sales tax) are likely to believe the facts contained in the set of accounting books if maintained according to generally accepted accounting principles.
d. Accounting records, backed up by proper and authenticated vouchers, are good evidence in a court of law.
e. If a business is to be sold as a going concern, then the values of different assets as shown by the balance sheet helps in bargaining proper price for the business.

MEANING AND FEATURES OF ACCOUNTING PRINCIPLES

For searching the goals of the accounting profession and for expanding knowledge in this field, a logical and useful set of principles and procedures are to be developed. We know that while driving our vehicles, follow a standard traffic rules. Without adhering traffic rules, there would be much chaos on the road. Similarly, some principles apply to accounting.

Thus, the accounting profession cannot reach its goals in the absence of a set rules to guide the efforts of accountants and auditors. The rules and principles of accounting are commonly referred to as the conceptual framework of accounting.

Accounting principles have been defined by the Canadian Institute of Chartered Accountants as "The body of doctrines commonly associated with the theory and procedure of accounting serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternatives exists. Rules governing the formation of accounting axioms and the principles derived from them have arisen from common experience, historical precedent statements by individuals and professional bodies and regulations of Governmental agencies". According to Hendriksen (1997), Accounting theory may be defined as logical reasoning in the form of a set of broad principles that (i) provide a general frame of reference by which accounting practice can be evaluated, and (ii) guide the development of new practices and procedures. Theory may also be used to explain existing practices to obtain a better understanding of them. But the most important goal of accounting theory should be to provide a coherent set of logical principles that form the general frame of reference for the evaluation and development of sound accounting practices.

The American Institute of Certified Public Accountants (AICPA) has advocated the use of the word" Principle" in the sense in which it means "rule of action". It discuses the generally accepted accounting principles as follows :

Financial statements are the product of a process in which a large volume of data about aspects of the economic activities of an enterprise are accumulated, analysed and reported. This process should be carried out in conformity with generally accepted accounting principles. These

principles represent the most current consensus about how accounting information should be recorded, what information should be disclosed, how it
should be disclosed, and which financial statement should be prepared. Thus, generally accepted principles and standards provide a common financial language to enable informed users to read and interpret financial statements.

Generally accepted accounting principles encompass the conventions, rules and procedures necessary to define accepted accounting practice at a particular time....... generally accepted accounting principles include not only broad guidelines of general application, but also detailed practices and procedures (Source : AICPA Statement of the Accounting Principles Board No. 4, "Basic Concepts and Accounting Principles underlying Financial Statements of Business Enterprises ", October, 1970, pp 54-55)

According to 'Dictionary of Accounting' prepared by Prof. P.N. Abroal, "Accounting standards refer to accounting rules and procedures which are relating to measurement, valuation and disclosure prepared by such bodies as the Accounting Standards Committee (ASC) of a particular country". Thus, we may define Accounting Principles as those rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. Accounting principles are man-made. They are accepted because they are believed to be useful. The general acceptance of an accounting principle usually depends on how well it meets the following three basic norms :
a) Usefulness b) Objectiveness, and c) Feasibility

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP): ACCOUNTING CONCEPTS AND CONVENTIONS

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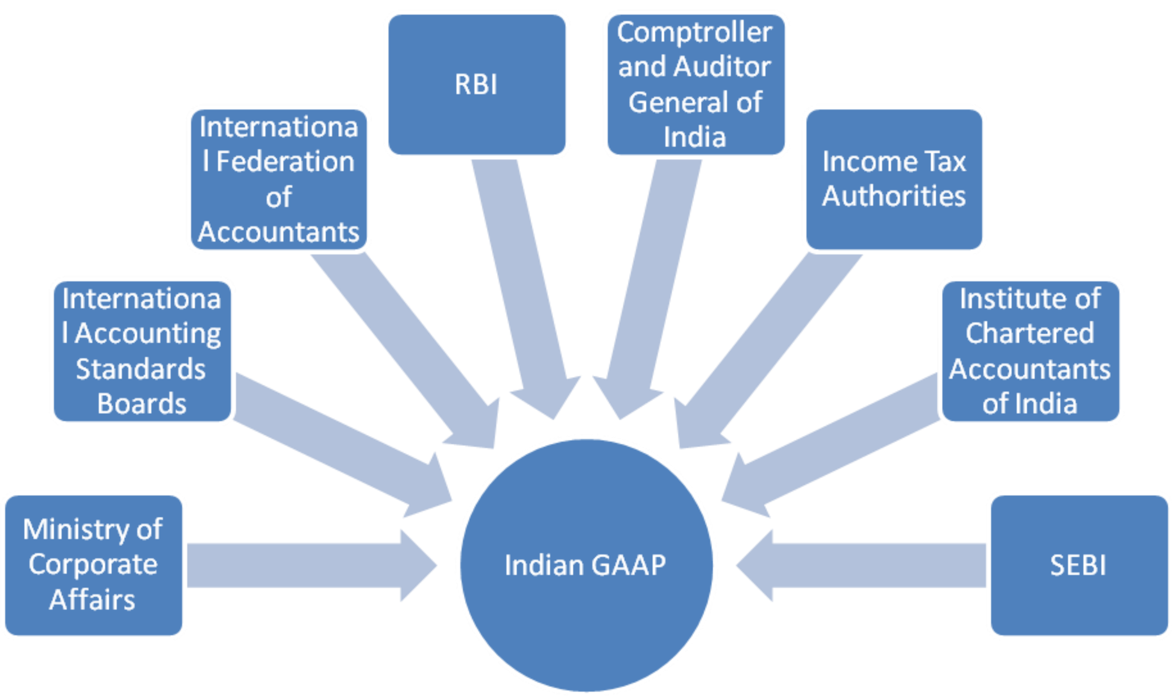
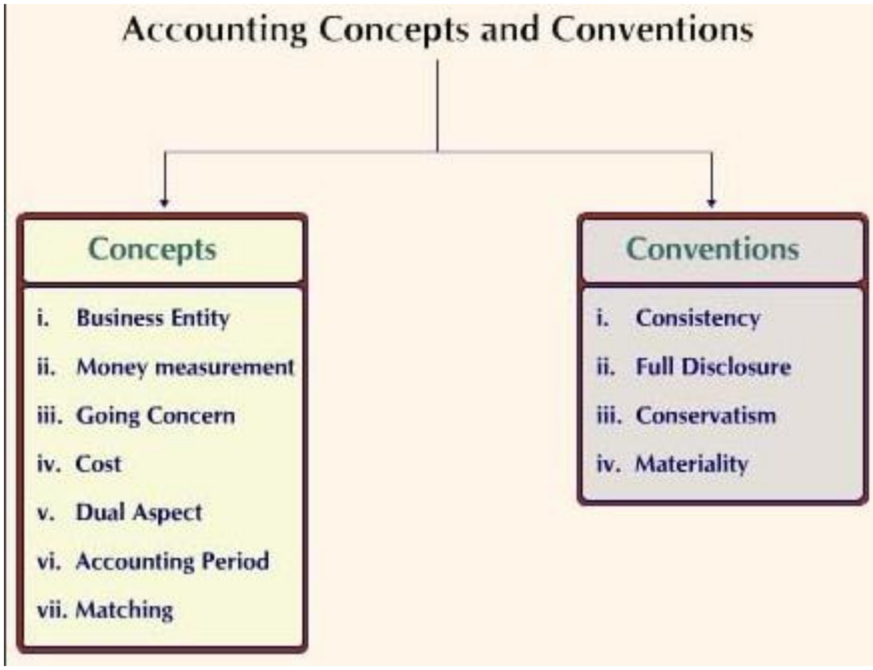


GAAP: Balance Sheet



1. Separate Business Entity Concept. In accounting we make a distinction between business and the owner. All the books of accounts records day to day financial transactions from the view point of the business rather than from that of the owner. The proprietor is considered as a creditor to the extent of the capital brought in business by him. For instance, when a person invests Rs. 10 lakh into a business, it will be treated that the business has borrowed that much money from the owner and it will be shown as a 'liability' in the books of accounts of business. Similarly, if the owner of a shop were to take cash from the cash box for meeting certain personal expenditure, the accounts would show that cash had been reduced even though it does not make any difference to the owner himself. Thus, in recording a transaction the important question is how does it affects the business ? For example, if the owner puts cash into the business, he has a claim against the business for capital brought in.

In so far as a limited company is concerned, this distinction can be easily maintained because a company has a legal entity of its own. Like a natural person it can engage itself in economic activities of buying, selling, producing, lending, borrowing and consuming of goods and services. However, it is difficult to show this distinction in the case of sole proprietorship and partnership. Nevertheless, accounting still maintains separation of business and owner. It may be noted that it is only for accounting purpose that partnerships and sole proprietorship are treated as separate from the owner (s), though law does not make such distinction. Infact, the business entity concept is applied to make it possible for the owners to assess the performance of their business and performance of those whose manage the enterprise. The managers are responsible for the proper use of funds supplied by owners, banks and others.

2. Money Measurement Concept. In accounting, only those business transactions are recorded which can be expressed in terms of money. In other words, a fact or transaction or happening

which cannot be expressed in terms of money is not recorded in the accounting books. As money is accepted not only as a medium of exchange but also as a store of value, it has a very important advantage since a number of assets and equities, which are otherwise different, can be measured and expressed in terms of a common
denominator.

We must realise that this concept imposes two limitations. Firstly, there are several facts which though very important to the business, cannot be recorded in the books of accounts because they cannot be expressed in money terms. For example, general health condition of the Managing Director of the company, working conditions in which a worker has to work, sales policy pursued by the enterprise, quality of product introduced by the enterprise, though exert a great influence on the productivity and profitability of the enterprise, are not recorded in the books. Similarly, the fact that a strike is about to begin because employees are dissatisfied with the poor working conditions in the factory will not be recorded even though this event is of great concern to the business. You will agree that all these have a bearing on the future profitability of the company.

Secondly, use of money implies that we assume stable or constant value of rupee. Taking this assumption means that the changes in the money value in future dates are conveniently ignored. For example, a piece of land purchased in 1990 for Rs. 2 lakh and another bought for the same amount in 1998 are recorded at the same price, although the first purchased in 1990 may be worth two times higher than the value recorded in the books because of rise in land values. Infact, most accountants know fully well that purchasing power of rupee does change but very few recognise this fact in accounting books and make allowance for changing price level.

3. Dual Aspect Concept. Financial accounting records all the transactions and events involving financial element. Each of such transactions requires two aspects to be recorded. The recognition of these two aspects of every transaction is known as a dual aspect analysis. According to this concept every business transactions has dual effect. For example, if a firm sells goods of Rs. 10,000 this transaction involves two aspects. One aspect is the delivery of goods and the other aspect is immediate receipt of cash (in the case of cash sales). Infact, the term 'double entry' book keeping has come into vogue because for every transaction two entries are made. According to this system the total amount debited always equals the total amount credited. It follows from 'dual aspect concept' that at any point in time owners' equity and liabilities for any accounting entity will be equal to assets owned by that entity. This idea is fundamental to accounting and could be expressed as the following equalities:

Assets = Liabilities + Owners Equity ....(1)
Owners Equity = Assets - Liabilities ....(2)

The above relationship is known as the 'Accounting Equation'. The term 'Owners Equity' denotes the resources supplied by the owners of the entity while the term 'liabilities' denotes the claim of outside parties such as creditors, debenture-holders, bank against the assets of the business. Assets are the resources owned by a business. The total of assets will be equal to total of liabilities plus owners capital because all assets of the business are claimed by either owners or outsiders.

4. Going Concern Concept. Accounting assumes that the business entity will continue to operate for a long time in the future unless there is good evidence to the contrary. The enterprise is viewed as a going concern, that is, as continuing in operations, at least in the foreseeable future. In other words, there is neither the intention nor the necessity to liquidate the particular business venture in the predictable future. Because of this assumption, the accountant while valuing the assets do not take into account forced sale value of them. Infact, the assumption that the business is not expected to be liquidated in the foreseeable future establishes the basis for many of the valuations and allocations in accounting. For example, the accountant charges depreciation of fixed assets values. It is this assumption which underlies the decision of investors to commit capital to enterprise.

Only on the basis of this assumption can the accounting process remain stable and achieve the objective of correctly reporting and recording on the capital invested, the efficiency of management, and the position of the enterprise as a going concern. However, if the accountant has good reasons to believe that the business, or some part of it is going to be liquidated or that it will cease to operate (say within six-month or a year), then the resources could be reported at their current values. If this concept is not followed, International Accounting Standard requires the disclosure of the fact in the financial statements together with reasons.

5. Cost Concept. The term 'assets' denotes the resources land building, machinery etc. owned by a business. The money values that are assigned to assets are derived from the cost concept. According to this concept an asset is ordinarily entered on the accounting records at the price paid to acquire it. For example, if a business buys a plant for Rs. 5 lakh the asset would be recorded in the books at Rs. 5 lakh, even if its market value at that time happens to be Rs. 6 lakh. Thus, assets are recorded at their original purchase price and this cost is the basis for all subsequent accounting for the business. The assets shown in the financial statements do not necessarily indicate their present market values. The term 'book value' is used for amount shown in the accounting records.

The cost concept does not mean that all assets remain on the accounting records at their original cost for all times to come. The asset may systematically be reduced in its value by charging 'depreciation', which will be discussed in detail in a subsequent lesson. Depreciation have the effect of reducing profit of each period. The prime purpose of depreciation is to allocate the cost of an asset over its useful life and not to adjust its cost.
However, a balance sheet based on this concept can be very misleading as it shows assets at cost even when there are wide difference between their costs and market values. Despite this limitation you will find that the cost concept meets all the three basic norms of relevance, objectivity and feasibility.

GAAP: INCOME STATEMENT

1. Accounting Period Concept. This concept requires that the life of the business should be divided into appropriate segments for studying the financial results shown by the enterprise after each segment. Although the results of operations of a specific enterprise can be known precisely only after the business has ceased to operate, its assets have been sold off and liabilities paid off, the knowledge of the results periodically is also necessary. Those who are interested in the operating results of business obviously cannot wait till the end. The requirements of these parties force the businessman ‘to stop’ and ‘see back’ how things are going on. Thus, the accountant must report for the changes in the wealth of a firm for short time periods. A year is the most common interval on account of prevailing practice, tradition and government requirements. Some firms adopt financial year of the government, some other calendar year. Although a twelve month period is adopted for external reporting, a shorter span of interval, say one month or three month is applied for internal reporting purposes. This concept poses difficulty for the process of allocation of long term costs. All the revenues and all the cost relating to the year in operation have to be taken into account while matching the earnings and the cost of those earnings for the any accounting period. This holds good irrespective of whether or not they have been received in cash or paid in cash. Despite the difficulties which stem from this concept, short term reports are of vital importance to owners, management, creditors and other interested parties. Hence, the accountants have no option but to resolve such difficulties.

2. The Matching concept. This concept is based on the accounting period concept. In reality we match revenues and expenses during the accounting periods. Matching is the entire process of periodic earnings measurement, often described as a process of matching expenses with revenues. In other words, income made by the enterprise during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. Broadly speaking revenue is the total amount realised from the sale of goods or provision of services together with earnings from interest, dividend, and other items of income.

Expenses are cost incurred in connection with the earnings of revenues. Costs incurred do not become expenses until the goods or services in question are exchanged. Cost is not synonymous with expense since expense is sacrifice made, resource consumed in relation to revenues earned during an accounting period. Only costs that have expired during an accounting period are considered as expenses. For example, if a commission is paid in January, 2002, for services enjoyed in November, 2001, that commission should be taken as the cost for services rendered in November 2001. On account of this concept, adjustments are made for all prepaid expenses, outstanding expenses, accrued income, etc, while preparing periodic reports.

3. Conservatism Concept. This concept requires that the accountants must follow the policy of ‘’playing safe” while recording business transactions and events. That is why, the accountant follow the rule anticipate no profit but provide for all possible losses, while recording the business events. This rule means that an accountant should record lowest possible value for assets and revenues, and the highest possible value for liabilities and expenses. According to this concept, revenues or gains should be recognised only when they are realised in the form of cash or assets (i.e. debts) the ultimate cash realisation of which can be assessed with reasonable certainty. Further, provision must be made for all known liabilities, expenses and losses, Probable losses regarding all contingencies should also be provided for. ‘Valuing the stock in trade at market price or cost price which ever is less’, ‘making the provision for doubtful debts on debtors in anticipation of actual bad debts’, ‘adopting written down value method of depreciation as against straight line method’, not providing for discount on creditors but providing for discount on debtors', are some of the examples of the application of the convention of conservatism.

The principle of conservatism may also invite criticism if not applied cautiously. For example, when the accountant create secret reserves, by creating excess provision for bad and doubtful debts, depreciation, etc. The financial statements do not present a true and fair view of state of affairs.

4. Realizations Concept. Realisation is technically understood as the process of converting non-cash resources and rights into money. As accounting principle, it is used to identify precisely the amount of revenue to be recognised and the amount of expense to be matched to such revenue for the purpose of income measurement. According to realisation concept revenue is recognised when sale is made. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. This implies that revenue is generally realised when goods are delivered or services are rendered. The rationale is that delivery validates a claim against the customer. However, in case of long run construction contracts revenue is often recognised on the basis of a proportionate or partial completion method. Similarly, in case of long run installment sales contracts, revenue is regarded as realized only in proportion to the actual cash collection. In fact, both these cases are the exceptions to the notion that an exchange is needed to justify the realisation of revenue.

5. Consistency Concept. The convention of consistency requires that once a firm decided on certain accounting policies and methods and has used these for some time, it should continue to follow the same methods or procedures for all subsequent similar events and transactions.

6. Materiality. Materiality concept states that items of small significance need not be given strict theoretically correct treatment. Infact, there are many events in business which are insignificant in nature. The cost of recording and showing in financial statement such events may not be well justified by the utility derived from that information. For example, an ordinary calculator costing Rs. 100 may last for ten years.

However, the effort involved in allocating its cost over the ten year period is not worth the benefit that can be derived from this operation. The cost incurred on calculator may be treated as the expense of the period in which it is purchased. Similarly, when a statement of outstanding debtors is prepared for sending to top management, figures may be rounded to the nearest ten or hundred.

This convention will unnecessarily overburden an accountant with more details in case he is unable to find an objective distinction between material and immaterial events. It should be noted that an item material for one party may be immaterial for another. Actually, there are no hard and fast rule to draw the line between material and immaterial events and hence, It is a matter of judgement and common sense. Despite this limitation, It is necessary to disclose all material information to make the financial statements clear and understandable. This is required as per IAS-1 and also reiterated in IAS-5. As per IAS-1, materiality should govern the selection and application of accounting policies.

Accrual Concept. It is generally accepted in accounting that the basis of reporting income is accrual. Accrual concept makes a distinction between the receipt of cash and the right to receive it, and the payment of cash and the legal obligation to pay it. This concept provides a guideline to the accountant as to how he should treat the cash receipts and the right related thereto. Accrual principle tries to evaluate every transaction in terms
of its impact on the owner's equity. The essence of the accrual concept is that net income arises from events that change the owner's equity in a specified period and that these are not necessarily the same as change in the cash position of the business. Thus it helps in proper measurement of income.

Illustration 1

State with reasons whether the following events are transactions or not to Mr. Nikhil, Proprietor, Delhi Computers

(i) Mr. Nikhil started business with capital (brought in cash)Rs. 40,000.
(ii) Paid salaries to staff Rs. 5,000.
(iii) Purchased machinery for Rs. 20,000 in cash.
(iv) Placed an order with Sen & Co. for goods for Rs. 5,000.
(v) Opened a Bank account by depositing Rs. 4,000.
(vi) Received pass book from bank.
(vii) Appointed Sohan as Manager on a salary of Rs. 4,000 per month.
(viii)Received interest from bank Rs. 500.
(ix) Received a price list from Lalit.

Solution :
Here, each event is to be considered from the view point of Mr. Nikhil's business. Those events which will change the financial position of the business of Mr. Nikhil, should be regarded as transaction.
(i) It is a transaction, because it changes the financial position of Mr. Nikhil's business. Cash will increase by Rs. 40,000 and Capital will increase by Rs. 40,000.
(ii) It is a transaction, because it changes the financial position of Mr. Nikhil's business. Cash will decrease by Rs. 5,000 and Salaries (expenses) will increase by Rs. 5,000
(iii) It is a transaction, because it changes the financial position of Mr. Nikhil's business. Machinery comes in and cash goes out.
(iv) It is not a transaction, because it does not change the financial position of the business.
(v) It is a transaction, because it changes the financial position of the business. Bank balance will increase by Rs. 4,000 and cash balance will decrease by Rs. 4,000.
(vi) It is also not a transaction, because it does not change the financial position of Mr. Nikhil.
(vii) It is also not a transaction, because it does not change the financial position

of Mr. Nikhil.
(viii) It is a transaction, because it changes the financial position of Mr. Nikhil's business.
(ix) It is not a transaction, because it does not change the financial position of the business of Mr. Nikhil.

ACCOUNTING EQUATION

Dual concept states that 'for every debit, there is a credit'. Every transaction should have two-sided effect to the extent of same amount. This concept has resulted in accounting equation which states that at any point of time assets of any entity must be equal (in monetary terms) to the total of owner's equity and outsider's liabilities. In other words, accounting equation is a statement of equality between the assets and the sources which finance the assets and is expressed as :

Assets = Sources of Finance

Assets may be tangible e.g. land, building, plant, machinery, equipment, furniture, investments, cash, bank, stock, debtors etc. or intangible e.g. patent rights, trade marks, goodwill etc.,

Sources include internal i.e. capital provided by the owner and external i.e. liabilities. Liabilities are the obligations of the business to others/outsiders. The above equation gets expanded.

Assets = Liabilities + Capital

All transactions of a business can be referred to this equation :

Assets = Liabilities + Owner's equity

A = L + OE

To further explain the transaction of revenues, expenses, losses and gains, the equation can be expanded thus :

Assets + Expenses = Liabilities + Revenue + Owner's equity
or
Assets = Liabilities + (Revenue – Expenses) + Owner's equity
Or
Assets = Liabilities + Owner's equity + Owner's equity (income) which ultimately becomes

Assets = Liabilities + Owner's equity

Let us consider the facts of the following case, step by step, to understand as to how the equation remains true even in changed circumstances

Illustration 2

1. Commenced business with cash Rs. 50,000
2. Purchased goods for cash Rs. 20,000 and on credit Rs. 30,000

3. Sold goods for cash Rs. 40,000 costing Rs. 30,000
4. Rent paid Rs. 500
5. Bought furniture Rs. 5,000 on credit
6. Bought refrigerator for personal use Rs. 5,000

Solution :
1. Business receives cash Rs. 50,000 (asset) and it owes Rs. 50,000 to the proprietor as his capital i.e. equity
Assets (=) Liabilities (+) Owner's equity
Cash Rs. 50,000 = Nil +Capital Rs. 50,000

(2) Purchased goods for cash Rs. 20,000 and on credit Rs. 30,000. Business has acquired asset namely – goods worth Rs. 50,000 and another asset namely = cash has decreased by Rs. 20,000 while liability– creditors have been created of Rs. 30,000.
Assets (=) Liabilities (+) Owner's equity
Cash 30,000 + Goods 50,000
= Creditors 30,000 +Capital 50,000

(3) Sold goods for cash Rs. 40,000 costing Rs. 30,000
This transaction has resulted in decrease of goods by Rs. 30,000 and increase in cash by Rs. 40,000 thus Increasing equity by Rs. 10,000
Assets (=) Liabilities (+) Owner's equity
Cash 70,000 + Goods 20,000 = Creditors 30,000 + Capital 60,000

CLASSIFICATION OF ACCOUNTS

Asset Accounts

- Land
- Buildings
- Equipment
- Prepaid expenses
- Trade receivables
- Bills receivables
- Cash
- Intangible assets like copy rights, goodwill, patent, etc.
- Marketable securities

Liability Accounts

- Bills payable
- Trade payables
- Unearned revenue
- Other short-term liabilities like wages payable, tax payable, interest payable, dividends payable.
- Long-term liabilities like debentures loans from banks and other financial institutions, long-term deposits.

Equity Account

- Share capital
- Retained earnings
- Revenues and expenses
- Drawings
- Dividends

Income- Expenditure Account

- Wages
- Rent
- Commission
- Interest paid
- Interest receive
- Sales revenue….etc..
- All expenses
- All income

Double-entry System

Assets:	Debit increase in asset to asset account Credit decrease in asset to asset account
Liabilities & Equity:	Credit increase in liability or equity to liability or equity account Debit decrease in liability or equity to liability or equity account
Income & Expenditure:	Debit all expenses Credit all income

Therefore,

Assets = Liabilities + Capital + Revenues - Expenses – Drawings (or Dividends)

Assets	
Debit	**Credit**
Increase (+)	**Decrease (-)**

Liabilities	
Debit	**Credit**
Decrease (-)	**Increase (+)**

Equity	
Debit	**Credit**
Decrease (-)	**Increase (+)**

Income & Expenditure	
Debit	**Credit**
Expenses	**Income**

ACCOUNTING CYCLE

INTRODUCTION

Any economic transaction or event of a business which can be expressed in monetary terms should be recorded. Traditionally, accounting is a method of collecting, recording, classifying, summarizing, presenting and interpreting financial data of an economic activity. The series of business transactions occurs during the accounting period and its recording is referred to an accounting process/ mechanism. An accounting process is a complete sequence of accounting procedures which are repeated in the same order during each accounting period.

Therefore, accounting process involves the following steps :

i) Identification of Transaction : In accounting, only financial transactions are recorded. A financial transaction is an event which can be expressed in terms of money and which brings change in the financial position of a business enterprise.

An event is an incident or a happening which may or may not bring any change in the financial position of a business enterprise. Therefore, all transactions are events but all events are not transactions. A transaction is a complete action, to an expected or possible future action. In every transaction, there is movement of value from one source to another. For example, when goods are purchased for cash, there is a movement of goods from the seller to the buyer and a movement of cash from buyer to the seller. Transactions may be external (between a business entity and a second party, e.g., goods sold on credit to Hari or internal (do not involve second party, e.g., depreciation charged on the machinery).

ii) Recording the transaction : Journal is the first book of original entry in which all transactions are recorded event-wise and date-wise and presents a historical record of all monetary transactions. Journal may further be divided into sub-journals as well.

iii) Classifying : Accounting is the art of classifying business transactions. Classification means statement setting out for a period where all the similar transactions relating to a person, a thing, expense, or any other subject are grouped together under appropriate heads of accounts.

iv) Summarising : Summarising is the art of making the activities of the business enterprise as classified in the ledger for the use of management or other user groups i.e. sundry debtors, sundry creditors etc. Summarisation helps in the preparation of Profit and Loss Account and Balance sheet for a particular financial year.

v) Analysis and Interpretation : The financial information or data is recorded in the books of account must further be analysed and interpreted so to draw meaningful conclusions. Thus, analysis of accounting information will help the management to assess in the performance of business operation and forming future plans also.

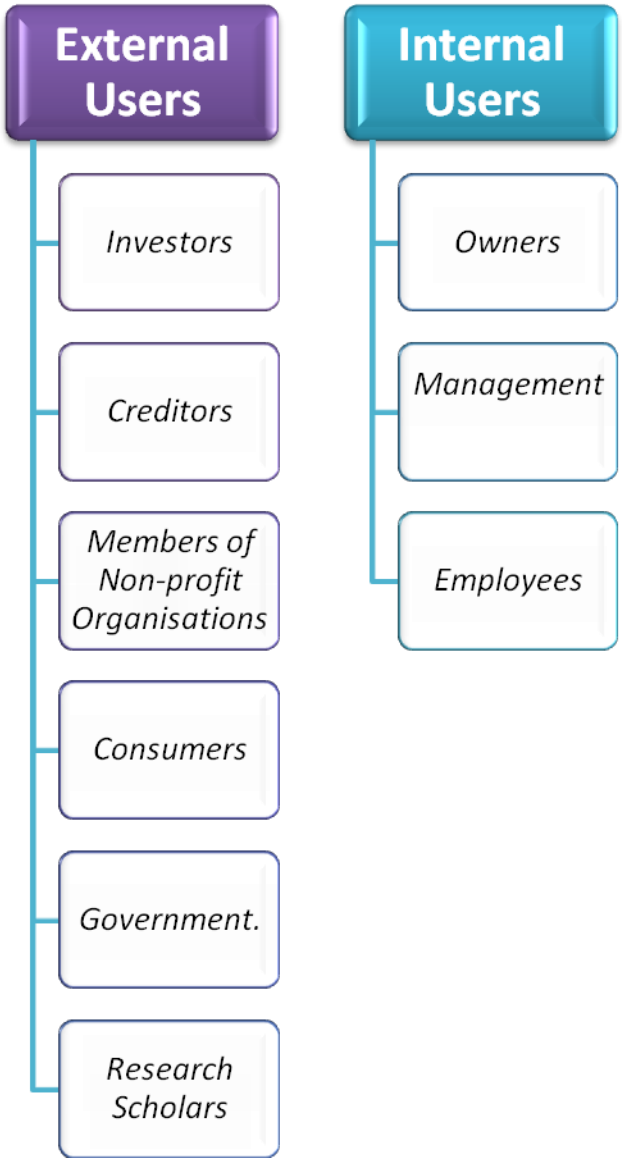
vi) Presentation or reporting of financial information : The end users of accounting statements must be benefited from analysis and interpretation of data as some of them are the "share holders" and other one the "stake holders". Comparison of past and present statements and reports, use of ratios and trend analysis are the different tools of analysis and interpretation.

From the above discussion one can conclude that accounting is an art which starts and includes steps right from recording of business transactions of monetary character to the communicating or reporting the results thereof to the various interested parties. For this purpose, the transactions are classified into various accounts, the description of which follows in the next section.

USERS OF ACCOUNTING INFORMATION

The basic objective of accounting is to provide information which is useful for persons inside the organisation and for persons or groups outside the organisation. Accounting is the discipline that provides information on which external and internal users of the information may base decisions that result in the allocation of economic resources in society.

I. External Users of Accounting Information : External users are those groups or persons who are outside the organization for whom accounting function is performed. Following can be the various external users of accounting information:



1. *Investors,* Those who are interested in investing money in an organization are interested in knowing the financial health of the organization of know how safe the investment already made is and how safe their proposed investment will be. To know the financial health, they need accounting information which will help them in evaluating the past performance and future prospects of the organisation. Thus, investors for their investment decisions are dependent upon accounting information included in the financial statements. They can know the profitability and the financial position of the organisation in which they are interested to make that investment by

making a study of the accounting information given in the financial statements of the organisation.

2. *Creditors.* Creditors (i.e. supplier of goods and services on credit, bankers and other lenders of money) want to know the financial position of a concern before giving loans or granting credit. They want to be sure that the concern will not experience difficulty in making their payment in time i.e. liquid position of the concern is satisfactory. To know the liquid position, they need accounting information relating to current assets, quick assets and current liabilities which is available in the financial statements.

3. *Members of Non-profit Organisations.* Members of non-profit organisations such as schools, colleges, hospitals, clubs, charitable institutions etc. need accounting information to know how their contributed funds are being utilised and to ascertain if the organisation deserves continued support or support should be withdrawn keeping in view the bad performance depicted by the accounting information and diverted to another organisation. In knowing the performance of such organisations, criterion will not be the profit made but the main criterion will be the service provided to the society.

4. *Government.* Central and State Governments are interested in the accounting information because they want to know earnings or sales for a particular period for purposes of taxation. Income tax returns are examples of financial reports which are prepared with information taken directly from accounting records. Governments also needs accounting information for compiling statistics concerning business which, in turn helps in compiling national accounts.

5. *Consumers.* Consumers need accounting information for establishing good accounting control so that cost of production may be reduced with the resultant reduction of the prices of goods they buy. Sometimes, prices for some goods are fixed by the Government, so it needs accounting information to fix reasonable prices so that consumers and manufacturers are not exploited. Prices are fixed keeping in view fair return to manufacturers on their investments shown in the accounting records.

6. *Research Scholars.* Accounting information, being a mirror of the financial performance of a business organisation, is of immense value to the research scholars who wants to make a study to the financial operations of a particular firm. To make a study into the financial operations of a particular firm, the research scholar needs detailed accounting information relating to purchases, sales, expenses, cost of materials used, current assets, current liabilities, fixed assets, long term liabilities and shareholders' funds which is available in the accounting records maintained by the firm.

II of Accounting Information. Internal users of accounting information are those persons or groups which are within the organisation.

Following are such internal users :

1. *Owners.* The owners provide funds for the operations of a business and they want to know whether their funds are being properly used or not. They need accounting information to know

the profitability and the financial position of the concern in which they have invested their funds. The financial statements prepared from time to time from accounting records depicts them the profitability and the financial position.

2. *Management.* Management is the art of getting work done through others, the management should ensure that the subordinates are doing work properly. Accounting information is an aid in this respect because it helps a manager in appraising the performance of the subordinates. Actual performance of the employees can be compared with the budgeted performance they were expected to achieve and remedial action can be taken if the actual performance is not upto the mark. Thus, accounting information provides "the eyes and ears to management".

The most important functions of management are planning and controlling. Preparation of various budgets, such as sales budget, production budget, cash budget, capital expenditure budget etc., is an important part of planning function and the starting point for the preparation of the budgets is the accounting information for the previous year. Controlling is the function of seeing that programmes laid down in various budgets are being actually achieved i.e. actual performance ascertained from accounting is compared with the budgeted performance, enabling the manager to exercise controlling case of weak performance. Accounting information is also helpful to the management in fixing reasonable selling prices. In a competitive economy, a price should be based on cost plus a reasonable rate of return. If a firm quotes a price which exceeds cost plus a reasonable rate of return, it probably will not get the order. On the other hand, if the firm quotes a price which is less than its cost, it will be given the order but will incur a loss on account of price being lower than the cost. So, selling prices should always be fixed on the basis of accounting data to get the reasonable margin of profit on sales.

3. *Employees.* Employees are interested in the financial position of a concern they serve particularly when payment of bonus depends upon the size of the profits earned. They seek accounting information to know that the bonus being paid to them is correct.

UNIT 2: ACCOUNTING PROCESS

Specimen of Journal Entry

Date	Particulars	LF	Debit (₹)	Credit (₹)

Ledger Folio: This column is meant to record the reference of the main book, i.e., ledger and is not filled in when the transactions are recorded in the journal. The page number of the ledger in which the accounts are appearing is indicated in this column, while the debits and credits are posted on the ledger accounts.

Specimen of Ledger Entry

Dr **Cr**

Date	Particulars	JF	(₹)	Date	Particulars	JF	(₹)
	To name of the account to be credited				By name of the account to be debited		

A SPECIMEN OF TRADING ACCOUNT IS SHOWN BELOW

Trading account for the year ended ……………

Particulars	Rs.	Rs.	Particulars	Rs.	Rs
To Opening stock		Xxx	By Sales	Xxx	
To purchases	Xxx		Less: Returns inwards (or)		
Less: purchase returns	Xxx	Xxx	Sales Returns	Xxx	Xxx
To Direct expenses:			By closing stock*		Xxx
Wages		Xxx			
Fuel & Power		Xxx			
Carriage inwards		Xxx			
Manufacturing Expenses		Xxx			
Royalty on production goods		Xxx			
Power		Xxx			
Coal water, Gas		Xxx			
Octroi		Xxx			
Import Duty		Xxx			
Customs Duty		Xxx			
Consumable stores		Xxx			
Foreman/Works Managers' Salary		Xxx	By Gross loss c/d* (transferred to profit and loss A/c)		Xxx
		Xxx			
To Gross profit c/d* (transferred to profit and loss A/c)					

		Xxx			**Xxx**

* Balancing figure will be either gross profit or loss in Trading A/c

THE SPECIMEN OF BALANCE SHEET IS SHOWN BELOW

Balance Sheet As on....................

Liabilities	Rs.	Assets	Rs.
Current Liabilities		**Liquid Assets**	
Sundry Creditors		Cash in Hand	
Bills Payable		Cash at Bank	
Bank Overdraft		**Floating Assets**	
Rent received in Advance		Sundry Debtors	
Outstanding Wages		Investments	
Pre. received in Advance		Stock in Trade	
Outstanding Expenses		Prepaid Expenses	
Reserve Fund		Prepaid Insurance	
Managers' Comm. Due		Commission Receivable	
Long Term Liabilities		Bills Receivable	
Loan from Bank		Accrued Interest	
Debentures		**Fixed Assets**	
Fixed Liabilities		Machinery	
Capital		Building	
Add: Net Profit		Furniture & Fixtures	
Add: Interest on Capital		Vehicles	
Less: Drawing		Loose Tools	
Less: Interest on Drawings		**Intangible Assets**	
Less: Loss if any		Goodwill	
		Patents	
		Copyright	
		Licenses	
		Trade Marks	
		Fictitious Assets	
		Preliminary Expenses	
		Advertisement	
		Underwriting Commission	
		Discount on Issue of Shares	
		Dis. on Issue of Debentures	
		Miscellaneous Expenses	
		Profit & Loss A/c	
Total		**Total**	

THE SPECIMEN OF PROFIT AND LOSS ACCOUNT IS SHOWN BELOW

Profit and Loss Account

For the year ended

Particulars	Rs.	Particulars	Rs.
o Gross loss b/d	Xxx	By Gross profit b/d	Xxx
To Administration Expenses		By Dividends received	Xxx
Salaries	Xxx	By Interest received	Xxx
Rent rates & taxes	Xxx	By Commission received	Xxx
Printing & Stationery	Xxx	By Rent received	Xxx
Postage and Telegrams	Xxx	By Profit on sale of assets	Xxx
Telephone expenses	Xxx	By Sundry revenue receipts	Xxx
Legal charges	Xxx	By Discount	Xxx
Insurance	Xxx	By Income from Investments	Xxx
Audit fees	Xxx	By Apprenticeship Premium	Xxx
Directors fees	Xxx	By Miscellaneous Revenue Receipts	Xxx
General expenses	Xxx	By Net loss transferred to capital A/c (Bal. Fig)*	Xxx
Heating & Lighting	Xxx		
To Selling & Distribution Expenses			
Showroom expenses	Xxx		
Advertising	Xxx		
Commission paid to salesmen	Xxx		
Bad debts	Xxx		
Provision for doubtful debts	Xxx		
Godown rent	Xxx		
Carriage outward	Xxx		
Upkeep of delivery vans	Xxx		
Bank Charges	Xxx		
Travellers' Salaries, Expenses & Commission	Xxx		
To Depreciation and Maintenance			
Depreciation	Xxx		
Repairs & Maintenance	Xxx		
To Financial Expenses			
Interest on borrowings	Xxx		
Discount allowed	Xxx		
Interest on Capital	Xxx		
Discount on Bills	Xxx		
To Extraordinary Expenses			
To abnormal losses (not covered by insurance)	Xxx		
Cash Defalcations	Xxx		
Loss on sale of assets	Xxx		
To Net profit transferred to capital A/c (bal.fig)*	Xxx		

	Xxx		Xxx

Note: *Either net profit or net loss is the balancing figure in P & L A/c

Practice Problems

Problem - 1: Journalise the following transactions in the books of ABC Ltd.

2013, Aug 1
Debit Balances: Cash in hand ₹ 8,000; Cash at bank ₹ 25,600; Stock of Goods ₹ 20,000; Furniture ₹ 4,000; Building ₹ 10,000.
Trade Receivables (Debtors): Vijay ₹ 2,700; Anil ₹ 1,500; Ashwin ₹ 2,000; Anu ₹ 1,800; Madhu ₹ 100.
Trade Payables (Creditors): Anand ₹ 5,000; Imran & Co. ₹ 7,700; Balwanth ₹ 5,200; Rai ₹ 10,000.

Aug 2	Purchase machinery and payment by cheque ₹ 5,000
Aug 2	Goods worth ₹ 5,000 given as charity
Aug 3	Received ₹ 9,750 from Shyam in full settlement of his account for ₹ 10,000
Aug 4	Received a first and final dividend of 50 paise in the rupee from the official receiver of Mr. Rajesh, who owed in ₹ 10,000
Aug 5	Sold to Mr. Mohan goods worth ₹ 10,000 less 3% cash discount and received ₹ 9,700 net on account by cheque
Aug 7	Bought from Raju & Co. Worth ₹ 15,000 at 10% trade discount and 2% cash discount terms and paid them half the amount in cash
Aug 8	Paid ₹ 500 in cash as wages on installation of machine
Aug 9	Supplied goods costing ₹ 1,000 to Mr. Mohan issued invoice at 20% above cost less 5% trade discount
Aug 11	Goods worth ₹ 2,000 were used by the proprietor for personal use
Aug 12	Goods uninsured worth ₹ 8,000 were destroyed by fire.
Aug 13	Received ₹ 2,646 from Vijay and allowed him discount ₹ 54
Aug 14	Bought 100 shares in Ajay & Co. Ltd @ ₹ 15 per share, brokerage paid ₹ 30
Aug 16	Goods worth ₹ 500 were damaged in transit: a claim was made on the railway authorities for the same
Aug 17	Cash ₹ 5,292 paid to Anand and discount allowed by him ₹ 108
Aug 18	Received cash from the railway in full settlement of claim for damaged in transit
Aug 19	Anu is declared insolvent and a dividend of 50 paise in the rupee is received from him in full settlement
Aug 20	Sold 40 shares of Ajay & Co. Ltd @ ₹ 18 per share, brokerage paid ₹ 15
Aug 20	Bought a Horse for ₹ 2,000 and a carriage for ₹ 1,000 for delivering to customer
Aug 21	One months' interest on Rai @ 12% p.a. became due but could not be paid
Aug 22	Received from travelling salesman ₹ 3,000 for goods sold by him after deducting his travelling expenses ₹ 150
Aug 23	Sold private car for ₹ 4,000 and bought a new one with the proceeds for business plus ₹ 5,000 from office cash
Aug 29	Out of the goods worth ₹ 5,000 insured for ₹ 4,000, a part is burnt by fire, the loss amounting to ₹ 400. The insurers admitted the claim for a proportionate loss and paid cash

Aug 30	The horse bought on Aug 20 died, its carcase were sold ₹ 50
Aug 30	Sold goods worth ₹ 10,000 less 10% trade discount
Aug 30	Old furniture appearing in the books of ₹ 6,000 is exchanged for new furniture of ₹ 10,000. The old furniture has been valued at ₹ 4,000 for exchange purpose.

Problem – 2: The following Trial Balance has been prepared wrongly. You are asked to prepare the Trial Balance correctly.

Name of the Account	Debit Balance (₹)	Credit Balance (₹)
Cash in hand	---	2,000
Purchase Returns	4,000	---
Wages	8,000	---
Establishment Expenses	12,000	---
Sales Returns	---	8,000
Capital	22,000	
Carriage Outward	---	2,000
Discount Received	1,200	---
Commission Earned	800	---
Machinery	---	20,000
Stock	---	10,000
Debtors	8,000	---
Creditors	---	12,000
Sales	---	44,000
Purchases	28,000	---
Bank Overdraft	14,000	---
Manufacturing Expenses	---	14,000
Loan from Vinod	14,000	---
Carriage Inward	1,000	---
Interest on Investments	---	1,000
Total	**1,13,000**	**1,13,000**

Problem 3: Journalise the following transactions for the month of January 2012, post them into Ledger and prepare Trial Balance.

Jan 1	Started business with ₹ 1,00,000, paid into Bank ₹ 50,000
Jan 2	Bought Furniture for ₹ 9,000
Jan 4	Purchased goods from Mohan & Co. for ₹ 40,000 for cash
Jan 5	Sold goods for ₹ 17,000
Jan 7	Paid Telephone rent ₹ 4,000
Jan 8	Purchased goods for ₹ 10,000 from Ashok & Co.
Jan 10	Paid ₹ 1,000 for advertisement by cheque
Jan 11	Bought Machine equipment for ₹ 7,500 from Dharam & Co. On credit
Jan 12	Sold goods to Bedi & Co. for ₹ 29,000
Jan 14	Withdrew ₹ 3,500 from the Bank for private use
Jan 16	Sold goods to Omega & Co. for ₹ 6,500 for cash
Jan 25	Received cash from Bedi & Co. ₹ 28,500, discount allowed ₹ 500
Jan 26	Paid into bank ₹ 25,000
Jan 31	Issued cheque for ₹ 3,000 in favour of the landlord for rent
Jan 31	Paid salaries to staff ₹ 6,000
Jan 31	Paid cash ₹ 9,500 Ashok & Co. in full settlement of their account

Problem 4:. Journalise the following transactions in the books of Shankar & Co.

2013		Rs.
June 1	Started business with a capital of	60,000
June 2	Paid into bank	30,000
June 4	Purchased goods from Kamal on credit	10,000
June 6	Paid to Shiram	4,920
June 6	Discount allowed by him	80
June 8	Cash Sales	20,000
June 12	Sold to Hameed	5,000
June 15	Purchased goods from Bharat on credit	7,500
June 18	Paid Salaries	4,000
June 20	Received from Prem	2,480
June 20	Allowed him discount	20
June 25	Withdrew from bank for office use	5,000
June 28	Withdraw for personal use	1,000
June 30	Paid Hanif by cheque	3,000

Problem 5: Journalise the following transactions:

2013	
June 1	Purchased goods worth Rs.300 from Vimal and Rs.500 from Kamal on credit.
June 3	Sale of goods worth Rs.1,000 to Balram and Rs.700 to Dhanram.
June 5	Cash of Rs.900 received from Ramasamy and Rs.800 from Krishnaswamy.
June 7	Paid Rs.800 to Pradeep and Rs.500 to Kuldeep
June 9	Withdrawn from bank Rs.600 for office use and Rs.300 for personal use

Problem 6: Journalise the following transactions: 2013

June 1	Karthik commenced business with Rs.20,000.
June 2	Paid into bank Rs.5,000.
June 3	Purchased Plant worth Rs.10,000 from Modi & Co.
June 4	Purchased goods worth Rs. 5,000 form Anwar.
June 6	Goods worth Rs.4,000 sold to Anbu
June 8	Sold goods worth Rs.2,000 for cash.
June 10	Goods returned by Anbu Rs.50.
June 15	Paid rent Rs.250.
June 18	Withdrawn from bank for office use Rs. 2,500
June 20	Paid Salaries Rs.1,800.
June 25	Withdrawn for personal use Rs.250
June 26	Goods returned to Anwar Rs.100.
June 27	Paid for office furniture Rs.1,500 by cheque.
June 28	Received Rs.3,900 cash from Anu and discount allowed Rs.50.
June 29	Paid Anwar on account Rs.4,800 and discount allowed by him Rs.100.

Problem 7: Journalise the following: year 2013

Apr. 1	Bought goods for cash Rs. 15,000
3	Sold goods for cash Rs. 19,000
5	Bought goods on credit from Perara Rs. 12,000
6	Sold goods on credit to Ravindar Rs. 16,000
8	Received from Ravindar Rs. 12,000
10	Paid to Perara Rs. 7,500
25	Bought furniture for cash Rs. 4,500

Problem 8: Journalize the following transactions in the books of Mr.Chandran:

2013

Apr. 1	Started business with cash Rs.40,000 and furniture Rs.10,000.
5	Paid tuition fee of the son Rs.1,000
8	Paid household expenses Rs.1,400.
10	Sold personal car for Rs.18,000 and the amount is brought into the business.
15	Withdrew goods for personal use Rs.2,000.
16	Sold goods to Navin on credit Rs.8,000.
18	Sold old typewriter Rs.1,000.
19	Purchase goods on credit from Ramesh Rs.20,000
20	Received interest on investment Rs.6,000.
22	Received commission from Manohar Rs.2,000.
23	Receive a cheque from Navin Rs.5,000.
25	Issued a cheque to Ramesh Rs.12,000
26	Received cash from Anand on account Rs.4,000
27	Paid cash to Bhagwan on account Rs.1,000.
28	Returned goods to Ramesh Rs.1,000.
29	Navin returned goods Rs.500.
30	Paid rent Rs.1,000. Paid salaries Rs.12,000.

Problem 9: Journalise the following transactions and Post them in relevant ledger accounts:

2011		Rs.
Jan. 1.	Bought from Das	1,000
Jan. 2.	Sold to Sen	400
Jan. 3.	Sold to Ramesh	250
Jan. 4.	Purchased from Suresh	200
Jan. 5.	Sales returns by Sen	50
Jan. 10.	Bought from Shyam	600
Jan. 12.	Returned to Suresh	100
Jan. 15.	Sold to Roy	800
Jan. 16.	Roy returned goods	200
Jan. 17.	Sold goods to Ram	300
Jan. 19.	Bough from Naresh	650
Jan. 21.	Sold to Bhatanger	750
Jan. 22.	Returned to Naresh	50
Jan. 25.	Bought from Khatju	850
Jan. 27.	Sold to Dheeran	260
Jan. 29.	Returns from Bhatanger	100
Jan. 30.	Dheeran Returned	60
Jan. 31.	Returns to Khatju	150

Problem 10: From the following transactions, pass journal entries, prepare ledger accounts and also prepare Trial Balance under (i) Balance method (ii) Total method.

	Rs.
Anil started business with	8,000
Purchased furniture	1,000
Purchased goods	6,000
Sold goods	7,000
Purchased from Raja	4,000
Sold to Somu	5,000
Paid to Raja	2,500
Received from Somu	3,000
Paid rent	200
Received commission	100

Problem 11: A book-keeper submitted to you the following Trail Balance, which he has not been able to agree. Rewrite the Trial Balance, correcting the mistakes committed by him.

Particulars	Dr. (Rs.)	Cr. (Rs.)
Capital	---	1,50,000
Drawings	32,500	---
Stock (1-1-2010)	1,74,450	---
Return inwards	---	5,540
Carriage inwards	12,400	
Deposit with Anand Gupta	---	13,750

Return outwards	8,400	
Carriage outwards	---	7,250
Loan to Ashok @ 5% given on 1-1-10	---	10,000
Interest on the above	---	250
Rent	8,200	---
Rent outstanding	1,300	---
Stock (31-12-2010)	---	1,87,920
Purchases	1,29,700	---
Debtors	40,000	---
Goodwill	17,300	---
Creditors	---	30,000
Advertisement expenses	9,540	---
Provision for doubtful debts	---	12,000
Bad debts	4,000	---
Patents and patterns	5,000	---
Cash	620	---
Sales	---	2,79,140
Discount allowed	---	3,300
Wages	7,540	---
Total	**4,50,950**	**6,99,150**

Problem 12: The following Trail balance has been prepared wrongly. You are asked to prepare the Trail balance correctly.

Particulars	Dr. (Rs.)	Cr. (Rs.)
Capital	22,000	---
Stock	---	10,000
Debtors	8,000	---
Creditors	---	12,000
Machinery	---	20,000
Cash in hand	---	2,000
Bank overdraft	14,000	---
Sales returns	---	8,000
Purchases returns	4,000	---
Misc. expenses	12,000	---
Sales	---	44,000
Purchases	26,000	---
Wages	10,000	---
Salaries	---	12,000
Prepaid insurances	---	200
Bills payable	10,800	---
Outstanding salaries	1,400	---
Total	**1,08,200**	**1,08,200**

UNIT 3: DEPRECIATION AND SHARES & DEBETNTURE

Concept and Meaning of Depreciation

From sole proprietorship to large multi-national corporations, all businesses have to take the concept of depreciation into account while carrying out their regular commercial ventures. Its principles apply to accounting, auditing, costing and taxation. Before we go on to its nuances, it is pertinent to understand the basic meaning of depreciation.

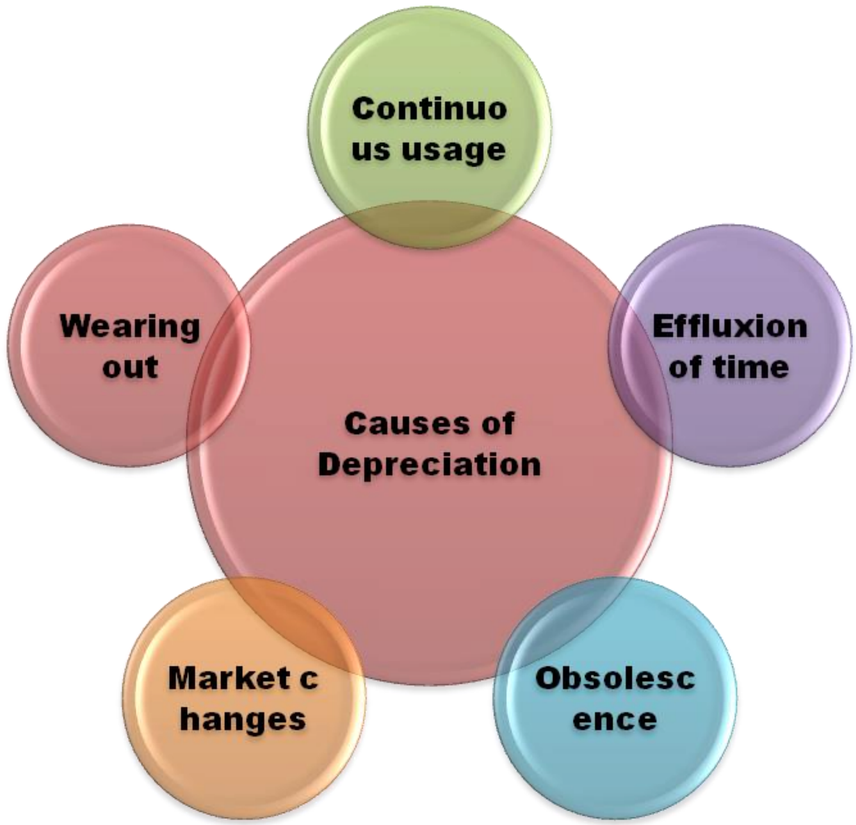
Meaning of Depreciation

The monetary values of all tangible assets tend to reduce gradually over time due to factors like wear and tear. The meaning of depreciation, in very simple words, is the rate at which this value drops. Hence, it compares an asset's current value with its original cost at the time of acquisition or purchase.

For example, let us consider a cloth manufacturing company that purchased a truck in 2010 for Rs. 50 lakh for the purpose of transportation of finished goods to its dealers. The truck's value will decrease each year with regular use over time. In order to determine the true reduced value of its truck every year, the company will deduct, say, 10% of its worth. This is the meaning of depreciation.

Depreciation applies to all tangible and generally fixed assets whose values decrease with time. These include buildings, vehicles, machinery, office equipment, furniture, etc. Land, however, does not come under this list because the value of land usually only increases; it reduces only during adverse economic downturns.

Causes of Depreciation



The most important cause of depreciation is regular wear and tear, but it is certainly not the only one. The following causes can reduce the value of an asset:

- Wearing out
- Consumption or other loss of value arising from usage
- Effluxion of time
- Obsolescence through technology
- Market changes

Purpose of Calculating Depreciation

Depreciation has wide-ranging implications in the field of accounting and taxation. Let us understand why.

- **Depreciation in accounting:** The applicability of depreciation to accounting is based on the matching principle, under which the cost of the asset is matched with the value it generates during the course of its useful life. In order to determine their real cost, the values of assets are reduced during every accounting year and are written off as expenses.
- **Depreciation in taxation:** Taxation laws allow depreciation to be deducted when tax liabilities are calculated because the depreciated value of an asset is written off as an expense under accounting. Consequently, under the Income Tax Act, 1961, assets can be depreciated at the rates prescribed.

The main purposes of calculating depreciation are:

- Measuring income or loss generated from assets
- Determining the real value of assets

- Ascertaining true expenditure incurred in the production
- Availing tax benefits and deductions

Accounting of Depreciation

Since depreciation is charged directly against assets, the journal entry for the same involves Depreciation A/c and the relevant Asset A/c. We have to debit Depreciation A/c because it is an expense or loss, while we credit Asset A/c as its value diminishes.

Date	**Particulars**		**Amount (Dr)**	**Amount (Cr)**
	Depreciation A/c	Dr	XXX	
	To Asset A/c			XXX
	(Being asset depreciated by Rs. XXX)			

Sometimes, a provision may be made for accumulated depreciation, under which total depreciation is calculated up to a specific date, instead of it being computed in each accounting year. The balance sheet explains this as a deduction from gross fixed assets.

Calculation of Depreciation

There are four common methods of calculating depreciation of assets.

1] Straight Line Method

Straight line method is the simplest way to calculate depreciation. Under this mode, the amount of value reduced from the original cost of the asset remains constant for every accounting year. For example, if we assume the rate of depreciation for a car worth Rs. 10 lakhs to be constant at Rs. 25,000, then its value will reduce by Rs. 25,000 in every accounting year during the course of its useful life.

2] Written down value method

Also known as Diminishing Balance Method. Under this method, the percentage rate of depreciation remains fixed, but we have to reduce the asset's value during every accounting year. The Income Tax Act, 1961 has prescribed this method for calculation of depreciation.

ACCOUNTING OF SHARE CAPITAL

The capital of a company is contributed by a large number of persons known as shareholders. These shareholders are issued shares of the company. The accounting of such transactions is special and involves the share capital account.

Share capital means the capital of a company divided into “shares”. These shares are of a fixed amount and are generally in multiples of 5 or 10. So share capital is basically the contributions made by all the shareholders of a firm. Since a capital account cannot be opened for every single shareholder, we club this amount in the share capital account.

From an accounting point of view, there are certain categories of share capital. They are as follows

1] Authorized Share Capital

Also known as Nominal or Registered Share Capital. It is the sum of money stated in the Memorandum of Association as the share capital of the company. It is the maximum amount of capital the company can raise by issuing shares

2] Issued Capital

This is the portion of the nominal capital which the company has issued for a subscription. This amount of capital is either less than or equal to the nominal capital, it can never be more.

3] Subscribed Capital

This is the part of the issued capital that has been subscribed by the shareholders. It’s not necessary that the whole of the issued capital will receive subscriptions, but at least 90% of issued capital should be subscribed generally.

4] Called-up Capital

The company may not always call up the full amount of the nominal value of shares. The amount of the subscribed capital called up from the shareholders is the called up capital, which is less or equal to the subscribed capital.

5] Paid-up Capital

This is the amount paid for the shares subscribed. If the shareholder does not pay on call, it will fall under “calls of arrears”. When all shareholders pay their full amounts paid up capital and subscribed capital will be equal.

6] Reserve Capital

The capital reserved by a company, to be used in the event of winding up of the company.

Shares Issued at Par – Share Capital Account

On Application Money Received

Application of shares does not guarantee allotment of shares. Some applications will be rejected. So when the application money is received we do not credit the share capital account. For the sake of convenience, we open a new account- share application account.

This money collected on the application must be deposited in the bank account in a Schedule Bank according to the Companies Act. This account is exclusively opened to deal with the application money. The journal entry for this transaction in the books of the company is as follows,

Date	Particulars		Amount	Amount
	Bank A/c	Dr	xxx	
	To Share Application A/c			xxx
	(Being share application amount received for ___ shares @ Rs ___ per share)			

On Allotment of Shares

After the company receives minimum subscriptions, it may start allotting the shares. Once the shares are allotted, the applicants now become stakeholders in the company, i.e. they get into a contract with the company. Let us see the journal entries passed in the books of the company in event of allotment.The first step is that the money received on the application for shares can now finally be transferred to the Share Capital Account since now the allotment has been finalized.

Date	Particulars		Amount	Amount
	Share Application A/c	Dr	xxx	
	To Share Capital A/c			xxx
	(Being Application money of ___ shares being transferred to Share Capital A/c)			

Then there may be the case that certain applications were rejected for any reasons. So the money received on the application must now be refunded within the stipulated time frame. The entry for the same will be,

Date	Particulars		Amount	Amount
	Share Application A/c	Dr	xxx	
	To Bank A/c			xxx

(Being Application money of ___ shares being refunded)

If the allotment was done on pro-rata basis than the excess application money received must be taken into account. But instead of refunding the money, it can simply be adjusted against the allotment payment due on such allotted shares. Such an adjustment entry will be,

Date	Particulars		Amount	Amount
	Share Application A/c	Dr	xxx	
	To Share Allotment A/c			xxx
	(Being Application money of ___ shares being adjusted against allotment)			

Then the final entry of this stages will be the allotment money becoming due, and finally being paid by the allottee. We will pass two entries for a better understanding of the process. But take note that one combined entry can also be passed instead of two.

Date	Particulars		Amount	Amount
	Share Allotment A/c	Dr	xxx	
	To Share Capital A/c			xxx
	(Being Allotment money becoming due)			

Date	Particulars		Amount	Amount
	Bank A/c	Dr	xxx	
	To Share Allotment A/c			xxx

(Being allotment money received on __ shares)

On Calls

The instalments after the allotment are known as calls, i.e. first call, second call, final call etc. If the shares are not fully paid up at the time of allotment, then several calls can be made until the shares are fully paid up. However, no call can exceed 25% of the nominal value of shares, and there must be at least one month between two calls.

Date	Particulars		Amount	Amount
	Share Call A/c	Dr	xxx	
	To Share Capital A/c			xxx
	(Being call amount due)			

Date	Particulars		Amount	Amount
	Bank A/c	Dr	xxx	
	To Share Call A/c			xxx
	(Being call amount received)			

Calls in Arrears

Sometimes when the company makes a call, the shareholder is unable to pay the call money. In this case, this stakeholder becomes in arrears, and it is called an unpaid call. The company may choose to simply debit the amount from the paid-up capital in the balance sheet. But companies choose to maintain a call-in-arrears account. The following entries are passed in the journal.

Date	Particulars		Amount	Amount
	Calls in Arrears A/c	Dr	xxx	

	To Share Call A/c			xxx
	(Being calls in arrears brought into the books)			

Then there are certain times when the calls in arrears are paid by the shareholder. However, the shareholder will have to pay an interest for the time delay.

Date	Particulars		Amount	Amount
	Bank A/c	Dr	xxx	
	To Calls in Arrears A/c			xxx
	To Interest A/c			xxx
	(Being call in arrear paid with interest)			

Calls in Advance

Then at times, shareholders pay more than the call amount. Such cases are called calls in advance. The excess amount received is a liability for the company. The following entry is passed when such advance is received and then is adjusted against the next call.

Date	Particulars		Amount	Amount
	Bank A/c	Dr	xxx	
	To Calls in Advance A/c			xxx
	(Being amount received as calls in advance)			

Date	Particulars		Amount	Amount
	Calls in Advance A/c	Dr	xxx	

To Share Call A/c xxx

(Being calls in advance adjusted against call)

Shares Issued at Premium

When the company decides to issue shares at a price higher than the nominal value or face value we call it shares issued at a premium. It is quite a common practice especially when the company has a great track record and strong financial performances and standing in the market.

So say the face value of a share is Rs 100/- and the company issues it at Rs 110/-. The share is said to have been issued at a 10% premium. The premium will not make a part of the Share Capital account but will be reflected in a special account known as the Securities Premium Account.

Now, this amount of premium can be called up by the company at any given time, i.e. with any call. The general norm is to collect the premium with either allotment or application money, rarely with call money. The premium amount as we discussed is credited to the Securities Premium Account. This account is found under the heading of Reserves and Surplus on the liabilities side of the Balance Sheet.

Securities Premium Account

Now according to the Companies Act 2013, there are some laws about the utilization of the Securities Premium Account. It states the specific purposes for which this balance may be used. So the account can only be used for such specific purposes and no other purpose.

- To issue fully paid-up bonus shares to its existing shareholders. However, you cannot exceed the limit of the unissued share capital of the company.
- Securities Premium Account can be used for writing off any preliminary expenses of the company.
- To write off expenses of issue of shares and **debentures**, such as commission paid or discount given on the issue of shares.
- The balance can also be used to provide for the premium that is payable on the redemption of debentures or of preference shares of the company.
- And finally, it can be utilized by the company to buy back its own shares.

Accounting Treatment for Shares Issued At Premium

The accounting treatment for shares issued at a premium will differ slightly than those issued at par.

When Premium is received with Application money

If the premium amount is called and received with the application money we do not credit it directly to the Securities Premium A/c. The application is received but it could be rejected as well, so we wait until the application is accepted and finalized. The entries will be as follows

Particulars		Amount	Amount
Bank A/c	Dr	xxx	
To Share Application A/c			xxx

(Being share application money received)

Particulars		Amount	Amount
Share Application A/c	Dr	xxx	
To Share Capital A/c			Xxx
To Share Premium A/c			Xxx

(Being application money transferred)

When Premium is received with Allotment money
Sometimes the premium will be collected with the allotment money. In this case, the entries will be as follows

Particulars		Amount	Amount
Bank A/c	Dr	xxx	
To Share Allotment A/c			Xxx

(Being share allotment money received)

Particulars		Amount	Amount
Share Allotment A/c	Dr	xxx	
To Share Capital A/c			xxx
To Share Premium A/c			xxx

(Being application money transferred)

One point to remember is if any advance money was received during the application, then such money may be adjusted towards the share allotment account. However, first the advance should be adjusted against the nominal value of the shares, and if still balance is left then be adjusted against the securities premium account.

Forfeiture of Shares

There are circumstances under which the shares of a stakeholder can be forfeited by the company under the provisions of the law. So what is done with the forfeited shares? And how are the previous accounting entries reversed? Let us take a look at the meaning and effect of forfeiture of shares.

When shares are allotted to an applicant, he and the company enter into a contract automatically. Then such an applicant is bound to pay the allotment money and all the various call monies till the shares are fully paid up. But if the shareholder fails to pay any of the calls (one or more) on the authorization of the board of Directors, the said shares can be forfeited. Forfeiture essentially means cancellation.

Before such forfeiture is done a notice must be given to the shareholder. The notice must provide the shareholder with a minimum of 14 days to make the payment due, or his shares will be forfeited. Even after such notice if the shareholder does not pay, then the shares will be canceled.

When the said shares are forfeited the shareholder ceases to be a member of the company. He loses all his rights and interests that a shareholder might enjoy. And once his name is removed from the register of shareholders he also losses all the money he has already paid towards the share capital. Such money will not be refunded.

Accounting Treatment for Forfeiture

When the shares have forfeited all entries regarding the issue of such shares have to be reversed. So the following adjustments are made for forfeiture of shares

i. Share Capital – debited with total amounts called up
ii. Unpaid Call A/c (Allotment, First Call etc) – credited with the portion of the amount called up but unpaid
iii. Share Forfeiture A/c – credited with the amount already paid by the defaulter

Date	**Particulars**		**Amount**	**Amount**
	Share Capital A/c	Dr	xxx	
	To Share Forfeiture A/c			xxx
	To Share Allotment/Call A/c			xxx
	(Being Shares being forfeited for non-payment)			

Points to be noted:

- If the company maintains a Calls in Arrears account, then that account will be credited with the unpaid portion of the amount instead of Share Allotment A/c or Share Call A/c.
- The balance in the Share Forfeiture A/c is shown under the Share Capital on the liabilities side of the balance sheet. This account will remain till the said shares forfeited are reissued by the company.

Forfeiture of Shares Issued at Premium

If the shares were initially issued at a premium then the forfeiture treatment changes a little. If at the time of the forfeiture the entire amount of premium has already been received by the company, then the entries remain the same, i.e. as if the shares were issued at par. Please note that the Share Premium Account will not be debited in this case.

However, at the time when the shares are forfeited if the entire, or part of the share premium is unpaid, certain adjustments must be made to Share Premium A/c. In such a case the Share Premium A/c will be debited by the amount of premium not received. So if none of the premium is received, the entry will be reversed completely. So both Share Capital account and Share Premium A/c (for the amount not received) will be debited.

Date	**Particulars**		**Amount**	**Amount**
	Share Capital A/c	Dr	xxx	
	Share Premium A/c	Dr	xxx	
	To Share Forfeiture A/c			xxx
	To Share Allotment/Call A/c			xxx
	(Being Shares being forfeited for non-payment)			

Again a point to remember if the company maintains a calls-in-arrears account, then that account will be credit instead of Share Allotment/Call A/c.

Forfeiture of Shares Issued at Discount

When the shares were initially issued at a discount and then forfeited, such a discount must be written off. So an adjustment entry will be passed to give this effect. So the discount applicable on the shares forfeited is written back by crediting the Discount on Issue A/c

Date	**Particulars**		**Amount**	**Amount**
	Share Capital A/c	Dr	xxx	
	To Discount on Share Issue A/c			xxx
	To Share Forfeiture A/c			xxx
	To Share Allotment/Call A/c			xxx

(Being Shares being forfeited for non-payment)

Reissue of Shares Forfeited

At times the directors of the company may decide to reissue the shares forfeited. The reissue can be done at par, premium or discount. Generally, the shares will be reissued at a discount. The maximum discount, however, will be restricted to the amount received on forfeiture of such shares plus their original discount if any. This discount given will be written off from the Share Forfeiture A/c.

Date	**Particulars**		**Amount**	**Amount**
	Bank A/c	Dr	xxx	
	Share Forfeiture A/c	Dr	xxx	
	To Share Capital A/c			xxx
	(Being forfeited shares reissued at discount)			

And if there is any balance left in the Share Forfeiture A/c, such a balance represents a profit and will be transferred to the Capital Reserve A/c

Date	**Particulars**		**Amount**	**Amount**
	Share Forfeiture A/c	Dr	xxx	
	To Capital Reserve A/c			xxx
	(Being balance transferred)			

ACCOUNTING FOR DEBENTRUES

A debenture is a document that acknowledges the debt. Debentures in accounting represent the medium to long term instrument of debt that the large companies use to borrow money. The term debenture is used interchangeably with terms bond, note, or loan stock.

The company issues the debentures under the seal of the company. The document of debenture contains the information regarding the rate of interest, repayment amount, and also the time when the company has to repay the debenture. The company can issue various types of debentures. They can be convertible or non-convertible, redeemable or non-redeemable, etc.

The transactions related to the debentures are very important for the company. Therefore, the company records these transactions in the books of the company. In this article, we will discuss the treatment of debentures in accounting.

There are two things that we need to keep in mind while treating debentures in accounting

- Issue of debentures
- Terms of issue of debentures

ISSUE OF DEBENTURES

There are three methods for issuing debentures

- Issue of debenture for cash
- Issue of debenture for consideration other than cash
- Issue of debentures as collateral security

ISSUE OF DEBENTURES FOR CASH

The company can issue debentures at par, premium, or discount at the time of their issue. The amount that is due on the debenture can be paid in installments, for instance, Application, Allotments, and Calls. When the company issues the debenture at a premium, the amount of premium is credited to Debenture Premium Account which is a capital profit. Further, the company transfers the amount of Debenture premium Account to the capital reserve account.

In the same way, when the company issue debenture at discount the amount is debited to the discount on issue of debentures account. The amount is shown on the asset side of the balance sheet, under the head miscellaneous expenses, until written off.

DEBENTURES ISSUE AT PAR
ON RECEIPT OF APPLICATION MONEY

Bank A/c Dr.
To Debenture Application A/c

ON ALLOTMENT OF DEBENTURES

Debentures Application A/c Dr
To Debenture A/c

ON MAKING ALLOTMENT OR CALL

Debenture Allotment/Call A/c Dr

To Debenture A/c

ON RECEIPT OF MONEY

Bank A/c Dr

To Debenture Allotment/Call A/c

DEBENTURE ISSUE AT A PREMIUM

Debentures are issued at a premium means that the value of the debenture issued is more than its face value.

Generally, the premium is collected at the time of allotment, other entries remain the same. Therefore, the entry relating to the allotment will change. The new entry will be

WHEN ALLOTMENT MONEY IS DUE

Debenture Allotment A/c Dr

To Debenture A/c

To Debenture Premium A/c

WHEN MONEY RECEIVED

Bank A/c

To Debenture Allotment A/c

DEBENTURE ISSUE AT A DISCOUNT

The debenture is issued at a discount when the amount of debenture received is less than its face value.

The discount on debenture is allowed at the time of allotment. Other entries remaining same the new allotment entry is

WHEN ALLOTMENT MONEY IS DUE

Debenture Allotment A/c Dr

Discount on Issue of Debenture A/c Dr

To Debenture A/c

WHEN MONEY IS RECEIVED

Bank A/c Dr

To Debenture Allotment A/c

ISSUE OF DEBENTURES FOR CONSIDERATION OTHER THAN MONEY

Sometimes the company issues the debentures to vendors for assets. The company purchases the assets from the vendor and issues the debentures as payment of purchase consideration.

The entries for this are as follows

FOR PURCHASING ASSETS

Assets A/c Dr

To Vendors A/c

FOR THE ISSUE OF DEBENTURES FOR CONSIDERATION OTHER THAN CASH

Vendor A/c Dr

To Debenture A/c

ISSUE OF DEBENTURES AS COLLATERAL SECURITY

A company sometimes issue debentures to serve as the collateral security for a loan or for bank overdrafts. The collateral security comes into force only when the principal security fails to pay the given loan. When the loan is paid, such debentures revert back to the company.

We can deal with the issue of debentures as collateral security in the following two ways

NO JOURNAL ENTRY

The company does not make any journal entry in its books of accounts regarding the issue of debentures. Therefore, the only transaction that the company will record in its books will be of loan against which the company issues these debentures. These loans will be shown as a liability.

Bank A/c Dr

To Loan A/c

WHEN THE COMPANY PASSES A JOURNAL ENTRY IN ITS BOOKS

ON TAKING LOAN

Bank A/c Dr

To Bank Loan A/c

ON THE ISSUE OF DEBENTURES AS COLLATERAL SECURITY

Debenture Suspense A/c Dr

To Debentures A/c

TERMS OF ISSUE OF DEBENTURE

The company can issue the debentures at par, premium, and discount. Further, the company can also redeem or repay the debentures at par, premium or discount. The company specifies the terms of redemption when the debentures are first issued.

There are six different scenarios of the term of issue of debentures. The entries passed for issue of debentures for these different scenarios are:

DEBENTURES ISSUE AT PAR AND REDEEMABLE AT PAR

Bank A/c Dr

To Debenture A/c

DEBENTURES ISSUE AT PAR AND REDEEMABLE AT PREMIUM

Bank A/c Dr

Loss on Issue of Debenture A/c Dr

To Debenture A/c

To Premium on Redemption of Debenture A/c

DEBENTURES ISSUE AT PREMIUM AND REDEEMABLE AT PAR

Bank A/c Dr

To Debenture A/c

To Premium on Issue of Debenture A/c

DEBENTURES ISSUE AT PREMIUM AND REDEEMABLE AT PREMIUM

Bank A/c Dr
Loss on Issue of Debenture A/c Dr
To Debenture A/c
To Premium on Issue of Debenture A/c
To Premium on Redemption of Debenture A/c

DEBENTURES ISSUE AT DISCOUNT AND REDEEMABLE AT PAR

Bank A/c Dr
Discount on Issue of Debenture A/c Dr
To Debenture A/c

DEBENTURES ISSUE AT DISCOUNT AND REDEEMABLE AT PREMIUM

Bank A/c Dr
Discount on Issue of Debenture A/c Dr
Loss on Issue of Debenture A/c
To Debenture A/c
To Premium on Redemption of Debenture A/c

UNIT 4: FINANCIAL ANALYSIS – I

FUND FLOW STATEMENT

What is Fund Flow Statement?

If a company needs to report its changes in net working capital, the company prepares a fund flow statement. Fund flow statement isn't a financial statement; rather it typically compares the sources of funds and the application of funds.

Uses of Fund Flow Statement

- Firstly, through fund flow statement a company can compare between two balance sheets and can see the differences between them.
- Secondly, fund flow statement helps a company see through where their money has been spent (i.e. application of funds) and from where they have received the money (i.e. the sources).
- Thirdly, fund flow statement helps a company see how much money it has received from long-term funds raised by issues of shares, debentures, and sale of non-current assets and how much funds are generated only from operations

Steps for Preparing Funds Flow Statement:

The steps involved in preparing the statement are as follows:
1. Determine the change (increase or decrease) in working capital.
2. Determine the adjustments account to be made to net income.
3. For each non-current account on the balance sheet, establish the increase or decrease in that account. Analyze the change to decide whether it is a source (increase) or use (decrease) of working capital.
4. Be sure the total of all sources including those from operations minus the total of all uses equals the change found in working capital in Step 1.

General Rules for Preparing Funds Flow Statement:

The following general rules should be observed while preparing funds flow statement:
1. Increase in a current asset means increase (plus) in working capital.
2. Decrease in a current asset means decrease (minus) in working capital.
3. Increase in a current liability means decrease (minus) in working capital.

4. Decrease in a current liability means increase (plus) in working capital.
5. Increase in current asset and increase in current liability does not affect working capital.
6. Decrease in current asset and decrease in current liability does not affect working capital.
7. Changes in fixed (non-current) assets and fixed (non-current) liabilities affects working capital.

Format of Funds Flow Statement

A funds flow statement can be prepared in statement form or 'T' form.

Funds Flow Statement (Statement Form)

A. Sources of Funds:

(*i*) Funds from Business Operations
(*ii*) Sale of Fixed Asset
(*iii*) Issue of Shares
(*iv*) Issue of Debentures
(*v*) Long-term borrowings

Total Sources

B. Application of Funds:

(*i*) Loss from Business Operation
(*ii*) Payment of Dividend
(*iii*) Payment of Tax
(*iv*) Purchase of Fixed Asset
(*v*) Payment of Long-term Loans
(*vi*) Redemption of Debentures
(*vii*) Redemption of Preference Shares

Total uses

Not increase/decrease in Working Capital
(Total sources minus Total uses)

Funds Flow Statement ('T' Form)

Source of Funds	₹	Application of Funds	₹
(*i*) Funds from Business Operations		(*i*) Loss from Business Operations	
(*ii*) Sale of Fixed Assets		(*ii*) Payment of Dividend	
(*iii*) Issue of Shares		(*iii*) Payment of Tax	
(*iv*) Issue of Debentures		(*iv*) Purchase of Fixed Assets	
(*v*) Long-term Borrowings		(*v*) Payment of Long-term Loans	
(*vi*) Decrease in Working Capital (If application amount is more than the sources amount)		(*vi*) Redemption of Debentures	
		(*vii*) Redemption of Preference Shares	
		(*viii*) Increase in Working Capital (if sources are more than the application amount)	
Total		Total	

Schedule of Changes in Working Capital:

Many business enterprises prefer to prepare another statement, known as schedule of changes in working capital, while preparing a funds flow statement, on a working capital basis. This schedule of changes in working capital provides information concerning the changes in each individual current assets and current liabilities accounts (items).
This schedule is a part of the funds flow statement and increase (decrease) in working capital indicated by the schedule of changes in working capital will be equal to the amount of changes in working capital as found by funds flow statement. The schedule of changes in working capital can be prepared by comparing the current assets and current liabilities at two periods.

The format of schedule of changes in working capital is as follows:

Schedule of Changes in Working Capital

	Items	As on	As on	Changes	
				Increase	Decrease
A.	Current Assets:				
	Cash Balance				
	Bank Balance				
	Accounts Receivable (Debtors)				
	Marketable Securities				
	Stock				
	Prepaid Expenses				
B.	Current Liabilities:				
	Bank Overdraft				
	Accounts payable (Creditors) outstanding expenses				
	Total				
	Net increase/decrease in working capital				

CASH FLOW STATEMENT

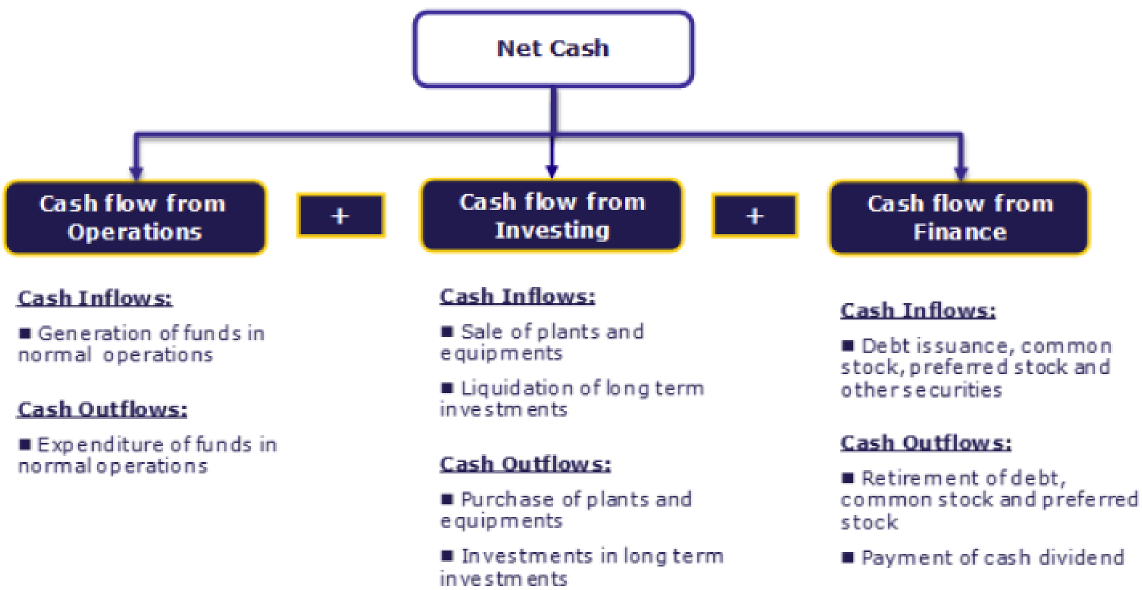
Statement of Cash flow is a statement in financial accounting which reports the details about the cash generated and the cash outflow of the company during a particular accounting period under consideration from the different activities i.e., operating activities, investing activities and financing activities over the specific accounting period.

What is the Statement of Cash Flows?

Cash flow Statement is one of the top 3 Financial Statements that helps us understand the flow of cash in the business and how it has moved in and out of the company in a particular period. Statement of Cash Flow is subdivided into three categories

- **Cash Flow from Operating Activities** – It represents cash inflows/outflows from the core business operations
- **Cash Flow from Investment Activities** – It represents cash inflows/outflows related to investment in the business including Property, Plant and Equipment.
- **Cash Flow from Financing Activities** – It represents cash outflows/inflows related to financing activities including debt and equity

Statement of Cash Flow



Cash flow from Operating Activities

It is the cash flow generated from the operation of the business. This cash flow is generated from the **principal revenue generation activities of the company.** The primary components of this statement of cash flow include accounts receivables, inventory, depreciation, and accounts payable.

- Statement of Cash flows from operating activities for Samsung is cash flow from the business of manufacturing and sale of Mobiles, TVs, refrigerators and other electronic activities which are its mainstream operating activities and not the cash flow from some sale of investments.
- Similarly, cash flows from operating activities of Coal India are the cash flows from generation and sale of coal and not from the sale of the old computers lying in its office.

Generally **net income (appearing in profit and loss account)** is considered as primary source of cash flow from operating activities and the same is adjusted with changes in current assets and liabilities, non-cash expenses and other items associated with investing and financing activities like dividend, interest on debentures, sale and purchase of assets, extraordinary income or expenses, etc.

Cash flow from Investing Activities

Cash Flow from Investments represents the cash flows from the acquisition or disposal of company long term investments such as investments in subsidiaries and associates, plant & equipment, fixed assets.

If Coca Cola is planning to build a bottling plant in India with an investment of $ 10Mn, the cash outflow of $10Mn is cash outflow from investment activities.

Cash flow from financing activities

It shows the cash inflows and outflows from transactions with providers of financing to the company like banks, shareholders and promoters.

Some of the examples from the statement of cash flow from financing activities are,

- Proceeds from borrowings,
- Proceeds from issuance of the shares,
- Repayment of borrowings,
- Buyback of shares
- Interest on loans and borrowings
- Dividend paid on shares issued Etc

UNIT 5: FINANCIAL ANALYSIS – II

- Analyzing the financial statements with the help of ratios is called ratio analysis. This is used to determine the financial soundness of a business concern. RA is designed and presented by Alexander wall in the year of 1909.
- The term ratios refer to the mathematical / arithmetical relationship between any two numericals or inter related variables. Or established relationship between two items expressed in quantitative form.
- Ratios can be used in the form of Percentage, Proportion, fraction, Quotient and Rates of number of items.

Classification of ratios by statement

On the basis of B/S
- Current Ratio
- Liquid Ratio
- Absolute Liquid Ratio
- Debt equity Ratio
- Proprietary Ratio
- Capital Gearing Ratio
- Assets Proprietorship Ratio
- Capital Inventory to Working capital Ratio
- Ratios of Current Assets to Fixed Assets

On the basis of P&L a/c
- GP Ratio
- Operating Ratio
- Operating Profit Ratio
- NP Ratio
- Expense Ratio
- Interest Coverage Ratio

On the basis of P&L a/c and B/S
- Stock Turnover Ratio
- Debtors Turnover Ratio
- Payable Turnover Ratio
- Fixed Asset Turnover Ratio
- Return on Equity
- Return on Shareholder's Fund
- Return on Capital Employed
- Capital Turnover Ratio
- Working Capital Turnover Ratio
- Return on Total Resources
- Total Assets Turnover

- Classification further grouped into Liquidity Ratios, Profitability Ratios, Turnover Ratios, Solvency Ratios and over all Profitability Ratios.

Types of Ratios

- **Liquidity Ratios**
- **Profitability Ratios**
- **Turnover Ratios**
- **Solvency Ratios**
- **Over all Profitability Ratios**

Classification of Ratios

Profitability Ratios
- Gross Profit Ratio
- Operating Ratio
- Expenses Ratio
- Operating Profit Ratio
- Net Profit Ratio
- Returns on Capital Employed
- Returns on Shareholders' Fund
- Returns on Equity Shareholders' Fund
- Returns on Total Assets

Leverage Ratios
- Operating Leverages
- Financial Leverages

Solvency Ratios
- Debt equity Ratio
- Proprietary Ratio
- Capital Gearing Ratio
- Capital Service Ratio

Financial Ratios
- ***Liquidity Ratios***
  - Current Ratio
  - Liquid Ratio
  - Absolute Liquid Ratio
  - Cash to Fund Expenditure for operations
  - Defensive Internal Ratio
  - Ratio of Inventory to Working Capital
- ***Stability Ratios***

- **Turnover Ratios**
- **Market tests**

Liquidity Ratios or Short term solvency ratios

- Short-term Solvency Ratios attempt to measure the ability of a firm to meet its short-term financial obligations.
- The term Liquidity means the extent of quick convertibility of assets in to money for paying obligation of short term nature.
- Accordingly, liquidity ratios are useful in obtaining an indication of a firm's ability to meet its current liability of a firm; the following ratios are commonly used.

Current Assets	**Current Liabilities**
Cash in hand	Sundry Creditors
Cash at bank	Bills Payable
Sundry Debtors	Outstanding and Accrued Expenses
Bills Receivable	Income tax payable
Marketable Securities	Short term advances
Inventories:	Unpaid or unclaimed dividend
Stock of raw materials	Bank Overdraft
Stock of work in progress	
Stock of finished goods	

Turnover Ratios

- Turnover ratios may be also termed as efficiency as ratios or performance ratios or Activity Ratios. Turnover means the number of times assets are converted or turned into sales. The turnover ratios indicate the rate at which different assets are turned over.
- **Types of Turnover Ratios**
  i) Inventory Turnover Ratios
  ii) Debtor's Turnover Ratio or Receivable Turnover Ratio (Debtor's Velocity)

  i. a) Debtors Collection Period Ratio
  iii) Creditors Turnover Ratios or Payable Turnover Ratio

ii. a) Debt Payment Period Ratio
iv) Working Capital Turnover Ratio
v) Fixed Assets Turnover Ratio
vi) Capital Turnover Ratio

Solvency Ratios

The term Solvency refers to the capacity of the business to meet its short term and long term obligations. SR indicates the sound of financial position of a concern to carry on its business smoothly and meet its all obligations. (Liquid and turnover ratios evaluate the short term solvency of the concern)

1) Debt Equity Ratio:

- Debt Equity Ratio is also called as internal – external equity ratio.
- This ratio is calculated to ascertain the firm's obligations to creditors in relation to funds invested by the owners.
- The ideal debt equity ratio is 1:1.
- This ratio also indicates all external liabilities to owner recorded claims.

Debt Equity Ratio = External equities / Internal equities

Debt Equity Ratio = Outsiders fund / Shareholders funds

Profitability Ratios

- **Profitability Ratio:** The term Profitability means the profit earning capacity of any activity PR is used to measure the overall efficiency or performance of a business.

✓ ***GPR:*** Relationship between gross profit and net sales
GPR = (GP / NS) X 100

Net Sales = Cost of Sales + Operating Exp. + Non Operating Exp

Gross Profit = Net Sales – Cost of Goods Sold

✓ ***NPR:*** or ***Sales Margin Ratio or Profit Margin Ratio or Net Profit to Sales Ratio:*** Relationship between NP and Sales. Indicates the overall efficiency in operating the business.

NP = (NP after tax / Net Sales) X 100

Price-Earnings Ratio (P/E Ratio):

- The Price-Earnings Ratio is calculated by dividing the ***current market price per share of the stock by earnings per share (EPS)***. (Earnings per share are calculated by dividing net income by the number of shares outstanding.)

Earning per share ratio:

- EPS measures the earning capacity of the concern from the owner's point of view and it is helpful in determining the price of the equity share in the market place and check the capacity of the concern to pay dividend to its shareholders.

EPS = NP after tax and Preference dividend / No. of equity shares

1. The following financial data relate to Lakme, a cosmetic and toiletries company in the Tata Group of Companies for the period ending on 31 March 20X6 and 20X7.

Lakme Financial Data for the year ending on 31 March

(Rs. In lakh)

Particulars	**20X6**	**20X7**
Revenue	6561	9773
Operating profit (EBDIT)	625	839
Depreciation	88	115
EBIT	537	724
Interest	216	376
Tax	0	65
PAT	321	283
Share Capital	316	316
Reserve and Surplus	1130	1264
Borrowings	1473	1530
Capital Employed	2919	3110
Gross Fixed Assets	1339	1589
Earnings per Share (EPS)	10.7	8.97
Dividend per share (DPS)	5.00	5.00

Comment on Lakme's performance. Show computation to support your answer.

2. Tata Unisys is an integrated information technology company. Its products include mini and micro processor based systems, software sets, serial printers and handlers. Following

table contains financial highlights of the company for the year 20X5-20X6 and 20X6-20X7. You are required to provide a critical evaluation of company's performance.

Tata Unisys Financial Data for the year ending on 31 March

(Rs. In lakh)

Particulars	20X5-X6	20X6-X7
Profit and Loss Items		
Net Sales	6448	8994
Raw Materials	1318	2011
Salaries and wages	814	1043
Power and fuel	50	75
Operating profit	1597	2226
Interest	73	91
Depreciation	308	488
Profit before tax (PBT)	1216	1647
Tax	465	635
PAT	751	1012
Balance Sheet Items		
Share capital	438	613
Reserve and Surplus	2097	2813
Borrowings	553	998
Gross fixed assets	1819	2836
Additional Information		
Dividend rate (%)	25	25
Bonus issue	-	2.5
Market price High(Rs.) Low (Rs.)	- - -	 550 200
No. of shares (lakh)	43.8	61.3
Net Worth	2535	3426
Capital Employed	3088	4424
EBIT	1289	1738

3. The Hindustan Manufacturing Company is a leading producer and exporter of engineering items such as steel, pipes, ingots, billets, etc. it has also recently added a chemical plant and a paper plant as part of its diversification strategy. The company started with a share capital of Rs.25 lakh in the early sixties, which has now increased to Rs.225 lakh. The number of shares outstanding is 22.50 lakh. The average market price (AMP) of the company's share during 20X1-20X3 has been: RS.26.38 in 20X1, Rs.34.50 in 20X2 and Rs.29.25 in 20X3. The financial data for the company are given in the following tables. Analysis the financial position of the company.

Hindustan Manufacturing Company
Profit and Loss Account for the year ending on 31 March

(Rs. In lakh)

Particulars	20X1	20X2	20X3
Net sales	2338.90	2825.69	3717.23
(-)COGS (Depreciation included)	1929.04	2322.80	3053.66
Gross Profit	409.86	502.89	663.57
(-) Selling and Admin Exp	239.72	262.10	357.87
Operating Income	170.14	240.79	305.70
(+) Other Income	15.24	25.38	36.91
EBIT	185.38	266.17	342.61
(-) Interest	59.84	124.98	143.46
PBT	125.54	141.19	199.15
Tax	41.79	30.00	64.29
PAT	83.75	111.19	134.86
Dividend Distributed	33.75	39.38	45.00
Retained earnings	50.00	71.81	89.86

Hindustan Manufacturing Company
Statement of Cost of Goods Sold for the year ending on 31 March

(Rs. In lakh)

Particulars	20X1	20X2	20X3
Raw Material	1587.34	2019.54	2751.52
Direct labour	138.13	170.86	228.94
Depreciation	23.07	38.64	41.59
Other manufacturing exp	205.34	255.72	329.44
Total direct manufacturing exp.	1953.88	2484.76	3351.49
(+) Opening stock in process	57.09	85.74	150.55
	2010.97	2570.50	3502.04
(-) closing stock in process	85.74	150.55	23.083
Cost of production	1925.23	2419.95	3271.21
(+) opening stock of finished goods	150.93	147.12	244.26
	2076.16	2567.07	3515.47
(-) closing stock of finished goods	147.12	244.26	461.81
Cost of Goods Sold	1929.04	2322.81	3053.66

Hindustan Manufacturing Company
Balance Sheet as on 31 March

(Rs. In lakh)

	Particulars	20X1	20X2	20X3
A	**Net Worth**			
	Share capital	225.00	225.00	225.00
	Reserve	286.13	357.95	447.81
	Total Net Worth	511.13	582.95	672.81
B	**Borrowings**			
	Long-term: Debentures	-	75.75	76.46
	FDs	199.87	285.90	312.73
	Long-term loan	199.87	361.65	389.19
	Total Borrowings	642.79	1003.04	1229.06
C	**Capital Employed (A+B)+** Short-term loan	1153.92	1585.99	1901.87
D	**Current Liabilities**			
	Short-term loan	442.92	641.39	838.87
	Trade Payables	35.99	211.21	339.35
	Provisions and others	22.87	270.97	376.53
	Total current liabilities	701.78	1123.57	1555.75
D	**Fixed Assets**			
	Gross block	653.49	841.64	921.55
	(-) Depreciation	159.55	194.46	235.44
	Other non-current assets	52.76	16.44	60.72
	Net Fixed Assets	546.70	663.62	746.83
E	**Current Assets**			
	Inventories: Raw material Stock in process Finished goods Inventories	 243.42 85.74 147.12 476.28	 384.06 150.55 244.28 778.89	 457.74 230.84 461.81 1150.39
	Debtors	253.16	340.61	483.18
	Cash and bank balance	8.37	98.84	26.08
	Others	128.27	186.21	211.27
	Total Current Assets	866.08	1404.55	1870.92
F	Net Current Asset			

Limitations of financial statements

The limitations of financial statements are those factors that a user should be aware of before relying on them to an excessive extent. Knowledge of these factors could result in a reduction of invested funds in a business, or actions taken to investigate further. The following are all limitations of financial statements.

Financial Statements Are Derived from Historical Costs

Transactions are initially recorded at their cost. This is a concern when reviewing the balance sheet, where the values of assets and liabilities may change over time. Some items, such as marketable securities, are altered to match changes in their market values, but other items, such as fixed assets, do not change. Thus, the balance sheet could be misleading if a large part of the amount presented is based on historical costs.

Financial Statements Are Not Adjusted for Inflation

If the inflation rate is relatively high, the amounts associated with assets and liabilities in the balance sheet will appear inordinately low, since they are not being adjusted for inflation. This mostly applies to long-term assets.

Financial Statements Do Not Contain Some Intangible Assets

Many intangible assets are not recorded as assets. Instead, any expenditures made to create an intangible asset are immediately charged to expense. This policy can drastically underestimate the value of a business, especially one that has spent a large amount to build up a brand image or to develop new products. It is a particular problem for startup companies that have created intellectual property, but which have so far generated minimal sales.

Financial Statements Only Cover a Specific Period of Time

A user of financial statements can gain an incorrect view of the financial results or cash flows of a business by only looking at one reporting period. Any one period may vary from the normal operating results of a business, perhaps due to a sudden spike in sales or seasonality effects. It is better to view a large number of consecutive financial statements to gain a better view of ongoing results.

Financial Statements May Not Be Comparable

If a user wants to compare the results of different companies, their financial statements are not always comparable, because the entities use different accounting practices. These issues can be located by examining the disclosures that accompany the financial statements.

Financial Statements Could be Wrong Due to Fraud

The management team of a company may deliberately skew the results presented. This situation can arise when there is undue pressure to report excellent results, such as when a bonus plan calls for payouts only if the reported sales level increases. One might suspect the presence of this issue when the reported results spike to a level exceeding the industry norm, or well above a company's historical trend line of reported results.

Financial Statements Do Not Cover Non-Financial Issues

The financial statements do not address non-financial issues, such as the environmental attentiveness of a company's operations, or how well it works with the local community. A business reporting excellent financial results might be a failure in these other areas.

Financial Statements May Not Have Been Verified

If the financial statements have not been audited, this means that no one has examined the accounting policies, practices, and controls of the issuer to ensure that it has created accurate financial statements. An audit opinion that accompanies the financial statements is evidence of such a review.

Financial Statements Have No Predictive Value

The information in a set of financial statements provides information about either historical results or the financial status of a business as of a specific date. The statements do not necessarily provide any value in predicting what will happen in the future. For example, a business could report excellent results in one month, and no sales at all in the next month, because a contract on which it was relying has ended.

Financial statements are normally quite useful documents, but it can pay to be aware of the preceding issues before relying on them too much.

Accounting Standards (ASs)

AS 1 Disclosure of Accounting Policies

AS 2 Valuation of Inventories

AS 4 Contingencies and Events Occuring after the Balance Sheet Date

AS 5 Net Profit or Loss for the period,Prior Period Items and Changes in Accounting Policies

AS 6 Depreciation Accounting

AS 7 Construction Contracts (revised 2002)

AS 8 Accounting for Research and Development

AS 9 Revenue Recognition

AS 10 Accounting for Fixed Assets

AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003),

AS 12 Accounting for Government Grants

AS 13 Accounting for Investments

AS 14 Accounting for Amalgamations

AS 15 (revised 2005) Employee Benefits

Limited Revision to Accounting Standard (AS) 15, Employee Benefits (revised 2005)

AS 15 (issued 1995)Accounting for Retirement Benefits in the Financial Statement of Employers

AS 16 Borrowing Costs

AS 17 Segment Reporting

AS 18, Related Party Disclosures

AS 19 Leases

AS 20 Earnings Per Share

AS 21 Consolidated Financial Statements

AS 22 Accounting for Taxes on Income.

AS 23 Accounting for Investments in Associates in Consolidated Financial Statements

AS 24 Discontinuing Operations

AS 25 Interim Financial Reporting

AS 26 Intangible Assets

AS 27 Financial Reporting of Interests in Joint Ventures

AS 28 Impairment of Assets

AS 29 Provisions,Contingent` Liabilities and Contingent Assets