

FINANCIAL ACCOUNTING

PGDF-101

BLOCK 1: INTRODUCTION TO FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

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FINANCIAL ACCOUNTING



Knowledge Management and
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ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)



PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included many tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!



FINANCIAL ACCOUNTING

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FINANCIAL ACCOUNTING

BLOCK 1: INTRODUCTION TO FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

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BLOCK 1: INTRODUCTION TO FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

Block Introduction

The importance of financial accounting can never be underestimated. It is a tool through which we are able to properly manage and measure the performance of our business.

The purpose of accounting is to provide the information that is needed for sound economic decision-making. The main purpose of financial accounting is to prepare financial reports that provide information about a firm's performance to external parties such as investors, creditors and tax authorities. Managerial accounting contrasts with financial accounting in that managerial accounting is for internal decision-making and does not have to follow any rules issued by standard-setting bodies. Financial accounting, on the other hand, is performed according to Generally Accepted Accounting Principles (GAAP) guidelines. In particular cases, financial statements must be prepared according to the International Financial Reporting Standards. In this block we will be studying the basics of financial accounting. This is an introduction to financial accounts. Unit 2 discusses the financial statement this portion will discuss the meaning of financial statements , how they are prepared ,what is there importance and how analysis is made on the basis of these statements.In this block we will be studying about the trial balance that is usually prepared using the Double-entry accounting system forms the basis for preparing the financial statements. All the figures in the trial balance are rearranged to prepare the profit and loss statementand balance sheet. There are certain accounting standards that determine the format for these accounts (SSAP, FRS, IFRS). The financial statements will display the income and expenditure for the company and a summary of the assets, liabilities and shareholders or owners' equity of the company on the date to which the accounts were prepared.

This block is certainly going to be of great help for the readers in understanding the basic concepts of accounting and understanding its importance.

Block Objective

After learning this block, you will be able to understand:

- Define financial accounting.
- The role and importance of financial accounting.
- The benefits and limitations of financial accounting.
- The meaning of financial statements.
- The nature and limitations of financial statements.
- Prepare financial statements, i.e. Profit and Loss A/c and Balance Sheet.
- Analyse Financial Statement and Ratios.
- The limitation of analysis of financial statements.

Block Structure

Unit 1: Introduction to Financial Accounting

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UNIT 1: INTRODUCTION TO FINANCIAL ACCOUNTING

Unit Structure

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1.1 Introduction

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1.8 Case Study

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1.0 Learning Objectives

After learning this unit, you will be able to understand:

- Define financial accounting.
- The role and importance of financial accounting.
- The benefits and limitations of financial accounting.

1.1 Introduction

Financial accountancy (or financial accounting) is the field of accountancy concerned with the preparation of financial statements for decision makers, such as stockholders, suppliers, banks, employees, government agencies, owners and other stakeholders. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power. The central need for financial accounting is to reduce the various principal-agent problems, by measuring and monitoring the agents' performance and thereafter reporting the results to interested users.

1.2 Financial Accounting

Financial accountancy is used to prepare accountancy data for people outside the organisation or for those, who are not involved in the ordinary administration of the company.

In short, financial accounting is the process of summarising financial data, which is taken from an organisation's accounting records and publishing it in the form of annual or quarterly reports, for the benefit of people outside the organisation.

Financial accountancy is governed not only by local standards but also by international accounting standard.

1.2.1 Role of Financial Accounting

- Financial accounting generates some key documents, which includes profit and loss account, patterning the method of business traded for a specific period and the balance sheet that provides a statement, showing mode of trade in business for a specific period.
- It records financial transactions showing both the inflows and outflows of money from sales, wages, etc.
- Financial accounting empowers the managers and aids them in managing more efficiently by preparing standard financial information, which includes monthly management report tracing the costs and profits against budgets, sales and investigations of the cost.

1.2.2 Importance of Financial Accounting

- It provides legal information to stakeholders such as financial accounts in the form of trading, profit and loss account and balance sheet.
- It shows the mode of investment for shareholders.
- It provides business trade credit for suppliers.
- It notifies the risks of loans in a business for banks and lenders.

All financial accounting procedures should be transparent and strictly followed. If accounting principles and standards will not be practised effectively, it can cause huge losses to the company. Satyam Computer Systems Ltd., for example, was involved in India's largest accounting scandal. The profits of the company were falsely inflated for many years. Satyam Chairman B. Ramalinga Raju then resigned, admitting the falsification of company accounts and inflation of revenue and profit figures. The company's auditors Price Waterhouse Coopers were also held responsible for the fraud.

Enron, a U.S. based power generation and distribution Company misled the public into believing that it was realising profits from legitimate trading of natural gas to energy. The company's traders helped in building up the "robust selling" scenario by publishing press releases about trade deals that did not actually take place. The company paid dividends to its investors from borrowed funds and from the capital markets. However, apart from investor's money, there was no actual earning.

To solve its cash deficit, Enron resorted to substantial borrowing that was provided by Citigroup and JP Morgan Chase. The company established bogus companies called "Mahoria" and "Yosemite" in Cayman Islands as a debt-cover-up. Citigroup and JP Morgan Chase provided \$8.5 billion in borrowed funds, channelled to two of Enron's fake companies. The money was showed as legitimate payments for energy trade deals of the two fake companies with Enron.

1.2.3 Benefits of Financial Accounting

- **Maintaining systematic records:** It is a primary function of accounting to keep a proper and chronological record of transactions and events, which provides a base for further processing and proof for checking and verification purposes. It embraces writing in the original/subsidiary books of entry, posting to ledger, preparation of trial balance and final accounts.
- **Meeting legal requirements:** Accounting helps to comply with various legal requirements. It is mandatory for joint stock companies to prepare and present their accounts in a prescribed form. Various returns such as income tax and sales tax are prepared with the help of the financial accounts.
- **Protecting and safeguarding business assets:** Records serve a dual purpose as evidence in the event of any dispute regarding ownership title of any property or assets of the business. It also helps prevent unwarranted and unjustified use. This function is of paramount importance, for it makes the best use of available resources.
- **Facilitating rational decision-making:** Accounting is the key to success for any decision-making process. Managerial decisions based on facts and figures take the organisation to heights of success. An effective price policy, satisfied wage structure, collective bargaining decisions, competing with rivals, advertisement and sales promotion policy, etc all owe it to well set accounting structure. Accounting provides the necessary database on which a range of alternatives can be considered to make the managerial decision-making process a rational one.
- **Communicating and reporting:** The individual events and transactions recorded and processed are given a concrete form to convey information to others. This economic information derived from financial statements and various reports is intended to be used by different groups who are directly or indirectly involved or associated with the business enterprise.

1.2.4 Limitations of Financial Accounting

One of the major limitations of financial accounting is that it does not take into account the non-monetary facts of the business like the competition in the market, change in the value for money, etc.

The following limitations of financial accounting have led to the development of cost accounting:

1. **No clear idea of operating efficiency:** You will agree that, at times, profit may be more or less, not because of efficiency or inefficiency but because of inflation or trade depression. Financial accounting will not give you a clear picture of the operating efficiency when prices are rising or decreasing because of inflation or trade depression.
2. **Weakness not spotted out by collective results:** Financial accounting discloses only the net result of the collective activities of a business as a whole. It does not indicate profit or loss of each department, job, process or contract. It does not disclose the exact cause of inefficiency, i.e. it does not tell where the weakness is because it discloses the net profit of all the activities of a business as a whole. Say, for instance, it can be compared with a reading on a thermometer. A reading of more than 98.4° or less than 98.4° discloses that something is wrong with the human body but the exact disease is not disclosed. Similarly, loss or less profit disclosed by the profit and loss account is a signal of bad performance of the business in whole, but the exact cause of such performance is not identified.
3. **Not helpful in price fixation:** In financial accounting, costs are not available as an aid in determining prices of the products, services, production order and lines of products.
4. **No classification of expenses and accounts:** In financial accounting, there is no such system by which accounts are classified so as to give relevant data regarding costs by departments, processes, products in the manufacturing divisions, by units of product lines and sales territories, by departments, services and functions in the administrative division. Further expenses are not attributed as to direct and indirect items. They are not assigned to the products at each stage of production to show the controllable and uncontrollable items of overhead costs.

5. **No data for comparison and decision-making:** It will not provide you with useful data for comparison with a previous period. It also does not facilitate taking various financial decisions like introduction of new products, replacement of labour by machines, price in normal or special circumstances, producing a part in the factory or sourcing it from the market, production of a product to be continued or given up, priority accorded to different products and whether investment should be made in new products, etc.
6. **No control on cost:** It does not provide for a proper control of materials and supplies, wages, labour and overheads.
7. **No standards to assess the performance:** In financial accounting, there is no such well-developed system of standards, which would enable you to appraise the efficiency of the organisation in using materials, labour and overhead costs. Again, it does not provide you any such information, which would help you to assess the performance of various persons and departments in order that costs do not exceed a reasonable limit for a given quantum of work of the requisite quality.
8. **Provides only historical information:** Financial accounting is mainly historical and tells you about the cost already incurred. As financial data is summarised at the end of the accounting period it does not provide day-to-day cost information for making effective plans for the coming year and the period after that.
9. **No analysis of losses:** It fails to provide a complete analysis of losses due to defective material, idle time, idle plant and equipment. In other words, no distinction is made between avoidable and unavoidable wastage.
10. **Inadequate information for reports:** It does not provide adequate information for reports to outside agencies such as banks, government, insurance companies and trade associations.
11. **No answer to certain questions:** Financial accounting will not provide you with answers to such questions as:
 - a. Should an attempt be made to sell more products or is the factory operating to its optimum capacity?
 - b. If an order or contract is accepted, is the price obtainable sufficient to show a profit?

- c. If the manufacture or sales of product X were discontinued and efforts were made to increase the sale of Y, what would be the effect on the net profit?
- d. Why the annual profit is of a disappointing amount despite the fact that output was increased substantially?
- e. If a machine is purchased to carry out a job, which at present is done by hand, what effect will this have on the profit line?
- f. Wage rates having been increased by 50 paisa per hour, should selling price be increased and if so, by how much?

Check your progress 1

1. Financial accountancy is used to prepare accountancy data for people _____the organisation or for those, who are not involved in the ordinary administration of the company.
 - a. Outside
 - b. inside

1.3 Let Us Sum Up

In this block we have got a basic introduction of the subject and understood the role of financial accounting in today's world.

The main role of financial accountancy is used to prepare accountancy data for people outside the organisation or for those, who are not involved in the ordinary administration of the company. Thereafter we discussed the importance of financial accounting. And discussed that it provides legal information to stakeholders such as financial accounts in the form of trading, profit and loss account and balance sheet. It even shows the mode of investment for shareholders. Financial accounting provides business trade credit for suppliers. Financial accounting notifies the risks of loan in business for banks and lenders. Thereafter we discussed the functions and limitations of financial accounting in very detail.

The study of this portion is going to be of great help for the students in understanding the basics of accounting and the role of accounting in our life.

1.4 Answer for Check Your Progress

Check your progress 1

Answers: (1-a)

1.5 Glossary

1. **Financial accounting** - is the process of summarising financial data, which is taken from an organisation's accounting records and publishing it in the form of annual or quarterly reports, for the benefit of people outside the organisation.

1.6 Assignment

Write a detailed note on financial accounting.

1.7 Activities

Explain the benefits and limitations of financial accounting.

1.8 Case Study

Write a note on role of financial accounting in India.

1.9 Further Readings

1. Accountancy, Shukla and Grewal, S. Chand and Company Ltd, 1997.
2. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 2002.
3. Financial Accounting, S. Kr. Paul, New Central Book Agency (P) Ltd, 2003.

UNIT 2: FINANCIAL STATEMENTS

Unit Structure

2.0 Learning Objectives

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2.2 Meaning of Financial Statements

2.2.1 Nature of Financial Statements

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2.3.2 Balance Sheet

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2.4.2 Ratio Analysis

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2.6 Answers for Check Your Progress

2.7 Glossary

2.8 Assignment

2.9 Activities

2.10 Case Study

2.11 Further Readings

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- The meaning of financial statements.
- The nature and limitations of financial statements.
- Prepare financial statements, i.e. Profit and Loss A/c and Balance Sheet.
- Analyse Financial Statement and Ratios.
- The limitation of analysis of financial statements.

2.1 Introduction

A financial statement (or financial report) is a formal record of the financial activities of a business, person or other entity. For a business enterprise, all the relevant financial information, presented in a structured manner and in a form easy to understand, is termed the financial statements. They typically include four basic financial statements:

1. **Balance Sheet** - Also referred to as statement of financial position or condition, it reports on a company's assets, liabilities and ownership equity at a given point in time.
2. **Income statement** - Also referred to as Profit and Loss statement (or a "P&L"), it reports on a company's income, expenses and profits over a period. Profit and Loss account presents information on the operations of the enterprise. These include sales and various expenses incurred during the processing state.
3. **Statement of retained earnings** - This explains the changes in a company's retained earnings over the reporting period.
4. **Statement of cash flows** - It reports on a company's cash flow activities, particularly its operating, investing and financing actions.

For large firms, these statements are often complex and may include an extensive set of notes or appendices attached to the financial statements, coupled with management discussion and analysis. The notes typically describe each item on the Balance Sheet, income statement and cash flow statement in further detail.

Notes to financial statements are considered an integral part of the financial statements.

2.2 Meaning of Financial Statements

A financial statement is an organised collection of data prepared in accordance with logical and consistent accounting procedures. Its function is to convey an understanding of key financial aspects of a business firm. It may show a position at a moment in time, as in the case of a Balance Sheet or may reveal a series of activities over a given duration, as in the case of an Income Statement.

Thus, the term financial statement includes trading account, profit and loss account, balance sheet and cash flow statement.

- **Trading account** - It is that part of a financial statement, which shows how the gross (operating) profit was generated through the firm's trading activities.

An example of the trading account of a business would look like this:

Trading account for XYZ Company for the year ended 31st March 2010

Category		
Sales		Rs 1,200,000
Opening Stock	Rs 1,50,000	
Purchases	Rs 4,00,000	
Less Closing Stock	Rs (2,20,000)	
Cost of Sales	Rs 3,30,000	(Rs 3,30,000)
Other Costs		(Rs 70,000)
Gross Profit		Rs 800,000

- **Profit and loss account** - It is a company's financial statement that indicates how the revenue (money received from the sale of products and services before expenses are taken out, also known as the "top line") is transformed

into the net income (the result after all revenues and expenses have been accounted for, also known as the "bottom line"). It displays the revenues recognised for a specific period and the cost and expenses charged against these revenues, including write-offs, (e.g. depreciation and amortisation of various assets) and taxes. The purpose of the income statement is to show managers and investors whether the company made or lost money during the period being reported.

- **Balance sheet** - It is a summary of the financial balances of a sole proprietorship, a business partnership or a company. Assets, liabilities and ownership equity are listed as of a specific date, such as the end of its financial year. A balance sheet is often described as a "snapshot of a company's financial condition". Of the four basic financial statements, the balance sheet is the only statement, which applies to a single point in time of a business' calendar year. A standard company balance sheet has three parts: assets, liabilities and ownership equity.
- **Cash flow statement** - It is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents and breaks the analysis down to operating, investing and financing activities. Essentially, the cash flow statement is concerned with the flow of cash in and cash out of the business. The statement captures both the current operating results and the accompanying changes in the balance sheet. As an analytical tool, the statement of cash flows is useful in determining the short-term viability of a company, particularly its ability to pay bills.

2.2.1 Nature of Financial Statements

According to the American Institute of Certified Public Accountants, financial statements reflect, "a combination of recorded facts, accounting conventions and personal judgments and the judgments and conventions applied affect them materially". This implies that data exhibited in the financial statements is affected by recorded facts, accounting conventions and personal judgments.

1. **Recorded facts** - The facts recorded in the books of accounts are known as Recorded Facts. Facts, which have not been recorded in the financial books, are not depicted in the financial statements, however material they might be. For example, fixed assets are shown at cost irrespective of their market or replacement price since such price is not recorded in the books.

2. **Accounting conventions** - Accounting conventions imply certain fundamental accounting principles, which have been sanctified by long usage. For example, because of the convention of 'Conservatism', provision is made for expected losses but expected profits are ignored. This means that the real financial position of the business may be much better than what has been shown by the financial statements.
3. **Personal judgments** - Even personal judgments have a fair amount of influence on the financial statements. For example, it is the choice of an accountant to choose the method of depreciation. Similarly, the method of amortisation of fictitious assets also depends on the personal judgment of the accountant.

2.2.2 Limitations of Financial Statements

The objectives of financial statements are subject to certain limitations as given below:

1. **Financial statements are essentially interim reports** - The profit exhibited by the Profit and Loss Account and the financial position revealed by the Balance Sheet is not exact. The instances of contingent liabilities, deferred revenue expenditure, etc. make them more imprecise.
2. **Accounting concepts and conventions** - The preparation of the financial statements is based on certain accounting concepts and conventions. Owing to this, the financial position, as disclosed by these statements, may not be realistic. Because of convention of conservatism, the income statement may not disclose true income of the business; probable losses are taken into consideration while probable incomes are ignored.
3. **Influence of personal judgment** - Many items are left to the personal judgment of the accountant. Examples include the method of depreciation, mode of amortisation of fixed assets, treatment of deferred revenue expenditure, etc. All of these depend upon the personal judgment of the accountant. The competency of this opinion relies on the experience and integrity of the accountant.
4. **Disclose only monetary facts** - Financial statements do not portray the facts that cannot be expressed in terms of money. For example, development of a team of loyal and efficient workers, enlightened management, the reputation and prestige of management in the eyes of the public are matters of

considerable importance for the business but out of the confines of financial statements. Therefore, financial statements can nowhere reflect such non-monetary aspects.

Check your progress 1

1. _____ is concerned with the flow of cash in and cash out of the business.
 - a. Cash flow statement
 - b. Money statement
 - c. Pass book
 - d. Cash book

2.3 Preparation of Financial Statements

As shown above, financial statements mainly comprise of two statements, i.e. the Balance Sheet and the income statement or Profit and Loss Account. They are usually prepared at the end of the accounting period; hence, they are also known as financial accounts of the company. In case of companies, the financial accounts have been termed as annual accounts and Balance Sheet. Section 210 of the Companies Act governs the preparation of the financial accounts of a company. Some significant provisions vis-à-vis the preparation of the above accounts is as follows:

1. At every Annual General Meeting of the company, the Board of Directors of the Company shall lay before the company:
 - The Balance Sheet as at the end of the accounting period.
 - A Profit and Loss Account for that period.

In the case of a company that does not engage in business for profit, an income and expenditure account shall be laid before the company instead of the Profit and Loss Account at its Annual General Meeting.

2. The Profit and Loss Account (or the income and expenditure account) relate to the period as per the following premises:
 - In case of the first Annual General Meeting of the company: From the date of incorporation of the company to a date not more than 9 months before the meeting.

- In case of any subsequent Annual General Meeting: From the date immediately after the period for which account was last submitted to not more than 6 months before the meeting.

The tenure for which the account has been prepared is called the financial year. It may be less or more than a calendar year but it shall not exceed 15 months. However, with the permission of the Registrar, it may extend up to 18 months.

According to Section 211, the Profit and Loss Account and the Balance Sheet of a company must give a true and fair view of the state of affairs of the company. The Balance Sheet should be in the form of, as prescribed in Part I of schedule VI or as near there to as the circumstances permit. (The form is shown later in the unit.) The Profit and Loss Account should comply with the requirements of Part II of Schedule VI of the Companies Act. Part III of Schedule VI includes just the interpretation of certain terms used in Schedule VI, Part I and Part II. Part IV has been added with effect from 15.5.1965. Part IV comprises of Balance Sheet Abstract in a Company's General Business Profile.

According to the Companies (Amendment) Act 1999, every Profit and Loss Account and Balance Sheet has to comply with the accounting standards as issued by the Institute of Chartered Accountants of India, in consultation with the National Advisory Committee on Accounting Standards established under the Companies Act. Where the Profit and Loss Account and Balance Sheet do not comply with the accounting standards, such companies shall disclose in its Profit and Loss Account and Balance Sheet the following:

- Deviations from the accounting standards.
- Reasons for such deviations.
- Financial effects arising from such deviations.

The Balance Sheet and Profit and Loss Account of the company have to be duly signed on behalf of the company by specific individuals as per the provisions of Section 215 of the Companies Act. These statements should be accompanied with the Directors and Auditors' reports. The Directors' report should consist of, besides other prescribed particulars, the amount, if any which, the board recommends to be paid by way of dividend and a statement showing the name of every employee of company who has been paid remuneration for that at a rate not less than Rs.2,00,000 per month (raised from Rs.1,00,000 p.m. w.e.f. 17.4.2002).

A copy of the Profit and Loss Account and Balance Sheet along with the Directors' and Auditors' reports should be sent not less than 21 days prior to the

date of the Annual General Meeting to every member of the company, every debenture holder and every trustee of the debenture holders. Three copies of such accounts and reports must be filed with the Registrar within 30 days from the date on which they were submitted in the meeting.

In the following pages, we are giving the particulars as required by Schedule VI in respect of both the Profit and Loss Account and the Balance Sheet and the special points that the students must keep in mind while preparing them.

2.3.1 Profit and Loss Account

Requirements of Profit and Loss Account.

The requirements of Profit and Loss Account can be categorised into two parts:

- General Requirements.
- Special Requirements as per Schedule VI, Part II.

1. General Requirements: These are related to three matters:

- a. **Heading-** In case of companies, it is not essential to segregate the Profit and Loss Account into three sections, viz. Trading Account, Profit and Loss Account and Profit and Loss Appropriation. It must also be noted that dividing the account into three sections is not prohibited and should be done to give a better idea regarding the profit earned and distributed by the company during a particular period.

The Profit and Loss Account can be prepared under two headings:

- Profit and Loss Account giving details regarding the Gross Profit and the Net Profit earned by the company during a particular period.
- Profit and Loss Appropriation Account giving details regarding the Balance of Profit and Loss Account brought forward from the last year, the Net Profit (or loss) trend (or made) during the year and appropriations made during the year.

Items shown in the Profit and Loss Account are popularly termed as items appearing “above the line” whereas the items shown in the Profit and Loss Appropriation Account are popularly termed as items appearing “below the line”.

- b. **Provision for Taxation** - Companies are liable to pay income tax at a high rate. Usually the tax rate is about 40% or more of the taxable profit. Though provision for taxation is an appropriation of profits, the common practice is to show it “above the line”, i.e. in the Profit and Loss Section and not in Profit and Loss Appropriation Section. In other words, profit after tax is taken from “Profit and Loss Account” to “Profit and Loss Appropriation” account. However, tax for a previous period, now provided or refunded for, is charged or credited to the Profit and Loss Account.
- c. **Accounting Year** - Though the Companies Act permits a company to select any period of 12 months as its accounting year, tax laws have made it almost obligatory for every company to close its books of accounts on 31st March every year.

2. Special Requirements as per Schedule VI, Part II:

The Profit and Loss Account of a company must be prepared in accordance with the requirement of Part II of Schedule VI of the Companies Act, 1956. These requirements are summarised as follows:

The Profit and Loss Account should clearly reveal the result of the working of the company during the period covered by the account. It should reveal separately the incomes and expenses of a non-recurring nature and exceptional transactions. The Profit and Loss Account should particularly disclose information in respect of the following items:

- a. The turn-over of the company.
- b. Commission paid to sole-selling agents.
- c. Commission paid to other selling agents.
- d. Brokerage and discount on sales other than the usual trade discount.
- e. Opening and closing of goods, purchases made or cost of goods manufactured or value of services rendered during the period covered by the account.
- f. Interest on company’s debentures and other fixed loans.
- g. Amount charged as income tax.
- h. Remuneration payable to the managerial personnel.

- i. Amount paid to auditor for services rendered as auditor and as advisor in any other capacity, viz. taxation matters, company law matters, management services, etc.
- j. The details of licensed, installed and actual capacity utilized.
- k. Value of imports, earnings in foreign exchange and amounts remitted during the year in foreign currencies on account of dividends.

For the sake of convenience of the students, we are giving below the format of Profit and Loss Account of a company:

Profit and Loss Account

..... **Company Limited, PROFIT and LOSS ACCOUNT, for the year..**

Dr.

Cr.

To Opening Stock	...	By Sales (less return)	...
To Purchase (less returns)	...	By Closing Stock	...
To Wages	...	By Gross Loss (c/d)*	...
To Manufacturing Expenses	...		
To Gross Profit (c/d)*	...		
To Gross Loss b/d*	...	By Gross Profit b/d*	...
To Salaries	...	By Dividends	...
To Rent	...	By Net Loss c/d**	...
To Insurance	...		
To Lighting	...		
To Auditors' Fees	...		

To Depreciation	...		
To Travelling and Conveyance	...		
	...		
To Printing and Stationery			
To Managing Director's Remuneration	...		
To Provision for Taxation	...		
To Net Profit c/d**	...		

* / ** Of the two, only one figure will appear.

Profit and Loss Account

PROFIT and LOSS APPROPRIATION ACCOUNT

For the year ending ...

Dr.

Cr.

Particulars	Rs.	Particulars	Rs.
To Net Loss for the year*	...	By Balance b/d	...
To Transfer to Reserves	...	By Net profit for the year*	...
To proposed Dividends	...	By Balance c/d**	...
To Balance c/d**

* / ** Of the two, only one figure will appear.

2.3.2 Balance Sheet

According to Section 210 of the Companies Act, it is mandatory for a company to prepare a Balance Sheet at the end of each trading period. Section 211 requires the Balance Sheet to be set up in the prescribed form. This provision is not applicable to banking, insurance, electricity and other companies governed by special Acts. The Central Government also holds the power to exempt any class of companies from compliance with the requirements of the prescribed form, in case it appears to be in public interest. The object of prescribing the form is to elicit proper information from the company for presenting a 'true and fair' view of the state of the company's affairs. By this principle, both window dressing and creating secret reserves will be considered against the provisions of Section 211.

Schedule VI, Part I gives the prescribed form of a company's Balance Sheet. Notes and instructions regarding various items are given under any of the items or sub-item. If the prescribed form cannot be conveniently given under any item due to lack of space, it can be given in a separate schedule or schedules. Such schedules will be annexed to and for M part of the Balance Sheet.

Schedule VI, Part I permits the presentation of Balance Sheet both in horizontal as well as vertical forms. These forms with necessary notes, explanations, etc. are given below:

Horizontal Form of Balance Sheet

Schedule VI Part 1

(Section 211)

Balance Sheet of ... (The name of the company will be entered here.)

As on ... (The date on which the Balance Sheet is prepared will be entered here.)

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	Share Capital			Fixed Assets	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>Authorised: ...shares of Rs... each</p> <p>Issued: (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class)... Shares of Rs...each</p> <p>Subscribed: (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class)... Shares of Rs... called up. (Of the above shares, ... shares are</p>			<p>Distinguishing as far as possible between expenditure upon</p> <ul style="list-style-type: none"> (a) Goodwill (b) Land (c) Building (d) Leaseholds (e) Railway sidings (f) Plant and Machinery (g) Furniture and Fittings (h) Development of property (i) Patents, Trade Marks and Designs (j) Livestock and (k) Vehicles etc. <p>(Under each head, the original cost and the additions thereto and deductions there from during the year and the total depreciation</p>	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>allotted as fully paid up, pursuant to a contract without payment being received in cash.</p> <p>Of the above shares... shares are allotted as fully paid up by way of bonus shares)</p> <p>Specify the source from which bonus shares are issued, e.g. capitalisation of profits or Reserves or from Securities Premium Account.</p> <p>Less: Call unpaid:</p> <p>(i) By directors</p> <p>(ii) By others</p> <p>Add: Forfeited</p>			<p>written off or provided up to the end of the year is to be stated.</p> <p>Depreciation written off or provided shall be allotted under the different asset heads and deducted in arriving at the value of Fixed Assets.</p> <p>In every case where the original cost cannot be ascertained, without unreasonable expense or delay, the valuation shown by the book is to be given for the purpose of this paragraph. Such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after</p>	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>Shares: (amount originally paid up)</p> <p>(Any capital profit on reissue of forfeited shares should be transferred to Capital Reserves)</p> <p>Note:</p> <p>1. Terms of redemption or conversion (if any) of any redeemable preference capital are to be stated together with earliest date of redemption or conversion.</p> <p>2. Particulars of any option on unissued Share Capital are to be specified.</p> <p>3. Particulars of the different classes of</p>			<p>deduction of the amounts previously provided or written off for depreciation or diminution in value and where any such asset is sold, the amount of sale proceeds shall be shown as deduction. Where sums have been written off on a reduction of capital or a revaluation of assets, every Balance Sheet (after the first Balance Sheet) subsequent to the reduction or revaluation shall show the reduced figures with the date.</p> <p>First five years subsequent to the date of the reduction shall show also the amount of the</p>	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>preference shares are to be given.</p> <p>These particulars are to be given along with Share Capital. Shares held by the holding company as well as by the ultimate holding company and its subsidiaries shall be separately stated in respect of Subscribed Share Capital (The auditor is not required to certify the correctness of such share-holdings as certified by the management)</p> <p>Reserves and Surplus:</p> <p>(1) Capital Reserves</p> <p>(2) Capital Redemption</p>			<p>reduction made. Similarly, where sums have been added by writing up the assets, every Balance Sheet subsequent to such writing up shall show the increased figures with the date of the increase in place of the original cost. Each Balance Sheet for the first five years subsequent to the date of the writing up shall also show the amount in increase made).</p> <p>Investments: Showing nature of investment and mode of valuation, for example, cost or market value and distinguishing between:</p> <p>(1) Investments in Government or Trust Securities</p>	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>Reserves between:</p> <p>(3) Securities Premium Account (Showing detail of its utilisation in the manner provided in Section 78 in the year of utilisation)</p> <p>(4) Other Reserves specifying the nature of each Reserve and the amount in respect thereof</p> <p>Less: Debit balance in Profit and Loss Account (if any). (The debit balance in the Profit and Loss Account shall be shown as a deduction from the uncommitted</p>			<p>(2) Investments in Shares, Debentures of Bonds) (Showing separately share fully paid up and Partly paid up and also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies).</p> <p>(3) Immovable Properties</p> <p>(4) Investments in Capital of Partnership Firms (Aggregate amount of Company's quoted investments and also the market value thereof shall be shown). (Aggregate amount of Company's</p>	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>(5) Surplus, i.e. balance in profits and loss account after providing for proposed allocation, namely: dividends, bonus and reserves</p> <p>(6) Proposed additions to Reserves</p> <p>(7) Sinking Funds Additions and Deductions since last Balance Sheet to be shown under each of the specified heads. The word “fund” in relation to any “Reserve” should be used only where such Reserve is specifically represented by earmarked investments.</p> <p>Secured Loans:</p>			<p>unquoted investments shall be shown).</p> <p>Current Assets, Loans and Advances</p> <p>(A) Current Assets</p> <p>(1) Interest accrued on Investments</p> <p>(2) Stores and Spare Parts</p> <p>(3) Loose Tools</p> <p>(4) Stock-in-trade</p> <p>(5) Work-in-Progress (in respect of (2) and (4) mode of valuation of shall be stated and the amount in respect of raw materials shall also be stated separately where practicable. Mode of valuation of work-in-progress shall be stated).</p> <p>(6) Sundry Debtors</p> <p>(a) Debts outstanding for a</p>	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>(1) Debentures</p> <p>(2) Loans and Advances from Bank</p> <p>(3) Loans and Advances from subsidiaries</p> <p>(4) Other Loans and Advances (Loans from directors and/or managers should be shown separately)</p> <p>Interest accrued and due on Secured Loans should be included under the appropriate sub-heads under the head “Secured Loans”. The nature of security is to be specified in each case.</p> <p>Loans under each head. In case of</p>			<p>period exceeding six Debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances).</p> <p>In regard to Sundry Debtors, particulars to be given separately or:</p> <p>(a) debts considered good and in respect of which the company is fully secured</p> <p>(b) debts considered good for which the company holds no security other than the debtor’s personal security</p> <p>(c) Debts</p>	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>Debentures, terms of redemption or conversion (if any) are to be stated together with earliest date of redemption or conversion.</p> <p>Unsecured Loans:</p> <p>(1) Fixed Deposits</p> <p>(2) Loans and advances (from subsidiaries)</p> <p>(3) Short-Term Loans and Advances:</p> <p>(a) From Banks</p> <p>(b) From Others</p> <p>(Short-Term loans include those, which are due for repayment not later than one year as on the date of the</p>			<p>considered doubtful or bad Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms of private companies respectively in which any director is a partner or director or a member to be separately stated</p> <p>Debts due from other companies under the names of the companies The maximum amount due by directors of other officers of the company at any time during the year to be shown by way of a note</p> <p>The provision to be shown under this</p>	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>Balance Sheet.</p> <p>(4) Other Loans and Advances:</p> <p>(a) From Banks</p> <p>(b) From Others</p> <p>(Loans from directors and /or manager should be shown separately.)</p> <p>Interest accrued and due on Unsecured Loans should be included under the appropriate sub-heads under the head “Unsecured Loans”.</p> <p>(Where Loans guaranteed by manager and /or directors, a mention thereof shall also be made together with the aggregate amount of such</p>			<p>head should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such provision, if already created, should be shown at every closing under “Reserves and Surplus” (in the Liabilities side) under a separate sub-head “Reserve for Doubtful or Bad Debts”).</p> <p>(7A) Cash balance on hand</p> <p>(7B) Bank Balances:</p> <p>(a) With Scheduled Banks</p> <p>(b) With others (In regard to bank balances, particulars to be given separately of</p> <p>(a) the balance lying with</p>	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	loans under each (1) Acceptances (2) Sundry Creditors (i) Total Dues to small scale undertakings (inserted w.e.f. 2.2.1999) (ii) Total dues of creditors other than small scale industrial undertakings (inserted w.e.f. 2.2.1999) (3) Subsidiary Companies (4) Advance payments and unexpired discounts for the portion for which value is still to be given. E.g. in the case of the following companies: Newspaper, Fire			Scheduled Banks on current accounts, call accounts and deposit accounts (b) the names of the bankers other than Scheduled Banks and the balances lying with each such banker Accounts and deposit accounts and the maximum amount outstanding at any time during the year with each such banker (c) the nature of the interest, if any of director or his relative in each of the bankers other than Scheduled Banks referred to in (b) above (B) Loans and Advances: (8) (a) Advances and loans to subsidiaries	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>Insurance, Theatres, Clubs, Banking and Steamship companies, etc.</p> <p>(5) Unclaimed Dividends</p> <p>(6) Other Liabilities (if any)</p> <p>(7) Interest accrued but not due on loans</p> <p>(The names of small-scale industrial undertakings to whom the company owes any sum including interest which is outstanding from more than 30 days, are to be disclosed (inserted w.e.f. 22.5.2002)</p> <p>B. Provisions</p> <p>(8) Provision for</p>			<p>(b) Advances and loans to partnership firms in which the company or any of its subsidiaries is a partner</p> <p>(9) Bills of Exchange</p> <p>(10) Advances recoverable in cash or in kind or for value to be received, e.g. Rates, Taxes, Insurance, etc.</p> <p>(11) Balance with Customs, Port Trust, etc. (where payable on demand)</p> <p>(The instructions regarding Sundry Debtors apply to “Loans and Advances” also. The amounts due from other companies under the same management within</p>	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	Taxation (9) Proposed Dividends (10) For Contingencies (11) For Provident Fund (12) For insurance, Pension and similar staff benefit schemes. (13) Other provisions (A foot-note to the Balance Sheet may be added to show separately) (1) Claims Against the company not acknowledged as debts (2) Uncalled liability on shares partly paid (3) Arrears of Fixed cumulative			the meaning of subsection (1-B) of Section 370 should also be given with the names of the companies; the Maximum amount due from every one of these at any time during the year must be shown). Miscellaneous Expenditure (to the extent not written off or adjusted) (1) Preliminary expenses (2) Expenses including commission, brokerage, underwriting or subscription of shares of debentures (3) Discount allowed on issue of shares of debentures	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>dividends</p> <p>(The period, for which the dividends are in arrears or if there is more than one class of shares, the dividends on each such class that is in arrears, shall be stated. The amount shall be stated before deduction of income tax, except that in case of the tax-free dividends, the amount shall be shown free of income tax and the fact that it is so shown shall be stated).</p> <p>(4) Estimated amount of contracts remaining to be executed on capital account and not provided</p>			<p>(4) Interest paid out of capital during construction (also starting the rate of interest)</p> <p>(5) Development expenditure not adjusted</p> <p>(6) Other sums (specifying nature)</p> <p>Profit and Loss Account</p> <p>(Show here the debit balance of Profit and Loss account carried forward after deduction of the uncommitted reserves, if any).</p>	

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs.	Figures for the previous year Rs.	Assets	Figures for the current year Rs.
	<p>for</p> <p>(5) Other money for which the company is contingently liable</p> <p>(The amount of any guarantees given by the Company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature and amount for each such contingent liability, if material, shall also be specified.</p>				

...Limited
Balance Sheet
As on...

Figures for the previous year Rs.	Liabilities	Rs.	Figures for the previous year Rs.	Assets	Rs.
	Share Capital			Fixed Assets	
	Authorised:			Goodwill	
	...Shares of Rs...			Land	
	Each			Building Plant	
	Issued:			Vehicles	
	Share of Rs....				
	Each ...Rs. Per share			Investments	
	called up			Government	
	Less: Calls in Arrears			Securities	
	Rs...			Shares	
	Reserve and Surplus			Debentures and Bonds	
	Securities Premium			Current Assets, Loans and	
	General Reserve			Advances	
	Profit and Loss			A. Current Assets:	
	Balance			Stock in trade	
	(Profit)			Loose Tools	
	Secured Loans			Work-in-progress	
	Debentures			Sundry Debtors	
	Loans from Banks			Cash and Bank Balance	
	Unsecured Loans			B. Loans and Advances	
	Fixed Deposits			Bills of Exchange	
	Loans from Banks				

Figures for the previous year Rs.	Liabilities	Rs.	Figures for the previous year Rs.	Assets	Rs.
	Current Liabilities and Provisions A. Current Liabilities Bills Payable Sundry Creditors Unclaimed Dividends B. Provisions Provision for Taxation Proposed Dividend Contingent Liabilities (i) Claims against company not acknowledged as debts (ii) Uncalled liability on share partly paid (iii) Arrears of fixed cumulative dividends			Advances to Subsidiaries Balance with Customs authority Miscellaneous Expenditure Preliminary Expenses Underwriting Commission Discount on Issue of Shares Profit and Loss Account (Loss)	

Vertical Form Of Balance Sheet

Name of the Company _____

Balance Sheet as at _____

Particulars	Schedule No.	Figures as at the end of the current financial year		Figures as at the end of the previous financial year	
I. Source of Funds					
(a) Capital	I		.....		.....
(b) Reserves and Surplus	II		.....		.....
(2) Loan Funds	III		.....		.....
(a) Secured Loan	IV		.....		.....
(b) Unsecured Loans					
Total		.....	.....	.....	.....
II. Application of Funds	V	.....		.....
(1) Fixed Assets					
(a) Gross Block					
Less: Depreciation Net Block	VI				
(b) Capital Work-in-progress	VII	.....	.....	.....	.....
(3) Investments		.....		.....
(4) Current Assets, Loans and Advances		.....		.....
(a) Inventories					
(b) Sundry Debtors					
(c) Cash and Bank Balances					
(d) Other Current Assets	VIII	.....		.....

Particulars	Sche dule No.	Figures as at the end of the current financial year		Figures as at the end of the previous financial year	
(e) Loans and Advances		.....		.....
Less: Current Liabilities and Provision	VIII	.....		.....
(a) Liabilities		.....		.....
(b) Provisions		.....		.....
Net Current Assets (VII) – (4) (a) Miscellaneous Expenditure to the extend not written off or adjusted		.....		.....

Solve the following:

The following is the trial balance of AB Industries Ltd. as on 31st March 2002

Accounts	Rs	Rs
Stock, 1st April 2001	6,75,000	
Sales		30,60,000
Wages	2,70,000	
Share capital (Authorised Capital 2,00,000 shares of Rs 10 each)		9,00,000
Discount		27,000
Purchases	22,05,000	
Carriage inward	8,550	

Purchases returns		90,000
Patents and trademark	43,200	
Salaries	67,500	
Bills receivable	45,000	
Sundry expenses	63,450	
Bills payable		63,000
Rent	36,000	
Debtors and creditors	2,47,500	1,57,500
Plant and machinery	2,61,000	
Furniture and fittings	1,53,000	
Cash at bank	4,15,800	
General reserve		1,39,500
Profit and loss account, 31st March 2001		54,000
TOTAL	44,91,000	44,91,000

Further information

1. Outstanding rent amounted to Rs. 7,200 while outstanding salaries Rs. 8,100 at the end of the year.
2. Make a provision for doubtful debts amounting to Rs. 4,590.
3. Stock on 31st March 2002 was valued at Rs. 7,92,000.
4. Depreciate plant and machinery @ 14% and furniture and fittings @18%.
5. Amortise patents and trademarks @ 5%.
6. Provide for managerial remuneration @ 10% of the net profits before tax.
7. Make a provision for income tax @ 35%.
8. The Board of Directors proposes a dividend @ 10% for the year ended 31st March 2002 after transfer to General Reserve @ 5% of profit after tax.

Required:

1. Prepare the following financial statements of AB Industries Ltd:
 - a. Profit and loss account for the year ended 31st March 2002
 - b. Profit and loss appropriation account for the year ended 31st March 2002
 - c. Balance sheet as on 31st March 2002
 - d. Briefly comment upon the performance of the company

Check your progress 2

1. Profit and Loss Account give details regarding the _____.
 - a. Net profit
 - b. Gross profit

2.4 Analysis of Financial Statements and Ratio Analysis

Financial statement analysis is defined as the process of identifying financial strengths and weaknesses of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account.

There are various methods or techniques that are used in analysing financial statements, such as comparative statements, schedule of changes in working capital, common size percentages, funds analysis, trend analysis and ratios analysis.

Financial statements are prepared to meet external reporting obligations and also for decision-making purposes. They play a dominant role in setting the framework for managerial decisions. However, the information provided in the financial statements is not an end in itself as no meaningful conclusions can be drawn from these statements alone. However, the information provided in the financial statements is of immense use in making decisions through analysis and interpretation of financial statements.

There are various advantages of financial statements analysis. The major benefit is that the investors get a fair idea to decide about the investments of their funds in the specific company. Secondly, regulatory authorities like International Accounting Standards Board can ensure whether the company is following the required accounting standards or not. Thirdly, financial statements analysis can help the government agencies to analyse the taxation due to the company. Moreover, company can analyse its own performance over the period through financial statements analysis.

Tools and Techniques of Financial Statement Analysis:

Following are the most important tools and techniques of a financial statement analysis:

1. Horizontal and Vertical Analysis
2. Ratios Analysis

2.4.1 Horizontal and Vertical Analysis

A. Horizontal Analysis or Trend Analysis:

Comparison of two or more year's financial data is known as horizontal analysis or trend analysis. Horizontal analysis is facilitated by showing changes between years in both dollar and percentage form.

Example of Horizontal or Trend Analysis:

Balance Sheet

Comparative Balance Sheet December 31, 2002 and 2001 (dollars in thousands)				
			Increase (Decrease)	
	2002	2001	Amount	Percent
Assets				
Current Assets:				
Cash	Rs.1,200	Rs.2,350	Rs.(1,150)*	(48.9)%

Accounts receivable	6,000	4,000	2000	50%
Inventory	8,000	10,000	(2000)	(20.0)%
Prepaid Expenses	3,000	120	180	150.0%
	-----	-----	-----	-----
Total current assets	Rs.15,500	Rs.28,970	(970)	(5.9)%
	-----	-----	-----	-----
Property and equipment:				
Land	4,000	4,000	0	0%
Building	12,000	8,500	3,500	41.2%
	-----	-----	-----	
Total property and equipment	16,000	12,500	3,500	28%
	-----	-----	-----	-----
Total assets	31,500	28,970	2,530	8.7%
	=====	=====	=====	=====
Liabilities and Stockholders' Equity				
Current liabilities:				
Accounts payables	Rs.5,800	Rs.4,000	1800	45%
Accrued payables	900	400	500	125%
Notes payables	300	600	(300)	(50%)
	-----	-----	-----	-----
Total current liabilities	7,000	5,000	2,000	40%

	-----	-----	-----	-----
Long term liabilities:				
Bonds payable 8%	7,500	8,000	(500)	(6.3)%
	-----	-----	-----	-----
Total long term liabilities	7,500	8,000	(500)	6.3%
	-----	-----	-----	-----
Total Liabilities	Rs.145,00	13,000	1,500	(11.5)%
Stock holders equity:				
Preferred stock, 100 par, 6%, Rs.100 liquidation value	Rs.2,000	Rs.2,000	0	0%

Common stock, Rs.12 par	6,000	6,000	0	0%
Additional paid in capital	1,000	1,000	0	0%
	-----	-----	-----	-----
Total paid in capital	9,000	9,000	0	0%
Retained earnings	8,000	6,970	1,030	14.8%
	-----	-----	-----	-----
Total stockholders' equity	17,000	15,970	1,030	6.4%
	-----	-----	-----	-----
Total liabilities and stockholders' equity	Rs.31,500	Rs.28,970	Rs.2,530	8.7%
	=====	=====	=====	=====

*Since we are measuring the change between 2001 and 2002, the dollar amounts for 2001 become the base figure for expressing these changes in percentage form. For example, cash decreased by figures Rs.1,150 between 2001 and 2002. This decrease expressed in percentage form is computed as follows:

$$[\text{Rs } 1,150 / \text{Rs } 2,350 = 48.9\%]$$

Other percentage figures in this example are computed by the same formula.

Income Statement

Comparative income statement and reconciliation of retained earnings For the year ended December 31, 2002 and 2001 (dollars in thousands).				
			Increase (Decrease)	
	2002	2001	Amount	Percent
Sales	Rs.52,000	Rs.48,000	Rs.4,000	8.3%
Cost of goods sold	36,000	31,500	4,500	14.3%
	-----	-----	-----	-----
Gross margin	16,000	16,500	(500)	(3.0)%
	-----	-----	-----	-----
Operating expenses:				
Selling expenses	7,000	6,500	500	7.7%
Administrative expense	5,860	6,100	(240)	(3.9)%
	-----	-----	-----	-----
Total operating expenses	12,860	12,600	260	2.1%
	-----	-----	-----	-----
Net operating income	3,140	3,900	(760)	(19.5)%
Interest expense	640	700	(60)	(8.6)%

	-----	-----	-----	-----
Net income before taxes	2,500	3,200	(700)	(21.9)%
Less income taxes (30%)	750	960	(210)	(21.9)%
	-----	-----	-----	-----
Net income	1,750	2,240	Rs. (490)	21.9%
			=====	
Dividends to preferred stockholders, Rs.6 per share (see balance sheet above)	120	120		
	-----	-----		
Net income remaining for common stockholders	1,630	2,120		
Dividend to common stockholders, Rs.1.20 per share	600	600		
	-----	-----		
Net income added to retained earnings	1,030	1,520		
Retained earnings, beginning of year	6,970	5,450		
	-----	-----		
Retained earnings, end of year	Rs. 8,000	Rs. 6,970		
	=====	=====		

Trend Percentage

Horizontal analysis of financial statements can also be carried out by computing trend percentages. Trend percentage states several years' financial data in terms of a base year. The base year equals 100%, with all other years stated in some percentage of this base.

Consider McDonald's Corporation, the largest global food service retailer, with more than 26,000 restaurants worldwide. McDonalds enjoyed tremendous growth during the 1990s, as evidenced by the following data:

	2000	1999	1998	1997	1996	1995	1994	1993	1992	1991	1990
Sales (millions)	Rs.14,243	Rs.13,259	Rs.12,421	Rs.11,409	Rs.10,687	Rs.9,795	Rs.8,321	Rs.7,408	Rs.7,133	Rs.6,695	Rs.6,640
Income (millions)	Rs.1,977	Rs.1,948	Rs.1,550	Rs.1,642	Rs.1,573	Rs.1,427	Rs.1,224	Rs.1,083	Rs.959	Rs.860	Rs.802

By simply looking at these data, one can see that sales increased every year. However, how rapidly sales have been increasing and how the increases in net income kept pace with the increase in sales is difficult to answer by looking at the raw data alone. The increases in sales and the increases in net income can be put into better perspective by stating them in terms of trend percentages, with 1990 as the base year. These percentages (all rounded) appear as follows:

	2000	1999	1998	1997	1996	1995	1994	1993	1992	1991	1990
Sales	215%	200%	187%	172%	161%	148%	125%	112%	107%	101%	100%
Income	247%	243%	193%	205%	196%	178%	153%	135%	120%	107%	100%

The trend analysis is particularly striking when the data is plotted as above. McDonald's growth was impressive through the entire 11-year period, but it was out paced by even higher growth in the company's net income. A review of the company's income statement reveals that the dip in net income growth in 1998 was attributable, in part, to the Rs.161.6 million that McDonalds spent to

implement its "Made for you" program and a special charge of Rs.160 million that related to a home office productivity initiative.

B. Vertical Analysis

Vertical analysis is the procedure of preparing and presenting common size statements. Common size statement is one that shows the items appearing on it in a percentage form as well as in a dollar form. Each item is stated as a percentage of some total of which that item is a part. Key financial changes and trends can be highlighted by the use of common size statement.

Vertical Analysis and Common Size Statements:

Definition and Explanation of Vertical Analysis and Common Size Statements:

Vertical analysis is the procedure of preparing and presenting common size statements. Common size statement is one that shows the items appearing on it in percentage form as well as in dollar form.

Balance Sheet

Common Size Comparative Balance Sheet December 31, 2002 and 2001 (dollars in thousands)				
			Common-Size Percentages	
	2002	2001	2002	2001
Assets				
Current assets:				
Cash	Rs. 1,200	Rs. 2,350	3.8%	8.1%
Accounts receivable, net	6,000	4,000	19.0%	13.8%
Inventory	8,000	10,000	25.4%	34.5%
Prepaid expenses	300	120	1.0%	0.4%

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	-----	-----	-----	-----
Total current assets	15,500	16,470	49.2%	56.9%
	-----	-----	-----	-----
Property and equipment:				
Land	4,000	4,000	12.7%	13.8%
Building and equipment	12,000	8,5000	38.1%	29.3%
	-----	-----	-----	-----
Total property and equipment	16,000	12,500	50.8%	43.1%
	-----	-----	-----	-----
Total assets	Rs. 31,500	Rs. 28,970	100.0%	100.0%
	=====	=====	=====	=====
Liabilities and Stockholders' Equity				
Current liabilities:				
Accounts payable	Rs. 5,800	Rs. 4,000	18.4%	13.8%
Accrued payable	900	400	2.9%	1.4%
Notes payable, short term	300	600	1.0%	2.1%
	-----	-----	-----	-----
Total current liabilities	7,000	5,000	22.2%	17.3%
	-----	-----	-----	-----
Long term liabilities:				
Bonds payable, 8%	7,500	8,000	23.8%	27.6%

	-----	-----	-----	-----
Total liabilities	14,500	13,000	46.0%	44.9%
	-----	-----	-----	-----
Stockholders' equity:				

Preferred stock, Rs.100, 6%, Rs.100 liquidation value	2,000	2,000	6.3%	6.9%
Common stock, Rs.12 par	6,000	6,000	19.0%	20.7%
Additional paid in capital	1,000	1,000	3.2%	3.5%
	-----	-----	-----	-----
Total paid in capital	9,000	9,000	28.6%	31.1%
Retained earnings	8,000	6,970	25.4%	24.1%
	-----	-----	-----	-----
Total stock holders equity	17,000	15,970	54.0%	55.1%
	-----	-----	-----	-----
	Rs. 31,500	Rs. 28,970	100.0%	100.0%
	=====	=====	=====	=====

Common-Size Comparative income statement For the year ended December 31, 2002 and 2001 (dollars in thousands)				
			Common-Size Percentage	
	2002	2001	2002	2001
Sales	Rs.52,000	Rs.48,000	100.0%	100.0%
Cost of goods sold	36,000	31,500	69.2%	65.6%
	-----	-----	-----	-----
Gross margin	16,000	16,500	30.8%	34.4%
	-----	-----	-----	-----
Operating expenses:				
Selling expenses	7,000	6,500	13.5%	13.5%
Administrative expense	5,860	6,100	11.3%	12.7%
	-----	-----	-----	-----
Total operating expenses	12,860	12,600	24.7%	26.2%
	-----	-----	-----	-----
Net operating income	3,140	3,900	6%	8.1%
Interest expense	640	700	1.2%	1.5%
	-----	-----	-----	-----
Net income before taxes	2,500	3,200	4.8%	6.7%
Income tax (30%)	750	960	1.4%	2.0%
	-----	-----	-----	-----

Net income	Rs. 1,750	Rs.2,240	3.4%	4.7%
	=====	=====	=====	=====

2.4.2 Ratio Analysis

The ratio analysis is the most powerful tool of financial statement analysis. Ratio simply means one number expressed in terms of another. Using ratio we can compare and measure relationship between two or more figures and ultimately understand how one number is related to another. The method of calculating a ratio is simple: we have to divide one number by another number to derive the ratio.

1. Profitability Ratio

Profitability ratio measure the results of business operations or overall performance and effectiveness of the firm. Some of the most popular profitability ratios are as under:

- Gross profit ratio
- Net profit ratio
- Operating ratio
- Expense ratio
- Return on shareholders investment or net worth
- Return on equity capital
- Return on capital employed (ROCE) Ratio
- Dividend yield ratio
- Dividend payout ratio
- Earnings Per Share Ratio
- Price earning ratio

2. Liquidity Ratio

Liquidity ratio helps us to measure the financial position or solvency of the firm in short runs. In other words, liquidity ratios are calculated to comment upon

the short term paying capacity of a concern or the firm's ability to meet its current obligations. Following are the most important liquidity ratios.

- a. current ratio
- b. Liquid / Acid test / Quick ratio

Activity Ratio

Activity ratios are calculated to measure the efficiency with which the resources of a firm have been employed. Activity ratio help us derive the time lapsed in converting the assets into sales. Following are the most important activity ratios:

- Inventory / Stock turnover ratio
- Debtors / Receivables turnover ratio
- Average collection period
- Creditors / Payable turnover ratio
- Working capital turnover ratio
- Fixed assets turnover ratio
- Over and under trading

Long Term Solvency or Leverage Ratio

Long-term solvency is also called 'leverage ratio'. Leverage ratio help us understand a firm's ability to meet the interest costs and payment schedules of its long term dues. Following are some of the most important long-term solvency or leverage ratios.

- Debt-to-equity ratio
- Proprietary or Equity ratio
- Ratio of fixed assets to shareholders funds
- Ratio of current assets to shareholders funds
- Interest coverage ratio
- Capital gearing ratio
- Over and under capitalisation

The basic components for the calculation of the gross profit ratio are gross profit and net sales. Net sales mean sales minus sales returns. Gross profit = net sales minus cost of goods sold.

- In the case of a trading concern, it would be equal to the opening stock plus purchases, minus closing stock plus all direct expenses relating to purchases.
- In the case of manufacturing concern, it would be equal to the sum of the cost of raw materials, wages, direct expenses and all manufacturing expenses.

In other words, generally, the expenses charged to the profit and loss account or operating expenses are excluded from the calculation of cost of goods sold.

Gross profit ratio (GP ratio) is the ratio of gross profit to net sales expressed as a percentage. It expresses the relationship between gross profit and sales.

Formula

Following formula is used to calculate gross profit ratios:

$$[\text{Gross Profit Ratio} = (\text{Gross profit} / \text{Net sales}) \times 100]$$

Example

Total sales = Rs.520,000; Sales returns = Rs.20,000; Cost of goods sold Rs.400,000. Calculate gross profit ratio.

Calculation

$$\begin{aligned} \text{Gross profit} &= [(520,000 - 20,000) - 400,000] \\ &= 100,000 \end{aligned}$$

$$\begin{aligned} \text{Gross Profit Ratio} &= (100,000 / 500,000) \times 100 \\ &= 20\% \end{aligned}$$

Net profit ratio is the ratio of net profit (after taxes) to net sales. It is expressed as percentage.

The net profit of the company and sales together form the net profit ratio. The net profits are obtained after deducting income tax and generally, non-operating expenses and incomes are excluded from the net profits for calculating this ratio. Thus, incomes such as interest on investments outside the business, profit on sales of fixed assets and losses on sales of fixed assets, etc. are excluded.

Formula

$$[\text{Net Profit Ratio} = (\text{Net profit} / \text{Net sales}) \times 100]$$

Example:

Total sales = Rs.520,000; Sales returns = Rs. 20,000; Net profit Rs.40,000.
Calculate net profit ratio.

Calculation:

$$\text{Net sales} = (520,000 - 20,000) = 500,000$$

$$\text{Net Profit Ratio} = [(40,000 / 500,000) \times 100] = 8\%$$

Operating Ratio

Operating ratio is the ratio of cost of goods sold plus operating expenses to net sales. It is generally expressed in percentage.

$$\text{Operating Ratio} = [(\text{Cost of goods sold} + \text{Operating expenses}) / \text{Net sales}] \times 100$$

Example

Cost of goods sold is Rs.180, 000, other operating expenses are Rs.30, 000, and net sales are Rs.300, 000. Calculate operating ratio.

Calculation:

$$\text{Operating ratio} = [(180,000 + 30,000) / 300,000] \times 100$$

$$= [210,000 / 300,000] \times 100 = 70\%$$

Expense Ratio

Expense ratio indicates the relationship of various expenses to net sales.

Following formula is used for the calculation of expense ratio:

$$[\text{Particular Expense} = (\text{Particular expense} / \text{Net sales}) \times 100]$$

Example:

Administrative expenses are Rs.2,500, selling expenses are Rs.3,200 and sales are Rs.2,500,000. Calculate expense ratio.

Calculation:

$$\text{Administrative expenses ratio} = (2,500 / 2,500,000) \times 100 = 0.1\%$$

$$\text{Selling expense ratio} = (3,200 / 2,500,000) \times 100 = 0.128\%$$

Return on Shareholders Investment or Net Worth Ratio

It is the ratio of net profit to share holder's investment. It is the relationship between net profit (after interest and tax) and shareholder /proprietor's fund.

Formula of return on shareholder's investment or net worth Ratio:

[Return on share holder's investment = {Net profit (after interest and tax) / Share holder's fund} × 100]

Example:

Suppose net income in an organisation is Rs.60, 000 where as shareholder's investments or funds are Rs.400, 000. Calculate return on shareholders investment or net worth.

Calculation:

Return on share holders investment = $(60,000 / 400,000) \times 100 = 15\%$

This means that the return on shareholders funds is 15 cents per dollar.

Return on Equity Capital (ROEC) Ratio

In real sense, ordinary shareholders are the real owners of the company. They assume the highest risk in the company. Preference shareholders have a preference over ordinary shareholders in the payment of dividend as well as capital.

Formula of return on equity capital or common stock

Formula of return on equity capital ratio is:

Return on Equity Capital = [(Net profit after tax – Preference dividend) / Equity share capital] × 100

Components

Equity share capital should be the total called-up value of equity shares. As the profit used for the calculations are the final profits available to equity shareholders as dividend, therefore the preference dividend and taxes are deducted in order to arrive at such profits.

Example:

Calculate return on equity share capital from the following information:

Equity share capital (Rs.1): Rs.1, 000,000; 9% Preference share capital: Rs.500, 000; Taxation rate: 50% of net profit; Net profit before tax: Rs.400, 000.

Calculation:

Return on Equity Capital (ROEC) ratio = $[(400,000 - 200,000 - 45,000) / 1,000,000] \times 100 = 15.5\%$

Return on Capital Employed Ratio (ROCE Ratio)

The prime objective of making investments in any business is to obtain satisfactory return on capital invested. Hence, the return on capital employed is used as a measure of success of a business in realising this objective.

Calculation of Capital Employed

Method 1 If it is calculated from the assets side, it can be worked out by adding the following:

- The fixed assets should be included at their net values, either at original cost or at replacement cost after deducting depreciation. In days of inflation, it is better to include fixed assets at replacement cost, which is the current market value of the assets.
- Investments inside the business.
- All current assets such as cash in hand, cash at bank, sundry debtors, bills receivable, stock, etc.
- To find out net capital employed, current liabilities are deducted from the total of the assets as calculated above.

Gross capital employed = Fixed assets + Investments + Current assets

Net capital employed = Fixed assets + Investments + Working capital*.

Method 2 Alternatively, capital employed can be calculated from the liabilities side of abalance sheet. If it is calculated from the liabilities side, it will include the following items:

- Share capital:
 - Issued share capital (Equity + Preference)
- Reserves and Surplus:
 - General reserve
 - Capital reserve
- Profit and Loss account
- Debentures

- Other long term loans

Computation of profit for return on capital employed

The profits for calculating return on capital employed should be computed according to the concept of "capital employed used". The profits taken must be the profits earned on the capital employed in the business. Thus, net profit has to be adjusted for the following:

- Net profit should be taken before the payment of tax or provision for taxation because tax is paid after the profits have been earned and has no relation to the earning capacity of the business.
- If the capital employed is gross capital employed then net profit should be considered before payment of interest on long-term as well as short-term borrowings.
- If the capital employed is used in the sense of net capital employed than only interest on long term borrowings should be added back to the net profits and not interest on short-term borrowings as current liabilities are deducted while calculating net capital employed.
- If any asset has been excluded while computing capital employed, any income arising from these assets should also be excluded while calculating net profits. For example, interest on investments outside business should be excluded.
- Net profits should be adjusted for any abnormal, non-recurring, non-operating gains or losses such as profits and losses on sales of fixed assets.
- Net profits should be adjusted for depreciation based on the replacement cost, if assets have been added at the replacement cost.

Formula of return on capital employed ratio:

[Return on Capital Employed = (Adjusted net profits*/Capital employed) ×100]

Dividend yield ratio

Dividend yield ratio is the relationship between dividends per share and the market value of the shares.

Following formula is used for the calculation of dividend yield ratio:

[Dividend yield ratio = dividend per share / market value per share]

Example:

A company declares dividend at 20% on its shares, each having a paid up value of Rs.8.00 and market value of Rs.25.00. Calculate dividend yield ratio:

Calculation:

$$\text{Dividend per share} = (20 / 100) \times 8 = \text{Rs.1.60}$$

$$\text{Dividend yield ratio} = (1.60 / 25) \times 100 = 6.4\%$$

Dividend Payout Ratio

Dividend payout ratio is calculated to find the extent to which earnings per share have been used for paying dividend and to know what portion of earnings has been retained in the business. It is an important ratio because ploughing back of profits enables a company to grow and pay more dividends in future.

Following formula is used for the calculation of dividend payout ratio:

$$[\text{Dividend payout ratio} = \text{dividend per equity share} / \text{earnings per share}]$$

A complementary of this ratio is retained earnings ratio. Retained earning ratio is calculated by using the following formula:

$$[\text{Retained earning ratio} = \text{retained earning per equity share} / \text{earning per equity share}]$$

Example:

Calculate dividend payout ratio and retained earnings from the following data:

Net Profit	10,000	No. of equity shares	3,000
Provision for taxation	5,000	Dividend per equity share	Rs.0.40
Preference dividend	2,000		

$$\text{Payout Ratio} = (\text{Rs.0.40} / \text{Rs.1}) \times 100 = 40\%$$

$$\text{Retained Earnings Ratio} = (\text{Rs.0.60} / \text{Rs.1}) \times 100 = 60\%$$

Earnings per Share (EPS) Ratio

An Earnings per Share ratio (EPS Ratio) is a small variation of the return on equity capital ratio and is calculated by dividing the net profit after taxes and preference dividend by the total number of equity shares.

Formula of EPS Ratio:

The formula of earnings per share is:

[EPS Ratio = (Net profit after tax – Preference dividend) / No. of equity shares (common shares)]

Example:

Equity share capital (Rs.1): Rs.1, 000,000; 9% Preference share capital: Rs.500,000; Taxation rate: 50% of net profit; Net profit before tax: Rs.400,000. Calculate earnings per share ratio.

Calculation:

$$\text{EPS} = 155,000 / 10,000 = \text{Rs.15.50 per share}$$

Price Earnings Ratio (PE Ratio)

Price earnings ratio (P/E ratio) is the ratio between market price per equity share and earning per share.

Following formula is used to calculate price earnings ratio:

$$[\text{Price Earnings Ratio} = \text{Market price per equity share} / \text{Earnings per share}]$$

Example:

The market price of a share is Rs.30 and earning per share is Rs.5. Calculate price earnings ratio.

Calculation:

$$\text{Price earnings ratio} = 30 / 5 = 6$$

Current Ratio

It is a measure of general liquidity and is most widely used to make the analysis for short-term financial position or liquidity of a firm. It is calculated by dividing the total of the current assets by total of the current liabilities.

Following formula is used to calculate current ratio:

$$[\text{Current Ratio} = \text{Current Assets} / \text{Current Liabilities}]$$

OR

$$[\text{Current Assets} : \text{Current Liabilities}]$$

Current assets are Rs.1, 200,000 and total current liabilities are Rs.600, 000.

Calculate current ratio.

Calculation:

$$\text{Current Ratio} = 1,200,000 / 600,000$$

= 2

OR

1200,000: 600,000

2: 1

Liquid or Liquidity or Acid Test or Quick Ratio

Liquid ratio is also termed as "Liquidity Ratio", "Acid Test Ratio" or "Quick Ratio". It is the ratio of liquid assets to current liabilities. The true liquidity refers to the ability of a firm to pay its short-term obligations as and when they become due.

Formula of Liquidity Ratio / Acid Test Ratio:

[Liquidity Ratio = Liquid Assets / Current Liabilities]

Example:

From the following information of a company, calculate liquid ratio. Cash Rs.180; Debtors Rs.1,420; inventory Rs.1,800; Bills payable Rs.270; Creditors Rs.500 Accrued expenses Rs.150; Tax payable Rs.750.

Liquid Assets = 180 + 1,420 = 1,600

Current Liabilities = 270 + 500 + 150 + 750 = 1,670

Liquid Ratio = 1,600 / 1,670 = 0.958: 1

Absolute Liquid Ratio

Absolute liquidity is represented by cash and near cash items. It is a ratio of absolute liquid assets to current liabilities. In the computation of this ratio, only the absolute liquid assets are compared with the liquid liabilities. The absolute liquid assets are cash, bank and marketable securities. It is to be observed that receivables (debtors/accounts receivables and bills receivables) are eliminated from the list of liquid assets in order to obtain absolute liquid assets since there may be some doubt in their liquidity.

Formula of Absolute Liquid Ratio:

[Absolute Liquid Ratio = Absolute Liquid Assets / Current Assets]

Inventory Turnover Ratio or Stock Turnover Ratio (ITR)

Every firm has to maintain a certain level of inventory of finished goods to be able to meet the requirements of the business. However, the level of inventory should be neither too high nor too low.

Formula of Stock Turnover/Inventory Turnover Ratio

The ratio is calculated by dividing the cost of goods sold by the amount of average stock at cost.

(a) [Inventory Turnover Ratio = Cost of goods sold / Average inventory at cost]

The cost of goods sold may not be known from the published financial statements. In such circumstances, the inventory turnover ratio may be calculated by dividing net sales by average inventory at cost. If average inventory at cost is not known, then inventory at selling price may be taken as the denominator. Similarly, where the opening inventory is not known, the closing inventory figure may be taken as the average inventory.

(b) [Inventory Turnover Ratio = Net Sales / Average Inventory at Cost]

(c) [Inventory Turnover Ratio = Net Sales / Average inventory at Selling Price]

(d) [Inventory Turnover Ratio = Net Sales / Inventory]

Example:

The cost of goods sold is Rs.500, 000. The opening stock is Rs.40, 000 and the closing stock is Rs.60, 000 (at cost). Calculate inventory turnover ratio.

Calculation:

Inventory Turnover Ratio (ITR) = $500,000 / 50,000^* = 10$ times

This means that an average one dollar invested in stock will turn into ten times in sales.

* $(Rs.40, 000 + Rs.60, 000) / 2 = Rs.50,000$

Debtors Turnover Ratio / Accounts Receivable Turnover Ratio

A concern may sell goods on cash as well as on credit. Credit is one of the important elements of sales promotion. The volume of sales can be increased by following a liberal credit policy.

Formula of Debtors Turnover Ratio

[Debtors Turnover Ratio = Net Credit Sales / Average Trade Debtors]

But when the information about opening and closing balances of trade debtors and credit sales is not available, then the debtors turnover ratio can be calculated by dividing the total sales by the balance of debtors (inclusive of bills receivables) given and formula can be written as follows.

[Debtors Turnover Ratio = Total Sales / Debtors]

Example:

Credit sales Rs.25, 000; Return inwards Rs.1, 000; Debtors Rs.3, 000; Bills Receivables Rs.1, 000. Calculate debtors' turnover ratio.

Calculation:

Debtors Turnover Ratio = Net Credit Sales / Average Trade Debtors

$$= 24,000^* / 4,000^{**}$$

$$= 6 \text{ Times}$$

*25000 less 1000 return inwards, **3000 plus 1000

Average Collection Period Ratio

The Debtors / Receivable Turnover ratio when calculated in terms of days is known as Average Collection Period or Debtors Collection Period Ratio.

Following formula is used to calculate average collection period:

[(Trade Debtors × No. of Working Days) / Net Credit Sales]

Example:

Credit sales Rs.25, 000; Return inwards Rs.1, 000; Debtors Rs.3, 000; Bills Receivables Rs.1, 000. Calculate average collection period.

Calculation:

Average collection period can be calculated as follows:

Average Collection Period = (Trade Debtors × No. of Working Days) / Net Credit Sales

$$4,000^* \times 360^{**} / 24,000 = 60 \text{ Days}$$

* Debtors and bills receivables are added.

** For calculating this ratio, usually the number of working days in a year is assumed to be 360.

Creditors / Accounts Payable Turnover Ratio

This ratio is similar to the debtors' turnover ratio. It compares creditors with the total credit purchases.

Following formula is used to calculate creditors' turnover ratio:

[Creditors Turnover Ratio = Credit Purchase / Average Trade Creditors]

Average Payment Period

Average payment period ratio gives the average credit period enjoyed from the creditors. It can be calculated using the following formula:

[Average Payment Period = Trade Creditors / Average Daily Credit Purchase]

[Average Daily Credit Purchase = Credit Purchase / No. of working days in a year]

OR

[Average Payment Period = (Trade Creditors × No. of Working Days) / Net Credit Purchase]

(In case information about credit purchase is not available, total purchases may be assumed to be credit purchase).

Working Capital Turnover Ratio

Working capital turnover ratio indicates the velocity of the utilisation of net working capital.

Formula of Working Capital Turnover Ratio

Following formula is used to calculate working capital turnover ratio:

[Working Capital Turnover Ratio = Cost of Sales / Net Working Capital]

Example:

Cash	10,000
Bills Receivables	5,000
Sundry Debtors	25,000
Stock	20,000
Sundry Creditors	30,000

Cost of sales	150,000
---------------	---------

Calculate working capital turnover ratio.

Calculation:

Working Capital Turnover Ratio = Cost of Sales / Net Working Capital

Current Assets = Rs.10, 000 + Rs.5, 000 + Rs.25, 000 + Rs.20, 000 = Rs.60, 000

Current Liabilities = Rs.30, 000

Net Working Capital = Current assets – Current liabilities

= Rs.60, 000 – Rs.30, 000

= Rs.30, 000

So the working Capital Turnover Ratio = 150,000 / 30,000 = 5 times

Fixed Assets Turnover Ratio

Fixed assets turnover ratio is also known as sales to fixed assets ratio. This ratio measures the efficiency and profit earning capacity of the concern.

Higher the ratio, greater is the intensive utilisation of fixed assets. Lower ratio means under-utilisation of fixed assets. The ratio is calculated by using following formula:

Formula of Fixed Assets Turnover Ratio

Fixed assets turnover ratio turnover ratio is calculated by the following formula:

Fixed Assets Turnover Ratio = Cost of Sales / Net Fixed Assets

Over and Under Trading

Overtrading

Overtrading and undertrading are facets of over and under-capitalisation. Overtrading is a curse to the business.

Undertrading

Undertrading is the reverse of over-trading. It means keeping funds idle and not using them properly. This is due to the under employment of assets of the business, leading to the fall of sales resulting in financial crisis. This makes the business unable to meet its commitments and ultimately leads to forced liquidation. The symptoms in this case would be a very high current ratio and very

low turnover ratio. Undertrading is an aspect of over-capitalisation and leads to low profit.

Debt to Equity Ratio

Debt-to-Equity ratio indicates the relationship between the external equities or outsiders funds and the internal equities or shareholders funds.

Formula of Debt to Equity Ratio

Following formula is used to calculate debt to equity ratio

[Debt Equity Ratio = External Equities / Internal Equities]

OR

[Outsiders funds / Shareholders funds]

As a long-term financial ratio, it may be calculated as follows:

[Total Long Term Debts / Total Long Term Funds]

OR

[Total Long Term Debts / Shareholders Funds]

From the following figures, calculate debt to equity ratio:

Equity share capital	1,100,000
Capital reserve	500,000
Profit and loss account	200,000
6% debentures	500,000
Sundry creditors	240,000
Bills payable	120,000
Provision for taxation	180,000
Outstanding creditors	160,000

Calculate the debt to equity ratio.

Calculation:

$$\begin{aligned} & \text{External Equities / Internal Equities} \\ & = 1,200,000 / 18,000,000 \\ & = 0.66 \text{ or } 4: 6 \end{aligned}$$

It means that for every four dollars worth of the creditors investment the shareholders have invested six dollars. That is external debts are equal to 0.66% of shareholders funds.

Proprietary Ratio or Equity Ratio

This is a variant of the debt-to-equity ratio. It is also known as equity ratio or net worth to total assets ratio.

Formula of Proprietary/Equity Ratio:

$$\text{Proprietary or Equity Ratio} = \text{Shareholders funds} / \text{Total Assets}$$

Shareholders funds are Rs.1, 800,000 and the total assets, which are equal to total liabilities are Rs.3, 000,000. Calculate proprietary ratio or Equity ratio.

Calculation:

$$\text{Proprietary or Equity Ratio} = 1,800,000 / 3,000,000$$

Fixed Assets to Proprietor's Fund Ratio

Definition:

The fixed asset to proprietor's fund ratio establishes the relationship between fixed assets and shareholders funds.

Formula:

$$[\text{Fixed Assets to Proprietors Fund} = \text{Fixed Assets} / \text{Proprietors Fund}]$$

Example:

Suppose the depreciated book value of fixed assets is Rs.36,000 and proprietor's funds are 48,000. The relevant ratio would be calculated as follows:

$$\text{Fixed assets to proprietor's fund} = 36,000 / 48,000 = 0.75 \text{ or } 0.75: 1$$

Current Assets to Proprietor's Fund Ratio

Current Assets to Proprietors' Fund Ratio establish the relationship between current assets and shareholder's funds.

Formula:

[Current Assets to Proprietors Funds = Current Assets / Proprietor's Funds]

Example:

This may be expressed either as a percentage or as a proportion. To illustrate, if the value of current assets is Rs.36,000 and the proprietor's funds are Rs.180,000 the relevant ratio would be calculated as follows:

$$\text{Current Assets to Proprietors Funds} = 36,000 / 180,000 = 0.2$$

This may also be expressed as 20%. It means that 20% of the proprietor's funds have been invested in current assets.

Debt Service Ratio or Interest Coverage Ratio

Interest coverage ratio is also known as debt service ratio or debt service coverage ratio.

Formula of Debt Service Ratio or interest coverage ratio:

[Interest Coverage Ratio = Net Profit before Interest and Tax / Fixed Interest Charges]

Example:

If the net profit (after taxes) of a firm is Rs.75, 000 and its fixed interest charges on long-term borrowings are Rs.10, 000. The rate of income tax is 50%. Calculate debt service ratio / interest coverage ratio.

Calculation:

$$\text{Interest Coverage Ratio} = (75,000^* + 75,000^* + 10,000) / 10,000 = 16 \text{ times}$$

*Income after interest is Rs.75, 000 + income tax Rs.75, 000

Capital Gearing Ratio

Closely related to solvency ratio is the capital gearing ratio. Capital gearing ratio is mainly used to analyse the capital structure of a company.

Formula of capital gearing ratio:

[Capital Gearing Ratio = Equity Share Capital / Fixed Interest Bearing Funds]

Example:

Calculate capital-gearing ratio from the following data:

	1991	1992
Equity Share Capital		
Reserves and Surplus	500,000	400,000
Long Term Loans	300,000	200,000
6% Debentures	250,000	300,000
	250,000	400,000

Calculation:

$$\text{Capital Gearing Ratio 1992} = (500,000 + 300,000) / (250,000 + 250,000)$$

$$= 8: 5 \text{ (Low Gear)}$$

$$1993 = (400,000 + 200,000) / (300,000 + 400,000)$$

$$6: 7 \text{ (High Gear)}$$

It may be noted that gearing is an inverse ratio to the equity share capital.

Highly Geared-----Low Equity Share Capital

Low Geared-----High Equity Share Capital

Over-capitalisation and Under-capitalisation

The total amount of funds available to an undertaking should be neither too much nor too low.

2.4.3 Limitations of Financial Statement Analysis

Although financial statement analysis is a highly useful tool, it has two limitations. These two limitations involve the comparability of financial data between companies and the need to look beyond ratios.

Comparison of Financial Data

There are different accounting methods that different companies adopt for maintaining their accounts. The comparison of one company with another using ratio analysis technique thus depends upon accounting method adopted by the two or more companies being compared. As an example, one company maintains inventory record using LIFO method while other uses FIFO method. In such an event, direct comparison of financial data such as inventory valuations and cost of goods sold between the two firms may be misleading. Sometimes enough data is presented in footnotes to the financial statements to restate data to a comparable basis. Otherwise, the analyst should keep in mind the lack of comparability of the

data before drawing any definite conclusion. Irrespective of these obvious limitations, comparison of key ratios often provides very useful data, which could be taken up for, further investigation.

The Need to Look Beyond Ratios

A new analyst may consider that the ratios are sufficient to predict the future financial status of the company however it is not the truth. Ratios only being the starting point of investigation and not end, using ratio analysis we often come to only a tentative conclusion. Ratios would help us raise critical questions, which need to be explored and answered using other techniques. Ratios hardly answer any question by themselves.

Along with ratios, there are other useful indicators such as industry trends, technological changes and changes in consumer tastes, changes in broad economic factors and changes within the firm itself that an analyst should look into. A recent change in a key management position, for example, might provide a basis for optimisation in the future, even though the past performance of the firm (as shown by its ratios) may have been mediocre.

Check your progress 3

1. Comparison of two or more year's financial data is known as?
 - a. Vertical analysis
 - b. Horizontal analysis

2.5 Let Us Sum Up

In this unit, we studied about financial statements in very detail. This unit concentrated on how are these statements built and what exactly is the role and importance of financial accounting in our life.

We have studied in this unit regarding the meaning, nature and limitations of financial statements. We even discussed why these financial statements prepared are. We learnt how to prepare profit and loss account as well as balance sheet. What are the different points to be kept in mind while preparing these statements have even been discussed here in very detail. In the later portion of unit

explanation was given on how to make analysis of financial statements and various ratios. How we can measure the performance of the business through these statements and ratios.

This unit is going to be of great help for the students in understanding the concepts of financial statements and will be of great help for them in measuring the performance of any business.

2.6 Answers for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-b)

Check your progress 3

Answers: (1-b)

2.7 Glossary

1. **Accounting** - The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.
2. **Financial Analysis** - Critical evaluation of data given in the financial statements.
3. **Financial Statement** - An organised collection of data according to logical and consistent accounting procedures conveying an understanding of some financial aspects of a business firm.

2.8 Assignment

Calculate:

1. Total sales = Rs.620, 000; Sales returns = Rs. 30,000; Cost of goods sold Rs.500, 000. Calculate gross profit ratio.
2. Total sales = Rs.320, 000; Sales returns = Rs. 20,000; Net profit Rs.40, 000. Calculate net profit ratio.
3. Administrative expenses are Rs.5, 500, selling expenses Rs.3, 200 and sales are Rs.3, 500,000. Calculate expense ratio.
4. A company declares dividend at 10% on its shares, each having a paid up value of Rs.7.00 and market value of Rs.25.00. Calculate dividend yield ratio.

2.9 Activities

From the following figures extracted from the books of Shri Govind, prepare a Trading and Profit and Loss Account for the year ended 31st March, 1999 and a Balance Sheet as on that date, after making necessary adjustments.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Shri Govind's Capital	2,28,800	Stock 1.4.1999	38,500
Shri Govind's Drawings	13,200	Wages	35,200
Plant and Machinery	99,000	Sundry Creditors	44,000
Freehold Property	66,000	Postage and Telegrams	1,540
Purchases	1,10,000	Insurance	1,760
Returns Outwards	1,100	Gas and Fuel	2,970
Salaries	13,200	Bad Debts	660
Office Expenses	2,750	Office Rent	2,860

Office Furniture	5,500	Freight	9,900
Discounts A/c (Dr.)	1,320	Loose Tools	2,200
Sundry Debtors	29,260	Factory Lighting	1,100
Loan to Shri Krishna @ 10% p.a. – balance as on 1.4.1999	44,000	Provision of D/D	880
Cash at Bank	29,260	Interest on loan to Shri Krishna	1,100
Bills Payable	5,500	Cash in Hand	2,640
		Sales	2,31,440

Adjustments:

1. Stock on 31st March, 1999 was valued at Rs. 72,600.
2. A new machine was installed during the year, costing Rs.15, 400/- but it was not recorded in the books as no payment was made for it. Wages Rs.1, 100 paid for its erection have been debited to wages account.
3. Depreciate:
 - Plant and Machinery by 33.3%
 - Furniture by 10%
 - Freehold Property by 5%
4. Loose tools were valued at Rs.1, 760 on 31.03.1999.
5. Of the Sundry Debtors, Rs.600 is bad and should be written off.
6. Maintain a provision of 5% on Sundry Debtors for doubtful debts.
7. The manager is entitled to a commission of 10% of the net profits after charging such commission.

2.10 Case Study

Visit a business organisation and study their financial accounting process.

2.11 Further Readings

1. Accountancy, Shukla and Grewal, S. Chand and Company Ltd, 1997.
2. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 2002.
3. Financial Accounting, S. K. Paul, New Central Book Agency (P) Ltd, 2003.
4. Fundamentals of Accounting, S. K. Paul, New Central Book Agency (P) Ltd, 2003.
5. Modern Accountancy, Hanif and Mukherjee, Law Point, 2006.

Block Summary

In this block we have studied about the financial statements, how these statements are prepared. The whole process starts with trial balance that is usually prepared using the Double-entry accounting system forms the basis for preparing the financial statements. All the figures in the trial balance are rearranged to prepare the profit and loss statement and balance sheet. There are certain accounting standards that determine the format for these accounts (SSAP, FRS, and IFRS). The financial statements will display the income and expenditure for the company and a summary of the assets, liabilities and shareholders or owners' equity of the company on the date to which the accounts were prepared.

So from the study of financial statements now we will be able to prepare the financial statements of any organization and would be in a position to evaluate its performance and position during a particular period of time.

Block Assignment

Short Answer Questions

Write a brief note on the following:

1. Financial statements
2. Profit and loss account
3. Balance sheet
4. Operating ratio
5. Gross profit
6. Net loss

Long Answer Questions

1. Discuss the nature and benefits of financial statements.
2. Discuss the limitations of financial statements.
3. Discuss the role of ratio analysis.

Enrolment No.

1. How many hours did you need for studying the units?

Unit No	1	2	3	4
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Language and Style	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Illustration used (Diagram, tables etc)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Conceptual Clarity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Check your progress Quest	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Feed back to CYP Question	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____

3. Any Other Comments.

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“

*Education is something
which ought to be
brought within
the reach of every one.*

”

- Dr. B. R. Ambedkar



Dr. Babasaheb Ambedkar Open University
'Jyotirmay Parisar', Opp. Shri Balaji Temple, Sarkhej-Gandhinagar Highway, Chharodi,
Ahmedabad-382 481.

FINANCIAL ACCOUNTING

PGDF-101

**BLOCK 2:
ACCOUNTS OF SOLE
TRADERS, PARTNERSHIP
FIRMS, NON-TRADING
CONCERNS AND
INSOLVENTS**



**Dr. Babasaheb Ambedkar Open University
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FINANCIAL ACCOUNTING



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ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)



PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included many tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!



FINANCIAL ACCOUNTING

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FINANCIAL ACCOUNTING

BLOCK 2: ACCOUNTS OF SOLE TRADERS, PARTNERSHIP FIRMS, NON-TRADING CONCERNS AND INSOLVENTS

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BLOCK 2: ACCOUNTS OF SOLE TRADERS, PARTNERSHIP FIRMS, NON-TRADING CONCERNS AND INSOLVENTS

Block Introduction

The prime objective of accounting is to ascertain how much profit or loss a business organisation has made during any accounting period and to determine its financial position on a given date.

Preparing final accounts or financial statements serve this purpose. After the preparation of Trial Balance, the next level of work in accounting is called “Final Accounts” level. Trial balance provides the essential input for the preparation of these accounts or statements. These accounts/statements provide necessary information to various interested groups, viz. shareholders, investors, creditors, employees, management and government agencies, etc. Therefore, these financial statements are prepared to serve the information needs of these diverse groups to enable them to make appropriate decisions. The Income statement is divided into two parts- Trading account and Profit and Loss account. Trading account is prepared to know the result of trading operation. The main objective of preparing the trading account is to ascertain gross profit or gross loss of a business during an accounting period, usually a year. Accounting treatment for partnership firm is similar to that of a sole proprietorship business. Individuals or institutions with activities other than trade are known as non-trading concerns. Examples of non-trading concerns are clubs, hospitals, libraries, colleges, athletic clubs, etc.

These institutions are started not for carrying on a business and making a profit but for some charitable, religious or similar purpose. Their income, which is derived from donations, subscriptions, entrances fees, etc., is spent on the objects for which they are started. Most of their transactions are cash transactions. Hence, they need not maintain as many books of account as the trading concerns. The main objective of keeping records in such concerns is to meet the statutory requirement and exercise control over the utilisation of funds. Hence, they usually maintain a Cash Book to record all receipts and payments (or separate Cash

Receipts Journal and Cash Payments Journal to provide the necessary details) and other books like Members Register, Minutes Book, Stock Register, etc. In this block we shall also be discussing about accounting insolvency. It is a different approach to standard insolvency. The later involves a firm missing or being unable to make a debt-servicing payment, while the former examines the firm's balance sheet. When a firm appears to be insolvent on the books, it is likely the debt holders will force a response. The company may attempt to restructure the business to alleviate its debt obligations or be placed in bankruptcy by the debt holders- a situation where the value of a company's liabilities exceeds its assets. Accounting insolvency looks only at the firm's balance sheet, deeming a company "insolvent on the books" when its net worth appears negative.

So in this block we will be studying the accounts of sole traders, partnership accounting and the accounting of non trading concerns.

Block Objective

After learning this block you will be able to understand:

- Final accounts of sole traders.
- Final accounts of partnership firms.
- Maintain capital accounts of partners and distribute profit among the partners.
- Final accounts of partnership firms.

Block Structure

Unit 1: Final Accounts of Sole Traders

Unit 2: Final Accounts Partnership Firms

Unit 3: Accounts for Non-Trading Concerns and Insolvents

UNIT 1: FINAL ACCOUNTS OF SOLE TRADERS

Unit Structure

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1.2.1 Format of a Trading Account

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1.6 Answers for Check Your Progress

1.7 Glossary

1.8 Assignment

1.9 Activities

1.10 Case Study

1.11 Further Readings

1.0 Learning Objectives

After learning this unit, you will be able to understand:

- Prepare the final accounts of sole traders.
- Work on the final accounts of partnership firms.
- Use the provisions relevant for accounting.
- Maintain capital accounts of partners.
- Distribute profit among partners.

1.1 Introduction

The final accounts (or financial statements) of a sole trader comprise:

- A trading and profit and loss account which shows the profit or loss of the business.
- A balance sheet, which shows the assets and liabilities of the business together with the owner's capital.

These final accounts can be produced more often than once a year in order to give information to the owner on how the business is progressing. However, it is customary to produce annual accounts for the benefit of the Inland Revenue, bank manager and other interested parties. In this way, the trading and profit and loss account covers an accounting period of a financial year (which can end at any date-it does not have to be the calendar year), and the balance sheet shows the state of the business at the end of the accounting period.

1.2 Trading Account

In accounting parlance, gross profit means overall profit. Gross profit is the difference between sale proceeds of a particular period and the cost of the goods actually sold. Since gross profit means overall profit, no deduction of general, administrative or selling and distribution expenses is made. Gross Profit is said to be made when the sale proceeds exceed the cost of goods sold. Conversely, when sale proceeds are less than the cost of the goods sold, gross loss is incurred. In preparation of the trading account, cost of goods sold means prime cost, which includes the adjusted purchases, all direct expenses and manufacturing overheads.

Trading account provides information about the gross margin, purchases and stock, ratio of direct expenses to sales, etc.

1.2.1 Format of a Trading Account

The format of a Trading Account is very important, because we should have a clear presentation of how gross profit is achieved. A Trading Account is prepared in “T” form just as every other account is prepared. It is one of the two accounts which are only prepared once in an accounting period to ascertain the profit or loss of the business. As it is prepared once in a year, no date or journal folio column is provided.

The format of a Trading Account and the usually appearing entries therein are shown below:

Trading Account of
(For the year ended.....)

Dr.

Cr.

Particulars	Amount (Rs.)		Particulars	Amount (Rs.)	
	In. Col.	Out. Col.		Inner Col.	Out. Col.
To Opening Stock			By Sales		
To Purchase			Less Sales Return		
Less Purchase Return			Return		
To Wages			By Closing stock		
To Carriage Inward			By Gross Loss***		
To Factory lighting, heating					
To Fuel and gas					
To Gross Profit else***					
Total			Total		

The names of the ledger accounts are written in the particulars columns and their respective balances are written in the amount columns. When an account is to be adjusted with some other account, then the balances of both these accounts are first written in inner column and the net effect of which is taken to outer column. The accounts without any further adjustments are taken to the outer column directly.

1.2.2 Trading Account Items (Dr. Side)

1. **Opening Stock** - In the beginning of any accounting period, balances of all assets, liabilities and capital are brought down by a way of passing an opening entry and entering the balance in respective account, stock is one of such accounts. The amount of stock recorded in the beginning of the accounting period remains unchanged during that period and appears in the trial balance as stock or opening stock. This account is closed at the end of the period by transferring the same to trading account as:

Trading account Dr.

To Opening Stock a/c

2. **Purchases** - It denotes the value of goods (in which the concern deals in) purchased either for cash or on credit for the purpose of resale. The balance of the purchase account, as it appears in the Trial Balance, shows the total purchases made during the accounting period. In respect of purchases, the following points must be noted:

- Purchase of capital asset should not be added with the purchases. If it is already included in purchases, it should be deducted from there.
- If goods purchased for personal use and added with the purchases, it should be excluded. This type of purchases should be treated as drawings.
- If some of the goods purchased are still in transit at the year-end, it is better to debit Stock-in-transit Account and credit Cash or Supplier's Account.
- If the amount of purchases includes goods received on consignment, or on approval or on hire purchase, these should be excluded from purchases.

- Cost of goods sent on consignment must be deducted from the purchases in case of a trading concern.

This account is closed at the end of the period by transferring the same to trading account as:

Trading account Dr.

To Purchases a/c

- 3. Purchases Returns / Returns Outwards** - Purchase return is the return of goods or raw material to the supplier for any reason such as damages, goods not as per description, wrong items and not as per P.O., etc. In such case the supplier's account is debited and the Purchase return account is credited. Thus, a purchase return account shows a credit balance and appears on credit side of trial balance. This Purchase return account appears to the debit side of trading account as a deduction from purchases. Purchase return is often termed as Return Outward.

This account is closed at the end of the period by transferring the same to trading account as:

Purchase Return A/c Dr.

To Trading A/c

- 4. Direct Expenses** - In case of trading concern direct expenses consists of all expenses incurred on purchase of goods and bringing them in a saleable condition. Whereas, in the case of a manufacturing concern this constitutes all expenses incurred on manufacture of those goods in which the firm deals in.

Direct expenses are debited to the trading account as:

Trading account Dr.

To wages a/c

To Carriage inward a/c

To factory lighting, heating a/c, etc.

- Wages incurred on manufacture or merchandise is called direct wages. These wages are to be recorded on trading account debit side. While indirect wages are to be debited to profit and loss account. When there is no prefix such as direct or indirect, wages are to be treated as direct and debited to the trading account. Moreover, when the phrase 'wages

and salary' is used and no explanation of the same is given, in such case the account is to be transferred to the trading accounts debit side. Whereas, when the term 'salary and wages' is used then the account is to be transferred to profit and loss account. Wages incurred on installation of machinery or on construction or repairs of a building do not form part of wages. Thus, payments to the workers for manufacture or merchandise are only to be considered as a part of wages and are to be debited to the trading account Carriage inward, freight, insurance, etc. incurred on purchases are also to be debited to the trading account. Carriage outward, freight outward, etc. are not debited to trading account but are to be taken to the P and L debit side. Thus, the transportation expenses incurred on purchase of raw material or merchandise are to be debited to trading account. The phrase inward or in indicates the expenses are related to purchases, whereas the phrase outward out indicate the expenses are related to sales Factory lighting, heating, power, fuel, etc. are to be debited to trading account as direct expenses. These are the expenses incurred on manufacturing activity and hence appear in trading account. Sometimes a separate manufacturing account is opened and all expenses related to manufacturing are transferred to the manufacturing account first and then to the trading account in the form of cost of production.

- **Custom duty** - When the merchandise or raw material (in case of manufacturing firm) is bought from a foreign vendor, the tax or duty paid on import of goods is called custom duty. This is an expense, debited to the trading account.
- **Royalty** - This is the amount paid by a lessee to the owner of an asset for the use of that asset, e.g. royalty paid for extracting coal from a coalmine, royalty paid to the author of a book, etc. Royalty based on the raw material extracted e.g. coal, iron, etc. is charged to the trading account as direct expenses, whereas the royalty, which is based on sale, e.g. royalty paid to the author of a book on the basis of the number of copies sold, is to be charged to the profit and loss account.
- **Other expenses** - The expenses like repairs of plant, depreciation of plant, factory building, etc. are considered as expenses related to manufacturing activity and hence debited to trading account.

1.2.3 Trading Account Items (Cr. Side)

1. **Sales** - It refers to the sale of goods in which the business deals in and includes both cash and credit sales. It does not include sale of old, obsolete or depreciated assets, which were acquired for use in the business. However, goods sent to customers on approval basis, free samples and sales tax, if any, included in the sales figure should be excluded. Sales tax sometimes included in the total sales revenue, should also be deducted as it is the tax collected and to be deposited with tax authorities. Sales account is a revenue account (nominal account), which denotes income earned from the main business activity or activities. The income is earned when goods or services are sold to customers. As per the accrual concept, income should be recognised as soon as it is accrued and not necessarily only when the cash is paid for. Revenue should be recognised only when significant risks and rewards (vaguely referred to as ownership in goods) are transferred to the customer. For example, if an invoice is made for sale of goods and the term of sale is door delivery; then sale can be recognised only on getting the proof of delivery of goods at the door of customer. If such proof is pending at the end of the accounting period, then this transaction cannot be taken as sales, but will be treated as unearned income. Sales account in trail balance constitutes gross sales made during the accounting period and it is to be transferred to the trading account as:

Sales A/c Dr.

To Trading A/c

2. **Sales Returns/Returns Inward** - When goods are returned by the buyers, for some reasons, in the books of account, "Returns Inwards Account or "Sales Returns Account" is debited and buyer is credited. In the Trial Balance, it appears on the debit side. There are two ways of showing sales returns in the Trading Account. It may be shown by way of deduction from sales in the Trading Account. An alternative way to show the sales returns on the debit side of the Trading Account. It is transferred to trading account by passing an entry as:

Trading account Dr.

To Sales Return a/c

3. **Abnormal Loss** - It refers to abnormal loss of stock due to fire, theft or accident. Since Trading Account is prepared under normal conditions of the business, abnormal loss if any is credited fully to the Trading Account.
4. **Closing Stock** - It refers to the value of goods lying unsold at the end of any accounting year. The stock at the end is valued at either cost or market price whichever less is. Since trial balance generally does not include closing stock, the following entry is recorded to incorporate the effect of closing stock in the Trading Account.

Closing Stock A/c Dr.

To Trading A/c

However, if closing stock forms the part of Trial Balance, it will not be transferred to the Trading Account but taken to Balance Sheet instead. In case the goods have been sent to customers on an approval (Sale/Return) basis, such goods should be included in the value of closing stock.

1.2.4 Balancing of Trading Account

This step is carried out once all the items of trial balance and the respective adjustments are taken care of and recorded in their respective places, viz. in trading account or in balance sheet or in profit and loss account. The total of the debit side and the total of credit side are computed, if the debit total exceeds the credit the difference between the two is termed as gross loss and recorded on credit side of trading account. If the credit total exceeds the debit total the difference is termed as gross profit and recorded on debit side of the trading account. Thus by recording the balancing figure on either of the sides the trading account is tallied, this process is called the balancing of trading account. Gross profit is transferred to the credit side of profit and loss account, where as gross loss is transferred to debit side of profit and loss account.

Check your progress 1

1. In case of trading concern _____ consists of all expenses incurred on purchase of goods and bringing them in saleable condition.
 - a. direct expenses
 - b. indirect expenses

1.3 Profit and Loss Account

After preparing Trading Account, the next step is to prepare Profit and Loss Account (also known as P and L account) with a view to ascertain net profit or net loss during an accounting period.

The Profit and Loss Account can be defined as a report that summarises the revenues and expenses of an accounting period to reflect the changes in various critical areas of firm's operations. As pointed out earlier, the balance of the Trading Account (gross profit or gross loss) is transferred to the Profit and Loss Account, which is the starting point of the preparation of this account. It takes into account all remaining indirect (normal and abnormal) expenses and losses related to or incidental to business. These operating and non-operating expenses are charged to Profit and Loss Account and shown to the debit side of the account.

After transferring the Gross Profit or Gross Loss from the Trading Account to the Profit and Loss Account, the sources of other incomes like commission or discount received are shown on the credit side of the Profit or Loss Account. The credit side also includes the non-trading income like interest on bank deposits or securities, dividend on shares, rent of property let-out, profit arising out of sale of fixed assets, etc. On the debit side, all other expenses appearing in the Trial Balance, which cannot find a place in the Trading Account, will appear. The debit side will also include the losses arising out of sale of assets and any abnormal losses.

P and L is also called as income statement, shows revenue items and expenses incurred to earn this revenue during the period. We see application of the matching concept and accounting period concept here. It must be ensured to match revenues and expenses to the accounting period to which they are related. As accounting exhibits the business activity in monetary terms, the P and L also follows the activity flow. Thus, Profit and Loss Account measures net income by

matching revenues and expenses as per the accounting principles. Net income is the difference between total revenues and total expenses.

1.3.1 Format of a P and L A/C

Just like the trading account, P and L can also be prepared in 'T' format like a ledger account. However, P and L can also be prepared in the form of an income statement wherein all incomes and gains are written first and expenses and losses are written as deductions. P and L in the 'T' form is as under:

Profit and Loss Account of.....

(For the year ended.....)

Dr.

Cr.

Particulars	Amount (Rs.)		Particulars	Amount (Rs.)	
	Inner Column	Outer Column		Inner Column	Outer Column
To Gross Loss***			By Gross Profit		
To Salary			By Interest rec.		
To Rent, rates and taxes			By Income Rec.		
To Telephone bill			By net loss++++		
To Electricity charges					
To General exp.					
To legal expenses					
To Audit fees					
To Depreciation On Diff Fixed Assets.					

To Interest					
To Discount					
To upkeep of Delivery van					
To Advertisement					
To Salesmen's Commission.					
To Net Profit+++					
Total			Total		

Either net profit or Net loss ++++

1.3.2 Profit and Loss Account Items (Dr. Side)

The Items that will appear on the debit side of a Profit and Loss Account can broadly be classified as under:

- **Management Expenses** - These are the expenses incurred for carrying out the day-to-day administration of a business. Expenses, under this head, include office salaries, office rent and lighting, printing and stationery and telegrams, telephone charges, etc.
- **Selling and Distribution Expenses** - These expenses are incurred for promoting sales and distribution of sold goods. Example of such expenses is godown rent, carriage outwards, advertisement, cost of after-sales service, selling agents' commission, etc.
- **Maintenance Expenses** - The expenses such as repairs, renewals, etc. incurred on maintenance of fixed assets are grouped under this head. The expenses related to assets used in manufacturing such as plant and machinery, factory premises, etc., if taken to trading account, should be excluded from this maintenance expenses. Maintenance also includes depreciation on fixed assets. Depreciation of office building, office furniture, and office equipments as well repairs of these assets are a few examples of maintenance expenses.

- **Financial Expenses** - These expenses are incurred for arranging finance necessary for running the business. These include interest on loans, discount on bills, brokerage and legal expenses for raising loan, etc.
- **Abnormal Losses** - Some abnormal losses may occur during the accounting period. All types of abnormal losses are treated as extra ordinary expenses and debited to Profit and Loss Account. Examples are stock lost by fire and not covered by insurance, loss on sale of machinery, cash defalcation, etc.

(Credit: Financial Accounting, A. Mukharjee and A. Hanif)

The wages and salaries earned by the worker - paid or unpaid - and rent, electricity, telephone expenses are to be taken into consideration, whether paid during the accounting period or otherwise. To ascertain the amount of expenses to be debited to the Profit and Loss Account, four types of event are needed to be considered and the cash payment made in connection with these events. They are as under:

- Expenses incurred and paid out in that year: If an item in expenditure is incurred in one year and also paid in the same year, the same will be debited to the Profit and Loss Account.
- Expenses incurred but not paid out, partly or fully during the current year: There are some expenses, which are incurred in the current accounting period, but not paid for, partly or fully, by the end of the period, are called “Outstanding Expenses”. These expenses become liabilities of the business at the end of the accounting year. In fact, on the date of the final accounts, outstanding expenses, both an expense and a liability exists without having been recorded in the books of account. For recording it, the following entry is to be passed:

Expenses A/c

Dr. (Will be shown in the P and L A/c)

To Outstanding Expenses A /c (will appear in the liabilities side of Balance Sheet)

- Expenses paid for during the current year, but not incurred, partly or fully: Sometimes, it happens that some expenses are paid during the current year, but not incurred, partly or fully, are known as “Prepaid Expenses”. Prepaid expense is an asset to the business and will be shown in the Balance Sheet. The adjustment entry to be passed”

Prepaid Expenses A/c Dr. (to be shown as asset in the Balance Sheet)

To Expenses A/c

(Balance of this account is to be debited to P and L A/c)

- Expenses of the current year likely to arise in subsequent period: Sometimes, an expense or a loss may arise in the future in connection with the current years' business. In such a case, we make a provision of the anticipated loss and a charge is created against the profit for the current period. This provision is shown either as a liability or as a contingent asset, i.e., it appears in the Balance Sheet as a deduction from some other asset. The best example of this anticipated expense is Provision for Bad debts.

1.3.3 Profit and Loss Account Items (Cr. Side)

The Items that will appear on the credit side of a Profit and Loss Account can broadly be classified as under:

- **Gross Profit** - Gross profit is the excess of sales revenue over the cost of goods sold. When credit side total of trading account exceeds debit side total the difference is termed as gross profit. G.P is the first item of P and L account credit side. This is the balance of the Trading Account transferred to the Profit and Loss Account. If the Trading Account shows a gross loss, it will appear on the debit side.
- **Other Incomes** - During the course of the business, other than income from the sale of goods, the business may have some other income of financial nature. The examples are discount or commission received.
- **Non-trading Income** - The business may have various transactions with the bank. At the end of the year, the business may earn some amount of interest, which will find a place in the Profit and Loss Account as non-trading income. The business may have some investment outside the business in the form of shares or debentures or units. Any incomes received from these investments are also considered as non-trading income and are treated in the same way.
- **Abnormal Gains** - There may be capital gains arising during the course of the year, e.g., profit arising out of sale of a fixed asset. The profit is shown as a separate income on the credit side of the Profit and Loss Account. We

must remember that all incomes form the abnormal gains or other income to be credited to the Profit and Loss Account if they arise or accrue during the period. Similarly, income received in advance is to be deducted from the income.

1.3.4 Balancing Profit and Loss Account

Once the respective accounts are transferred from the trial balance to P and L account, gross profit/loss transferred from trading account and all adjustments are take care of, the next step in preparation of P and L is the balancing of the account. This is just like balancing of trading account, the totals of debit side and credit side are computed and the difference between these totals is either a net profit or net loss. If the total of debit side exceeds the total of credit side then there is a net loss where as when the total of credit side exceeds the total of debit side then there is a net profit. Net Profit is the last item to be recorded on debit side else net loss is the last item on credit side. After computing net profit/loss, the totals of two sides of P and L match.

The balance in the profit and loss account represents the net profit or net loss. If the credit side is more than the debit side, it shows the net profit, and if the debit side shows more than the credit side, it shows net loss. When the profit and loss account shows a net profit, we pass the following entry:

Profit and Loss A/c	Dr.
To Net Profit A/c	

If the Profit and Loss Account shows a net loss, the entry will be reversed.

1.3.5 Adjustments

A common query about the adjustments is ‘why at all these adjustments appear when proper care is taken before preparation of trial balance and all necessary entries are passed before preparation of trial balance?’

When all important facts are taken care of before preparation of trial balance and effect is given to respective accounts, there remain no adjustments.

However, in common practice, a few facts remained untouched before preparation of trial balance and should be taken into consideration while preparing

final accounts. These facts appear in the form of adjustments. Some common adjustments and their effects on final accounts are given below:

Sr. No.	Adjustment	Effect
1	Closing stock	Trading account: Cr. Side and Balance Sheet: Asset side.
2	Expenses outstanding	Add to respective expenses on Trading or P and L a/c Dr side and Balance sheet liability side.
3	Expenses prepaid	Deduct from respective expenses and Balance sheet Asset side.
4	Income outstanding	Add to respective income on P and L a/c Cr side and Balance sheet Asset side.
5	Income pre - received	Deduct from respective income and Balance sheet liability side.
6	Depreciation of fixed asset	Deduct from respective asset, Balance sheet Asset side and Record to P and L debit side as depreciation on the asset.
7	Bad debts written off	Deduct from Debtors, Balance Sheet Asset side, enter in P and L a/c on debit side.
8	Reserve for discount on debtors	Deduct from Debtors, Balance Sheet Asset side, enter in P and L a/c on debit side.
9	RDD or RBD	Deduct from Debtors, Balance Sheet Asset side, enter in P and L a/c on debit side.
10	Goods distributed as free samples	Trading a/c Cr. Side as free samples else deduct from purchases and P and L a/c add to advertisement or take separately as promotion expenses.
11	Goods destroyed by fire/goods lost	a) When goods are not insured:

It should be noted here that no adjustment is required for any bad debt, which is appearing already in the Trial Balance. The bad debts, which is appearing in the Trial Balance is to be debited to Profit and loss account of the Period.

2. Provision for Bad Debts

Credit sales are recognised as income at the time of the sale without knowing the exact time of collection. In course of time, loss may result from unsuccessful attempts to collect the amount due from the customers. Every organisation creates a provision for this anticipated loss, from the reported income of the credit sales in the current period.

There are different methods of creating provision for bad debts. Here, we will discuss only one method. Accounting entry will depend upon the situation whether provision for bad debts appearing in the Trial Balance or not appearing in the Trial balance.

Situation 1: When provision for Bad Debts Not Appearing in the Trial Balance:

The accounting entry will be:

Profit and Loss Account Dr.

 To Provision for Bad Debts Account

(To be shown in the Balance Sheet as a deduction for Debtors)

Situation 2: When provision for Bad Debts Appearing in the Trial Balance:

At first, calculate the amount of provision to be created at the end of the period in the same way as above. Now compare the provision with the provision appearing in the Trial Balance.

- a. If the new provision is more than the provision appearing in the Trial Balance, pass the following entry:

Profit and Loss Account Dr.

 To provision for Bad Debts

[New provision less new provision]

- b. If the new provision is less than the provision appearing in the Trial Balance, pass the following entry:

Provision for Bad Debts Dr.

To Profit and Loss Account
[Old provision less new provision]

Here, it should be noted that only new provision should be shown in the Balance Sheet as a deduction from Sundry Debtors.

Illustrative Example

Pass necessary entries from the following information:

Dr.	Trial Balance		Cr.
	Rs.		Rs.
Sundry Debtors	40,600	Provision for Bad Debts	1,500

Additional information: (i) Bad debt Rs. 600 after preparation of Trial Balance;
(ii) Create a provision for bad debts @ 5% on Sundry Debtors.

Solution:

Journal	Dr.	Cr.
Bad Debt A/c	Dr. 600	
	To Sundry Debtors A/c	600
(Being Bad Debt written off)		
Profit and Loss A/c	Dr. 500	
	To Provision for Bad Debt A/c	500
(Being the creation of additional provision)		

Balance Sheet

Liabilities	Rs.	Assets	Rs.
		Sundry Debtors	40,600
		Less: Bad Debt	600__
			40,000
		Less: PBD	_2,000_
			38,000

Dr.	Profit and Loss A/c		Cr.
	Rs.		Rs.
To Provision for Bad Debt			
New 2000			
Less: Old 1500	500		
To Bad Debt	600		

Note: New provision to be created: Sundry Debtors Rs. 40,600 Less: Bad Debts Rs. 600 = Rs. 40,000.

New provision required @ 5% on Rs. 40,000 = Rs. 2000 Less: Provision already in Trial Balance Rs. 1,500 = Rs. 500 (additional).

Illustrative Example:

From the following information, pass necessary journal entries:

Dr.	Trial Balance		Cr.
	Rs.	Rs.	
Sundry Debtors	40,600	Provision for Bad Debts	2,900

Additional information: (i) Bad debt Rs. 600 after preparation of Trial Balance; (ii) Create a provision for bad debts @ 5% on Sundry Debtors.

Solution:

Journal	Dr.	Cr.
Bad Debt A/c	Dr. 600	
To Sundry Debtors A/c		600
(Being Bad Debt written off)		
Provision for Bad Debt A/c	Dr. 900	
To Profit and Loss A/c		900
(Being the excess provision credited to Profit and Loss A/c)		

Balance Sheet

Liabilities	Rs.	Assets	Rs.
		Sundry Debtors	40,600
		Less: Bad Debt	600__
			40,000
		Less: PBD	_2,000_
			38,000

Dr. Profit and Loss A/c Cr.

	Rs.		Rs.
To Bad Debt	600	By provision for Bad Debt	
		Old 2900	
		Less: New 2000	900

Note: New provision to be created: Sundry Debtors Rs. 40,600 Less: Bad Debts Rs. 600 = Rs. 40,000.

New provision required @ 5% on Rs. 40,000 = Rs. 2000 Less: Provision already in Trial Balance Rs. 2,900= Rs. 900 (excess).

3. Provision for Discount on Debtors

Most business houses give a cash discount to debtors who make prompt payment, i.e., who make payment on or before a given date. It is clear that the real worth of debtors will be the gross figure of debtors minus the cash discount that they would take. The figure of debtors should be accordingly adjusted.

The difficulties, however, are that nobody knows how many debtors will take cash discount and what the amount will be. Therefore, all that is possible is to make a rough estimate. Usually, it is made at a percentage of outstanding debtors who actually repay their obligation. Therefore, the estimate amount of bad debt should be deducted from the total of debtors; debtors; and provision for discount on debtors should be made only on the balance. Accounting entry will be:

- a. When asset account is maintained at written down value:
1. Depreciation Account Dr.
 To Asset Account
 (Being depreciation charged)
 2. Profit and Loss Account Dr.
 To Depreciation Account
 (Being depreciation transferred to Profit and Loss Account)
- b. When asset account is maintained at cost price:
1. Depreciation Account Dr.
 To Provision for Depreciation Account
 (Being depreciation Charged)
 2. Profit and Loss Account Dr.
 To Depreciation Account
 (Being depreciation transferred to Profit and Loss Account)

Total accumulated depreciation is shown in the Balance Sheet liabilities side. Alternatively, it can be shown by way of deduction from the original cost of assets side. Here, it should be noted that no adjustment is required for depreciation already appearing in the Trial Balance. Depreciation, which is already appearing in the Trial Balance, should only be debited to Profit and Loss Account.

6. Goods Distributed as free samples:

This is one kind of advertisement. When goods are distributed to the prospective customer as free samples, an expense is incurred (known as advertisement expense) and there is a usual reduction from the stock of goods. The following entry is passed:

Advertisement Account	Dr.
To Purchase Account	(For a trader)
Or	
To Trading Account	(For a manufacturer)

At the year-end, transferring to the Profit and Loss Account closes Advertisement Account:

Profit and Loss Account Dr.

 To Advertisement Account

7. **Income Tax**

Income tax is not an expense to earn revenue. Therefore, while ascertaining the profit of concern, income tax is not treated as an expense to be deducted from the profit. For a sole proprietor, income tax is payable by the owner and not by the business. Therefore, if income tax appears in the Trial Balance, it should be treated as drawings and should be deducted from capital. Following are the entries to be passed:

a. Income Tax Account Dr. (When Paid)

 To Cash/ Bank Account

b. Drawing Account Dr.

 To Income Tax Account

However, for a registered partnership firm, it is payable by the business itself and not by the partners. It generally appears as an appropriation of the net profits. The following entry is passed:

Profit and Loss Appropriation Account Dr.

 To Income Tax Account

8. **Drawing Made by the Proprietor**

Drawing Made by the proprietor (s) may be in cash or in kinds. Drawing relate to the resources of the business and the capital of the owner(s).

Drawings made in Cash: In this case, following entries are passed:

a. Drawings Account Dr.

 To Cash/Bank Account

b. Capital Account Dr.

 To Drawings Account

Drawings made in kinds: When some of the stocks are withdrawn from the business, the following entries are passed:

a. Drawings Account Dr.

 To Purchases Account

If the amount is not paid within the accounting period, it will be shown in the liability side of the Balance Sheet as commission payable.

Problem arises in the ascertainment of the amount payable as commission, since commission may be paid at a certain percentage before or after charging such commission. If the commission is paid before charging commission, calculation is very easy. We simply multiply the rate with the profits. For example, if the amount of commission is 10% of Rs. 44,000. But if the amount of commission is payable after charging such commission, we have to calculate the commission as follows:

Let total commission payable = x

$X = 10\% (\text{Rs. } 44,000 - x)$ or $x = \text{Rs. } 4,400 - 1.1x = \text{Rs. } 4,400$

Or, $x = \text{Rs. } 4,400 / 1.1 = \text{Rs. } 4,400$.

13. Goods sent on approval basis

When goods are sold to the customers on sale or return or on approval basis, it is not considered as sale till the time it is not approved by the customers or the expiring of a fixed period as agreed by the parties. When goods are sold initially to a customer on approval basis, we pass the entry for the sales. At the year-end, if the goods are still lying with the customer awaiting approval; the following entries are to be passed:

1. To cancel previous entry

Sales Account	Dr. (Sales Value)
To Sundry Debtors Account	

2. To add the value of the closing stock (Cost of goods lying with the customer):

Stock with Customers Account	Dr.
To Trading Account	

In the Balance Sheet, it will be deducted from the sundry debtors at sales price and the closing stock will be increased by the cost of such sales.

Following are the respective formats of balance sheets to bring out the clarity of concept:

1.4.1 Format in Liquidity Order

BALANCE SHEET OF

As on

Liabilities	Amt (Rs.)	Assets	Amt (Rs.)
Current Liabilities		Current Assets	
Bank Overdraft		Cash in hand	
Outstanding Expenses		Cash at bank	
Bills Payable		Marketable Securities	
Sundry Creditors		Short term Investment	
Income Received in Advance		Bills Receivables	
		Sundry Debtors	
Long Term Liabilities		Prepaid Expenses	
Mortgaged Loan		Accrued Income	
Loan from Bank		Long term Investment	
Capital		Fixed Assets	
Add Profit		Furniture and Fixtures	
Less Loss		Motor Vehicles	
Less Drawings		Tools and Equipments	
		Plant and Machinery	
		Land and Building	
		Intangible Assets	
		Patents	
		Copyrights	

		Trademarks	
		Goodwill	

1.4.2 Order of Permanence

BALANCE SHEET OF

As on

Liabilities	Amt (Rs.)	Assets	Amt (Rs.)
Capital		Fixed Assets	
Add Profit		Goodwill	
or (Less Loss)		Land and Building	
Less Drawings		Plant and Machinery	
		Tools and Equipments	
Long Term Liabilities		Motor Vehicles	
Mortgage Loan		Furniture and Fixtures	
Loan from Bank		Patents	
		Trademarks	
Current Liabilities		Investments (Long Term)	
Income Received in Advance		Current Assets	
Sundry Creditors		Stock	
Bills Payable		Accrued Income	
Outstanding Expenses		Prepaid Expenses	
Bank Overdraft		Sundry Debtors	
		Bills Receivables	
		Short term Investments	
		Marketable Securities	
		Cash and Bank Balance	
		Fictitious Assets	

		Advertisement	
		Profit and Loss Account	
		Miscellaneous Expenses	

1.4.3 Explanation and Clarification of Certain Items

1. Adjustments and entries related to sundry debtors:
 - a. Bad debts given in the trial balance: P and L account debit side.
 - b. Bad debts as an adjustment: Deduct from debtors and enter in P and L account debit side.
 - c. Three adjustments are given: i) Reserve for discount on debtors @ 2.5% ii) create reserve for bad debts @10%, iii) bad debts @5% of debtors. In addition, suppose the debtors' balance given is 56500Rs. Then the calculations on debtors would be as follows:

Debtors	56500	
Less: bad debts @5% on 56500	2825	
	53675	
Less: RDD@ 10% on 53675	5367.50	
	48307.50	
Less: Reserve for discount @2.5 on 48307.5	1207.69	
	47099.81	

This sequence should be followed for following reasons:

- RDD should be created for doubtful debtors. Therefore, the debtors whom we treated as bad should be deducted from total debtors for the computation of RDD.
 - Discount should be offered to good debtors only. Hence, bad debt and RDD should be deducted from total debtors before computing reserve for discount on debtors.
2. When the closing stock is given in the trial balance then it is to be recorded in balance sheets asset side and it will not appear in the trading accounts credit side.

3. Expenses Outstanding: For example, there is an adjustment of the salary for March as it hasn't been paid then the amount of outstanding salary is to be added to the salary account on the P and L accounts debit side and second effect is to be given to the balance sheet's liability side.
4. Computation of manager's commission on net profit: Suppose,
 - a. General Manager is to be given commission at 10% of net profits after charging his commission.
 - b. Works manager is to be given a commission at 12% of net profit before charging General Manager's commission and his own.

Commission payable to works manager and general manager is computed as below:

Profit before charging any commission	150,000
Commission to works manager @ 12% on 150,000	18,000
Profit after works manager's commission	132,000
Commission to General Manager	12,000
(132,000/110 x 100)	

Check your progress 3

1. _____ means orderly arrangement in which various assets and liabilities are presented or shown in the Balance Sheet.
 - a. Sorting
 - c. Chronological
 - b. Marshalling

1.5 Let Us Sum Up

In this unit, we have studied in very detail about the process of preparing final accounts of sole traders. Understand the format of trading account and know the various items appearing in it. How to prepare profit and loss account and what types of items are reflected in it. We even learnt how to prepare balance sheet for sole traders.

Final accounts is considered to be main tool in the hands of any business entrepreneur be it a big or small business. With the help of final accounts a trader is in a position of measure the actual performance of his business and how far has he been able to achieve his goal. In this unit we focused on the final accounts of a sole traders and this piece of information is going to be of great help for them in understanding the basic concepts associated to it.

1.6 Answer for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-a)

Check your progress 3

Answers: (1-b)

1.7 Glossary

1. **Assets** - Assets represent what a business owns or is due. Equipment, vehicles, buildings, creditors, money in the bank, cash are all examples of the assets of a business
2. **Balance Sheet** - A summary of all the accounts of a business, usually prepared at the end of each financial year. The term 'balance sheet' implies that the combined balances of assets exactly equal the liabilities.
3. **Capital** - An amount of money put into the business.
4. **Closing Balance** - The balance of an account at the end (or close), of an accounting period. This figure is then carried forward to the next accounting period.
5. **Closing Stock** - Closing stock is the stock of inventory available with the business at the end of the accounting period.

6. **Manufacturing Account** - An account used to show what it cost to produce the finished goods made by a manufacturing business.
7. **Trading Account** - An account, which shows the gross profit or loss of a manufacturing or retail business, i.e. sales less the cost of sales.
8. **Trial Balance** - A statement showing all the accounts used in a business and their balances.

1.8 Assignment

Discuss the various debit and credit side items of a trading account.

1.9 Activities

Write a brief note on profit and loss account and explain how it is different from trading account.

1.10 Case Study

Write a brief note on balance sheet and its different types of formats.

1.11 Further Readings

1. Accountancy, Shukla and Grewal, S. Chand and Company Ltd, 1997.
2. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 2002.
3. Financial Accounting, S. Kr. Paul, New Central Book Agency (P) Ltd, 2003.

UNIT 2: FINAL ACCOUNTS PARTNERSHIP FIRMS

Unit Structure

2.0 Learning Objectives

2.1 Introduction

2.2 Provisions Relevant for Accounting Partnership Firms

2.2.1 Maintenance of Capital Accounts of Partners

2.2.2 Distribution of Profit Among Partners

2.3 Profit and Loss Appropriation Account

2.4 Profit and Loss Account

2.5 Balance Sheet

2.6 Let Us Sum Up

2.7 Answers for Check Your Progress

2.8 Glossary

2.9 Assignment

2.10 Activities

2.11 Case Study

2.12 Further Readings

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- To prepare final accounts of partnership firms.
- Apply the provisions relevant for accounting.
- Maintain capital accounts of partners.
- Distribute profit among partners.

2.1 Introduction

Section 4 of the Indian Partnership Act 1932 defines partnership as the 'relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all'. The persons entering into partnership with one another are individually called 'partners' and collectively called 'firm'.

2.2 Provisions Relevant for Accounting Partnership Firms

The important provisions affecting partnership accounts are as follows:

1. **Profit Sharing Ratio** - If the partnership deed is silent about the profit sharing ratio, the profits and losses of the firm are to be shared equally by partners, irrespective of their capital contribution in the firm.
2. **Interest on Capital** - No partner is entitled to claim any interest on the amount of capital contributed by him in the firm as a matter of right. However, interest can be allowed when it is expressly agreed to by the partners. Thus, no interest on capital is payable if the partnership deed is silent on the issue. In case the deed provides for payment of interest on capital but does not specify the rate, the interest will be paid at the rate of 6 per cent per annum. Further the interest is payable only out of the profits of the business and not if the firm incurs losses during the period.
3. **Interest on Drawings** - No interest is to be charged on the drawings made by the partners, if there is no mention in the Deed.
4. **Interest on Advances** - If any partner has advanced some money to the firm beyond the amount of his capital for the purpose of business; he shall be entitled to get an interest on the amount at the rate of 6 per cent per annum.
5. **Remuneration for Firm's Work** - No partner is entitled to get salary or other remuneration for taking part in the conduct of the business of the firm unless there is a provision for the same in the Partnership Deed.

Apart from the above, the Indian Partnership Act specifies that subject to contract between the partners:

- a. If a partner derives any profit for him/her self from any transaction of the firm or from the use of the property or business connection of the firm or the firm name, he/she shall account for the profit and pay it to the firm.
- b. If a partner carries on any business of the same nature as and competing with that of the firm, he/she shall account for and pay to the firm, all profit made by him/her in that business.

2.2.1 Maintenance of Capital Accounts of Partners

All transactions relating to partners of the firm are recorded in the books of the firm through their capital accounts. This includes the amount of money brought in as capital, withdrawal of capital, share of profit, interest on capital, interest on drawings, partner's salary, commission to partners, etc.

There are two methods by which the capital accounts of partners can be maintained. These are: (i) fixed capital method, and (ii) fluctuating capital method. The difference between the two lies in whether or not the transactions other than addition/withdrawal of capital are recorded in the capital accounts of the partners.

- **Fixed Capital Method:** Under the fixed capital method, the capitals of the partners shall remain fixed unless additional capital is introduced or a part of the capital is withdrawn as per the agreement among the partners. All items like share of profit or loss, interest on capital, drawings, interest on drawings, etc. are recorded in separate accounts, called Partner's Current Account. The partners' capital accounts will always show a credit balance, which shall remain the same (fixed) year after year unless there is any addition or withdrawal of capital. The partners' current account on the other hand, may show a debit or a credit balance. Thus under this method, two accounts are maintained for each partner viz., capital account and current account, While the partners' capital accounts shall always appear on the liabilities side in the balance sheet, the partners' current account's balance shall be shown on the liabilities side, if they have credit balance and on the assets side, if they have debit balance. The partner's capital account and the current account under the fixed capital method would appear as shown below:

Partner's Capital Account

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
	To Bank (Permanent withdrawal of capital)		Xxx		By Balance b/d		xxx
	To Balance C/d		xxx		By Bank (New capital introduced)		xxx
			Xxx				xxx

Partner's Current Account

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
	To Balance B/d (in case of opening debit balance)		Xxx		By Balance B/d (in case of opening credit balance)		xxx
	To Drawings		xxx		By Salary		xxx
	To Interest on Drawings		xxx		By Commision		xxx
	To P and L Appropriation (for share of loss)		xxx		By Interest on Capital		xxx
	To Balance C/d (in case of credit)				By P and L Appropriation (for share of Profit)		xxx
					By Balance C/d (in case of debit closing balance)		

	closing balance)						
			Xxx				xxx

- Fluctuating Capital Method:** Under the fluctuating capital method, only one account, i.e. capital account is maintained for each partner. All the adjustments such as share of profit and loss, interest on capital, drawings, interest on drawings, salary or commission to partners, etc. are recorded directly in the capital accounts of the partners. This makes the balance in the capital account to fluctuate from time to time. That is the reason why this method is called fluctuating capital method.

Partner's Capital Account

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
	To Drawings		xxx		By Balance		xxx
	To Interest on Drawings		xxx		B/d By Bank(Fresh Capital Introduced)		xxx
	To P and L Appropriation		xxx		By Salary		xxx
	To Balance C/d		xxx		By Interest on Capital		xxx
					By P and L Appropriation		xxx
			xxx				xxx

2.2.2 Distribution of Profit among Partners

The profits and losses of the firm are distributed among the partners in an agreed ratio. However, if the partnership deed is silent, the firm's profits and losses are to be shared equally by all the partners.

You know that in the case of sole partnership the profit or loss, as ascertained by the profit and loss account is transferred to the capital account of the proprietor. In case of partnership, however, certain adjustments such as interest on drawings, interest on capital, salary to partners, and commission to partners are required to be made. For this purpose, it is customary to prepare a Profit and Loss Appropriation Account of the firm and ascertain the final figure of profit and loss to be distributed among the partners, in their profit sharing ratio.

Check your progress 1

1. If the partnership deed is silent about the profit sharing ratio, the profits and losses of the firm are to be shared _____ by partners.
 - a. Equally
 - b. In the ratio of their capital
 - c. As they wish

2.3 Profit and Loss Appropriation Account

Profit and Loss Appropriation Account is merely an extension of the Profit and Loss Account of the firm. It shows how the profits are appropriated or distributed among the partners. All adjustments in respect of partner's salary, partner's commission, interest on capital, interest on drawings, etc. are made through this account. It starts with the net profit/net loss as per Profit and Loss Account is transferred to this account. The journal entries for preparation of Profit and Loss Appropriation Account and making various adjustments through it are given as follows:

Journal Entries

1. **Transfer of the balance of Profit and Loss Account to Profit and Loss Appropriation**

Account:

- a. If Profit and Loss Account shows a credit balance (net profit)

Profit and Loss A/c Dr.

To Profit and Loss Appropriation A/c

- b. If Profit and Loss Account shows a debit balance (net loss)

Profit and Loss Appropriation A/c Dr.

To Profit and Loss A/c

2. Interest on Capital

- a. For crediting interest on capital to partners' capital account:

Interest on Capital A/c Dr.

To Partner's Capital/Current A/cs (individually)

- b. For transferring interest on capital to Profit and Loss Appropriation Account:

Profit and Loss Appropriation A/c Dr.

To Interest on Capital A/c

3. Interest on Drawings

- a. For charging interest on drawings to partners' capital accounts:

Partners Capital/Current A/c's (individually) Dr.

To Interest on Drawings A/c

- b. For transferring interest on drawings to Profit and Loss Appropriation Account:

Interest on Drawings A/c Dr.

To Profit and Loss Appropriation A/c

4. Partner's Salary

- a. For crediting partner's salary to partner's capital account:

Salary to Partner A/c Dr.

To Partner's Capital/Current A/c's (individually)

- b. For transferring partner's salary to Profit and Loss Appropriation Account:

Profit and Loss Appropriation A/c Dr.
To Salary to Partner's A/c

5. Partner's Commission

a. For crediting commission to a partner, to partner's capital account:

Commission to Partner A/c Dr.
To Partner's Capital/Current A/c's (individually)

b. For transferring commission paid to partners to Profit and Loss Appropriation

Account:

Profit and Loss Appropriation A/c Dr.

To Commission to Partners Capital/Current A/c

6. Share of Profit or Loss after appropriations

If Profit:

Profit and Loss Appropriation A/c Dr.

To Partner's Capital/Current A/c's (individually)

If Loss:

Partner's Capital/Current A/c's (individually) Dr.

To Profit and Loss Appropriation A/c

The Performa of Profit and Loss Appropriation Account is given as follows

Profit and Loss Appropriation Account

Date	Particulars	J F	Amount	Date	Particulars	J F	Amount
	To Pand L (loss if any)		xxx xxx		By Profit anf loss (profit if any)		xxx
	To Salary to partner		xxx		To Interest on Drawings		xxx
	To Interest on		xxx xxx		To Partner's		xxx

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Capital		xxx		capital		
To				(distribution		
Commission		xxx		of loss)		
To Interest on						
partner's loan						
To Partner's						
Capital a/c						
(distribution						
of profits)						
		xxx				xxx

Check your progress 2

1. _____ is merely an extension of the Profit and Loss Account of the firm.
 - a. Balance sheet
 - b. Profit and Loss Appropriation Account

2.4 Profit and Loss Account

A Profit and Loss Account shows how much profit or loss has been incurred by a company from its income after providing for all its expenditure within a financial year. One may also know how the profit available for appropriation is arrived at by using profit after tax as well as portion of reserves. Further, it shows the profit appropriation towards dividends, general reserve and balance carried to the balance sheet.

The Box-2 exhibits Profit and Loss Account of XYZ Company Ltd. Item-1 represents income, Items from 2 to 6 show various expenditure items. Items from 7 to 12 show the profits available for appropriation and items 13 (a), (b), and (c) indicate appropriation of profits.

BOX – 2

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED

31st March, 2005

Particulars	Rupees (in Crores)	Rupees (in Crores)	Rupees (in Crores)
		As on 31st March, 2005	As on 31st March, 2004
Income			
1. Sale of products and other income		2595.99	1969.10
Expenditure			
2. Manufacturing and other expenses	2275.37		1742.54
3. Depreciation	54.26		48.91
4. Interest	81.63		73.63
5. Expenditure transferred to capital accounts	49.82		(44.27)
6. Total expenditure		2316.44	1820.81
Profit before tax			
7. Tax for the year		234.55	148.29
Profit after tax			
8. Investment allowance reserve		142.05	102.54
9. Investment allowance (utilised reserve written back		4.66	3.55

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10. Debenture redemption reserve		(15.2)	(11.2)
11. Capital redemption reserve		(0.57)	(0.57)
12. Balance brought forward from previous year		86.71	33.65
Amount available for appropriations			
13. Appropriations			
a. Proposed Dividends*		41.54	31.26
b. General Reserve		100	10
c. Balanced credited to Balance sheet		76.11	86.71
		217.65	127.97
14. Notes to profit and Loss Account			
• Details as per Directors Report			
As per our report attached			
To the Balance sheet		For and on behalf of the Board	
For XYZ and Co.	PQR	AAA	
Chartered Accountants	Chairman	BBB	
ABC		CCC	

Partner		DDD		Directors
For LMN and co.	GHI			
Chartered Accountants	Vice Chairman and			
DEF	Managing Director			
Partner	STU			
Mumbai, 10th July 2004	Secretary	Mumbai, 28th June 2004		

For a company, the profit and loss statement is the most important document presented to the shareholders. Therefore, each company tries to give maximum stress on its representation/ misrepresentation. One should consider the following:

1. Is there an overall improvement of sales as well as profits (operating, gross and net) over the similar period (half-yearly or annual) previous year? If so, the company's operational management is good.
2. Check for the other income carefully, for here companies have the scope to manipulate. If the other income stems from dividend on the investments or interest from the loans and advances, it is good, because such income is steady. But if the other income is derived by selling any assets or land, be cautious since such income is not an annual occurrence.
3. Also, check for the increase of all expenditure items viz. raw material consumption, manpower cost and manufacturing, administrative and selling expenses. See whether the increases in these costs are more than the increase in sales. If so, it reveals the operating conditions are not conducive to making profits. Similarly, check whether ratio of these costs to sales could be contained over the previous year. If so, then the company's operations are efficient.
4. Evaluate whether the company could make profit from its operations alone. For this, you should calculate the profits of the company, after ignoring all

other income except sales. If the profit so obtained is positive, the company is operationally profitable, which is a healthy sign.

Scrutinise the depreciation as well as interest for any abnormal increase. The increase in depreciation is attributed to higher addition of fixed assets, which is good for long-term operations of the company. High depreciation may suppress the net profits, but it is good for the cash flow. So instead of looking out for the net profits, check the cash profits and compare whether it has risen. High interest cost is always a cause of concern because the increased debt burden cannot be reduced in the short run. Calculate the earnings per share and the various ratios. In case of half yearly results, multiply half-yearly earnings per share by 2 to get approximately the annualised earnings per share.

Check your progress 3

1. A _____ shows how much profit or loss has been incurred by a company from its income after providing for all its expenditure within a financial year.
 - a. Profit and loss account
 - b. Profit and loss appropriation account

2.5 Balance Sheet

A balance sheet is a snapshot of a business' financial condition at a specific moment in time, usually at the close of an accounting period. A balance sheet comprises assets, liabilities, and owners' or stockholders' equity. Assets and liabilities are divided into short- and long-term obligations including cash accounts such as checking, money market or government securities. At any given time, assets must equal liabilities plus owners' equity. An asset is anything the business owns that has monetary value. Liabilities are the claims of creditors against the assets of the business.

Balance sheets can identify and analyze trends, particularly in the area of receivables and payables. Is the receivables cycle lengthening? Can receivables be collected more aggressively? Is some debt uncollectable? Has the business been slowing down payables to forestall an inevitable cash shortage?

Balance sheets, along with income statements, are the most basic elements in providing financial reporting to potential lenders such as banks, investors and vendors who are considering how much credit to grant the firm.

A balance sheet consists of the following components:

1. **Assets** - Assets are subdivided into current and long-term assets to reflect the ease of liquidating each asset. Cash, for obvious reasons, is considered the most liquid of all assets. Long-term assets, such as real estate or machinery, are less likely to sell overnight or have the capability of being quickly converted into a current asset such as cash.
2. **Current assets** - Current assets are any assets that can be easily converted into cash within one calendar year. Examples of current assets would be checking or money market accounts, accounts receivable and notes receivable that are due within one year's time.
 - Cash - Money available immediately, such as in checking accounts, is the most liquid of all short-term assets.
 - Accounts receivables - This is money owed to the business for purchases made by customers, suppliers, and other vendors.
 - Notes receivables - Notes receivables that are due within one year are current assets. Notes that cannot be collected on within one year should be considered long-term assets.
3. **Fixed assets** - Fixed assets include land, buildings, machinery and vehicles that are used in connection with the business.
 - **Land** - Land is considered a fixed asset but, unlike other fixed assets, is not depreciated, because land is considered an asset that never wears out.
 - **Buildings** - Buildings are categorised as fixed assets and are depreciated over time.
 - **Office equipment** - This includes office equipment such as copiers, fax machines, printers, and computers used in your business.
 - **Machinery** - This figure represents machines and equipment used in your plant to produce your product. Examples of machinery might include lathes, conveyer belts, or a printing press.
 - **Vehicles** - This would include any vehicles used in your business.

- **Total fixed assets** - This is the total dollar value of all fixed assets in your business, less any accumulated depreciation.
4. **Total assets** - This figure represents the total dollar value of both the short-term and long-term assets of your business.
 5. **Liabilities and owners' equity** - This includes all debts and obligations owed by the business to outside creditors, vendors, or banks that are payable within one year, plus the owners' equity. Often, this side of the balance sheet is simply referred to as "Liabilities".
 - **Accounts payable** - This is comprised of all short-term obligations owed by your business to creditors, suppliers, and other vendors. Accounts payable can include supplies and materials acquired on credit.
 - **Notes payable** - This represents money owed on a short-term collection cycle of one year or less. It may include bank notes, mortgage obligations or vehicle payments.
 - **Accrued payroll and withholding** - This includes any earned wages or withholdings that are owed to or for employees but have not yet been paid.
 - **Total current liabilities** - This is the sum total of all current liabilities owed to creditors that must be paid within a one-year period.
 - **Long-term liabilities** - These are any debts or obligations owed by the business that are due more than one year out from the current date.
 - **Mortgage note payable** - This balance of a mortgage extends out beyond the current year. For example, you may have paid off three years of a fifteen-year mortgage note, of which the remaining eleven years, not counting the current year, are considered long-term.
 - **Owners' equity** - Sometimes this is referred to as stockholders' equity. Owners' equity is made up of the initial investment in the business as well as any retained earnings that are reinvested in the business.
 - **Common stock** - This is stock issued as part of the initial or later-stage investment in the business.

- **Retained earnings** - These are earnings reinvested in the business after the deduction of any distributions to shareholders, such as dividend payments.

6. Total liabilities and owners' equity - This comprises all debts and monies that are owed to outside creditors, vendors, or banks and the remaining monies that are owed to shareholders, including retained earnings reinvested in the business.

A sample balance sheet has been given below:

Department Of Foreign Affairs And Trade

Balance Sheet

As at 30 June 2007

		2007	2006
	Notes	\$'000	\$'000
ASSETS			
Financial Assets			
Cash	6A	49,088	28,713
Receivables	6B	498,365	377,026
Total Financial Assets		547,453	405,739
Non Financial Assets			
Land and Building	7A,C	1,706,653	1,517,193
Infrastructure, Plant and Equipment	7B,C	94,549	75,184
Assets held for Sale	7D	14,485	1,409
Intangibles	7E	8,892	12,706
Inventories	7F	16,396	20,467
Other Non-Financial Assets	7G	21,174	21,320

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Total Non-Financial Assets		1,862,149	1,648,279
Total Assets		2,409,602	2,054,018
LIABILITIES			
Payables			
Suppliers	8A	78,387	52,527
Other Payables	8B	11,053	7,823
Total Payables		89,440	60,350
Interest Bearing Liabilities			
Leases	9A	2,214	2,918
Total Interest Bearing Liabilities		2,214	2,918
Provisions			
Employees	10A	110,403	105,611
Other Provisions	10B	8,485	7,985
Total Provisions		118,888	113,596
Total Liabilities		210,542	176,864
NET ASSETS		2,199,060	1,877,154
EQUITY			
Contributed Equity		1,491,462	1,385,519
Reserves		365,169	257,560
Retained Surpluses / (accumulated deficit)		342,429	234,075
TOTAL EQUITY		2,199,060	1,877,154

Current Assets		594,066	438,730
Non-Current Assets		1,815,536	1,615,288
Current Liabilities		194,584	161,011
Non-Current Liabilities		15,958	15,853

Check your progress 4

1. A _____ is a snapshot of a business' financial condition at a specific moment in time, usually at the close of an accounting period.

- a. trading account
- b. profit and loss account
- c. balance sheet

2.6 Let Us Sum Up

In this unit, we had a detailed discussion on preparation of final accounts of a partnership firm.

In this unit we studied in detail about the partnership firm and its accounts i.e. the financial statements being prepared by these firms. We learnt the format of profit and loss account and balance sheet of partnership firm. We even learnt about the profit and loss appropriation account which is used for appropriating the profit of firm. We learnt the various provisions of accounting in case of partnership firm which are used while preparing final accounts of a firm. How are capital accounts maintained in case of partnership firm. This unit is going to be of great help for the students in understanding the concepts of partnership.

2.7 Answer for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-b)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-c)

2.8 Glossary

1. **Manufacturing Account** - An account used to show what it cost to produce the finished goods made by a manufacturing business.
2. **Trading Account** - An account, which shows the gross profit or loss of a manufacturing or retail business, i.e. sales less the cost of sales.

2.9 Assignment

Discuss the provisions relating to accounting of partnership firms.

2.10 Activities

Discuss the various methods of maintenance of capital accounts.

2.11 Case Study

Illustrate the method of distribution of profit among partners in case of partnership firm.

2.12 Further Readings

1. Accountancy, Shukla and Grewal, S. Chand and Company Ltd, 1997.
2. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 2002.
3. Financial Accounting, S. K. Paul, New Central Book Agency (P) Ltd, 2003.
4. Fundamentals of Accounting, S. K. Paul, New Central Book Agency (P) Ltd, 2003.
5. Modern Accountancy, Hanif and Mukherjee, Law Point, 2006.

UNIT 3: ACCOUNTS FOR NON-TRADING CONCERNS AND INSOLVENTS

Unit Structure

3.0 Learning Objectives

3.1 Introduction

3.2 Accounts of Non-Trading Concerns

3.2.1 Receipt and Payment Account

3.2.2 Income and Expenditure Account

3.3 Accounts for Insolvents

3.4 Let Us Sum Up

3.5 Answer for Check Your Progress

3.6 Glossary

3.7 Assignment

3.8 Activities

3.9 Case Study

3.10 Further Readings

3.0 Learning Objectives

After learning this unit, you will be able to understand:

- Prepare accounts of non trading concern.
- Discuss receipt and payment account.
- Draw income and statement account.
- Explain accounts for insolvents.

3.1 Introduction

Proper accounting is essential for non-trading concern to provide the required information. Such institutions prepare receipts and payment account to show the receipts and payments of cash. Income and expenditure account is prepared to know the surplus or deficit for the period. Balance sheet is prepared to know the financial status of the concern.

Insolvency of a person means that he is unable to pay his liabilities. This will mean that bill accepted by him will be dishonoured. Therefore, when it is known that a person has become insolvent, entry for dishonour of his acceptance should be passed. Later something may be received from his estate.

3.2 Accounts for Non-Trading Concerns

The detailed and transparent financial information of non-trading concern can be obtained by preparing receipts and payment account, income and expenditure account as well as balance sheet.

You have an idea of the Cash Book now. Let us give you a brief idea about the other books.

1. **Members' Register** - Most charitable institutions are organised as societies, which are registered with the Registrar of Societies. They are required to keep full Provisions and Reserves record of their subscribers (called members). Hence, they maintain a Members' Register showing their names, addresses, date of admission, etc.
2. **Minutes Books** - The societies function based on decisions taken by the general body of members and their managing committee. They have to keep separate minutes books for recording the proceedings of the meeting of general body and that of the managing committee. Minute's book is a permanent record of the decisions taken from time to time.
3. **Stock Register** - Every society possesses fixed assets like furniture, office equipment, etc. They have to keep a complete record of these items in a register called the Stock Register, which shows date of purchase, quantity purchased the amount at which purchased, etc. Similarly, they also keep a stock register for consumable items like stationery, sports materials, etc.

which, in addition to the details of purchases, will also show their consumption and balances.

The non-trading concerns also maintain a ledger containing the accounts of all incomes, expenses, assets and liabilities. This facilitates the preparation of final accounts at the end of the accounting year.

Non-trading concerns usually maintain their accounts by the double entry system and periodically prepare their final accounts for the submission to their members and subscribers. The method of preparing final accounts by non-trading concerns is different from that of trading concerns.

3.2.1 Receipt and Payment Account

Receipt and payment account is a mere summary of the cashbook for a year. It begins with the cash in hand at the commencement and ends with that at the close of the year. Similarly, to cash account, in receipts and payments account, the receipts are shown on the debit side while payments are shown on the credit side.

3.2.2 Income and Expenditure account

Income and expenditure account is merely another name for profit and loss account. Such type of profit and loss account is generally adopted by non-trading concerns such as clubs, societies, hospitals, etc. This account is credited with all earnings (both realised and unrealised) and debited with all expenses (both paid and unpaid). The difference represents a surplus or deficiency for a given period, which is carried to the capital account. It should be noted that items of receipts or payments of capital nature such as legacies, purchases or sales of any fixed assets must not be included in this account.

Following is the difference between receipt and payment account and Income and expenditures account:

Receipts and Payment Account		Income and Expenditure Account	
1	It is a summary of the cashbook.	1	It takes the place of profit and loss account in non-trading concerns.
2	It begins with an opening balance and ends with a closing balance.	2	Does not commence with any balance.
3	It records all sums received and paid whether they relate to revenue or capital items.	3	It includes revenue items only.
4	It includes all sums actually received during the year whether they relate to the past, current or next year.	4	It includes the items relating to year for which it is prepared. Provision is made for all outstanding expenses and accrued income.
5	The receipts are shown on the debit side and the payments on the credit side.	5	Income is shown on the credit side and expenses on the debit side.
6	It simply ends with a closing balance of cash and does not show the result for the period.	6	It definitely shows whether there has been an excess of income over expenditures or vice versa.

Check your progress 1

- _____ account is a mere summary of the cashbook for a year.
 - Receipt and payment
 - Cash account
 - Cash book
 - Profit and loss account

3.3 Accounts for Insolvents

Insolvency means the inability to pay one's debts as they fall due. Usually used to refer to a business, insolvency refers to the inability of a company to pay off its debts. When a firm appears to be insolvent on the books, it is likely the debt holders will force a response. The company may attempt to restructure the business to alleviate its debt obligations, or be placed in bankruptcy by the debt holders.

When amount is received, the following journal entry is passed:

Cash Account [Dr.]
To Debtor's Personal Account [Cr.]

The remaining amount will be irrecoverable and therefore, should be written off as a bad debt.

Example:

On 1st January 1991, A drew and B accepted a bill at 3 months for \$1,000. On 4th January 1991, A discounted the bill at his bank at 6 percent per annum and remitted half the proceeds to B. On 1st February 1991, B drew and A accepted a bill at 3 months for \$400. On 4th February 1991, B discounted the bill at 6 percent per annum and remitted half the proceeds to A. A and B agreed to share the discount equally.

At maturity, A met his acceptance but B failed to meet his and A therefore had to pay the bill. A drew and B accepted a new bill at 3 months for the original bill plus interest at 6% per annum. On 1st July 1991, B became insolvent and only 50 cents in a dollar were received from him.

Record the above transactions in A's journal and write up B's account.

Solution:

Journal Entries in the Books of A

1991	Bills receivable account		1,000	
Jan. 1	To B			1,000
	(Bill drawn on B)			
Jan. 4	Bank Account		985	

	Discount account		15	
	To Bills receivable account			1,000
	(Bill discounted)			
	B		500	
	To Bank account			492.5
	To Discount account			7.5
	(Half the proceeds remitted to B)			
Feb. 1	B		400	
	To Bills payable account			400
	(Acceptance given)			
Feb. 4	Cash account		197	
	Discount account		3	
	To B			200
	(Half the proceeds received)			
April 4	B		1,000	
	To Bank account			1,000
	(Bill dishonoured)			
	Bills payable account		400	
	To Cash account			400
	(Bill met)			
	B		15	
	To Interest account			15

Accounts of
Sole Traders,
Partnership
Firms, Non-
Trading
Concerns and
Insolvents

	(Interested charged)			
	Bill receivable account		1,015	
	To B			1,015
	(A new bill drawn)			
July 1	B		1,015	
	To Bills receivable account			1,015
	(Bill dishonoured)			
	Cash account		357.5	
	Bad debts account		357.5	
	To B			715
	(B became insolvent and only 50 cents in a dollar received)			

B's Account

1991				
Jan.4	To Bank	492.5	By B/R	1,000
	To Discount	7	By Cash	197
Feb.1	To B/P	400	By Discount	3
April	To Bank	1,000	By B/R	1,015
4	To Interest	15	By Cash	357.5
	To B/R	1015	By Bad Debts	357.5
July 1	Total	2,930	Total	2,930

Check your progress 2

1. _____ means the inability to pay one's debts as they fall due.
 - a. Bad debts
 - b. Insolvency

3.4 Let Us Sum Up

In this unit, our main area of focus was on none trading and the insolvents. These terms were defined and explained in very detail.

We learnt that insolvents are the perosns who have been declared insolvent. In this unit even non trading concerns were explained. We even discussed the importance of preparing final accounts in case of non trading concerns. What type of accounts is prepared in case of non trading concerns? The receipt and payments accounts were discussed in detail. Apart from this income and expenditure account have even been discussed in detail.

This unit is going to be of great help for the students in understanding the concepts insolvency and what type of accounting is done in the particular case of insolvency.

3.5 Answer for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-b)

3.6 Glossary

1. **Closing Balance** - The balance of an account at the end (or close), of an accounting period. This figure is then carried forward to the next accounting period.

2. **Closing Stock** - Closing stock is the stock of inventory available with the business at the end of the accounting period.

3.7 Assignment

From the following figures extracted from the books of Shri Govind, you are required to prepare a trading and profit and loss account for the year ended 31st March, 1999 and abalance sheet as on that date after making the necessary adjustments.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Shri Govind's Capital	2,28,800	Stock 1.4.1999	38,500
Shri Govind's Drawings	13,200	Wages	35,200
Plant and Machinery	99,000	Sundry Creditors	44,000
Freehold Property	66,000	Postage and Telegrams	1,540
Purchases	1,10,000	Insurance	1,760
Returns Outwards	1,100	Gas and Fuel	2,970
Salaries	13,200	Bad Debts	660
Office Expenses	2,750	Office Rent	2,860
Office Furniture	5,500	Freight	9,900
Discounts A/c (Dr.)	1,320	Loose Tools	2,200
Sundry Debtors	29,260	Factory Lighting	1,100
Loan to Shri Krishna @ 10% p.a. – balance as on 1.4.1999	44,000	Provision of D/D	880

Cash at Bank	29,260	Interest on loan to Shri Krishna	1,100
Bills Payable	5,500	Cash in Hand	2,640
		Sales	2,31,440

Adjustments:

- Stock on 31st March, 1999 was valued at Rs. 72,600.
- A new machine was installed during the year costing Rs.15, 400, but it was not recorded in the books as no payment was made for it. Wages Rs.1, 100 paid for its erection have been debited to wages account.
- Depreciate:
 - Plant and Machinery by 33.33 %
 - Furniture 10%
 - Freehold Property by 5%
- Loose tools were valued at Rs.1, 760 on 31.03.1999.
- Of the Sundry Debtors Rs.600 are bad and should be written off.
- Maintain a provision of 5% on Sundry Debtors for doubtful debts.
- The manager is entitled to a commission of 10% of the net profits after charging such commission.

[Ans.: Gross Profit: Rs. 1,08,570, Net Profit: Rs. 40,800, Balance Sheet total: Rs. 3,25,380.]

3.8 Activities

Rishikesh had a small business enterprise. He has given the trial balance as on 31st March, 2006 as below.

Particulars	Debit Rs	Credit Rs.
Mr. Rishikesh's capital		100000
Machinery	36000	
Depreciation on machinery	4000	
Repairs to machinery	5200	
Wages	54000	
Salaries	21000	
Income tax of Mr. Rishikesh	1000	
Cash in had	4000	
Land and building	149000	
Depreciation on building	5000	
Purchases	250000	
Purchase returns		3000
Sales		498000
Citi Bank		7600
Accrued Income	3000	
Salaries outstanding		4000
Bills receivables	30000	
Provision for doubtful debts		10000

Bills payable		16000
Bad debts	2000	
Discount on purchases		7080
Debtors	70000	
Creditors		62520
Opening stock	74000	
Total	708200	708200

Additional information:

- Stock as on 31st March 2006 was valued at Rs 60000.
- Write off further Rs 6000 as bad debt and maintain a provision of 5% on doubtful debt.
- Goods costing Rs 10000 were sent on approval basis to a customer for Rs 12000 on 30th March 2006. This was recorded as actual sales.
- Rs 2400 paid as rent for office was debited to Landlord's a/c and was included in debtors.
- General Manager is to be given commission at 10% of net profits after charging works manager's and his commission.
- Works manager is to be given a commission at 12% of net profit before charging General Manager's commission and his own.

You are required to prepare final accounts in the books of Mr. Rishikesh.

3.9 Case Study

The following is the Schedule of balances as on 31.03.1998 extracted from the books of Shri. Joshi, who carries on business under the name and style of Messrs Ramesh Joshi and Co. at Pune.

Particulars	Dr. Amount (Rs.)	Cr. Amount (Rs.)
Cash in Hand	1,400	
Cash at Bank	2,600	
Sundry Debtors	86,000	
Stock as on 1.4.1997	62,000	
Furniture and Fixture	21,400	
Office Equipment	16,000	
Buildings	60,000	
Motor Car	20,000	
Sundry Creditors		43,000
Loan from Joshi		30,000
Reserve for Bad Debts		3,000
Purchases	1,40,000	
Purchase Returns		2,600
Sales		2,30,000
Sales Returns	4,200	
Salaries	11,000	
Rent for Godown	5,500	

Interest on loan from Mr. Joshi	2,700	
Rates and Taxes	2,100	
Discount received from Creditors		1,600
Freight on purchase	1,200	
Carriage Outward	2,000	
Drawings	12,000	
Printing and Stationery	1,800	
Electric Charges	2,200	
Insurance Premium	5,500	
General Office Expenses	3,000	
Bad Debts	2,000	
Bank Charges	1,600	
Motor Car Expenses	3,600	
Capital Account		1,62,000

Prepare trading and profit and loss account for the year ended on 31st March 1998 and the balance sheet as at that date after making provision for the following:

- 1 Depreciate Building by 5%
- 2 Furniture and Fixtures by 10%: one steel table purchased during the year for Rs.1, 400 was sold for same price but the wrongly credited to sales account.
- 3 Office Equipment by 15%: Purchases of a typewriter during the year for Rs.4, 000 has been wrongly debited to purchases account.
- 4 Motor Car by 20%
- 5 Value of Stock at the close of the year was Rs.44, 000.

- 6 One month rent for godown is outstanding.
- 7 One month salary is outstanding.
- 8 Interest on Loan from Joshi is payable @12% p.a.
- 9 Reserve for Bad debts is to be maintained at 5% on sundry debtors.
- 10 Insurance premium includes Rs.4, 000 paid towards proprietor's life insurance policy and the balance of the insurance charges cover the period from 1.4.1997 to 30.6.1998.
- 11 Half of the building is used for residential purposes of Shri Joshi.

3.10 Further Readings

1. Accountancy, Shukla and Grewal, S. Chand and Company Ltd, 1997
2. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 2002
3. Financial Accounting, S. Kr. Paul, New Central Book Agency (P) Ltd, 2003
4. Fundamentals of Accounting, S. K. Paul, New Central Book Agency (P) Ltd, 2003
5. Modern Accountancy, Hanif and Mukherjee, Law Point, 2006

Block Summary

In this block a very detailed discussion was made on the portion of final accounts. As discussed earlier that financial accounts is an important tool through which we measure the performance of a business during a particular financial year.

The main function and objective of accounting is to ascertain how much profit or loss a business organisation has made during any accounting period and to determine its financial position on a given date. Trial balance gives the required input for the preparation of these accounts or statements. These final accounts provides vital information to various interested groups, viz. shareholders, investors, creditors, employees, management and government agencies, etc. The Income statement basically is divided in two major portions and they are Trading account and Profit and Loss account. The purpose of trading account is to know the result of trading operation; it gives us the gross profit or gross loss of a business during an accounting period, usually a year. Whereas the profit and loss account includes all the indirect expenses and it shows the net profit. Accounting treatment of partnership firm is almost similar to that of a sole proprietorship business. Individuals or institutions with activities other than trade are known as non-trading concerns.

In the above block we studied in very detail the importance of preparing accounts of sole traders, partnership firms and non trading concerns. It also helped us knowing the process through which we can prepare the final accounts and the method through which we can make analysis on the basis of these financial statements.

Block Assignment

Short Answer Questions.

Write a brief note on the following:

1. Sole tradership
2. Partnership firm
3. Non trading concern

Long Answer Questions

1. Explain the process of preparing final accounts in case of a sole proprietor.
2. Explain the method of preparing final accounts in case of partnership.
3. Briefly discuss the method of preparing final accounts in case of non trading concerns.

Enrolment No.

1. How many hours did you need for studying the units?

Unit No	1	2	3	4
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Language and Style	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Illustration used (Diagram, tables etc)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Conceptual Clarity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Check your progress Quest	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____
Feed back to CYP Question	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____ _____

3. Any Other Comments.

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*Education is something
which ought to be
brought within
the reach of every one.*

”

- Dr. B. R. Ambedkar



Dr. Babasaheb Ambedkar Open University
'Jyotirmay Parisar', Opp. Shri Balaji Temple, Sarkhej-Gandhinagar Highway, Chharodi,
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FINANCIAL ACCOUNTING

PGDF-101

BLOCK 3: JOINT VENTURE, BILLS AND DEPRECIATION



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FINANCIAL ACCOUNTING



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ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)



PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included many tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!



FINANCIAL ACCOUNTING

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FINANCIAL ACCOUNTING

BLOCK 3: JOINT VENTURE, BILLS AND DEPRECIATION

UNIT 1

JOINT VENTURE, BILLS OF EXCHANGE AND
ACCOMMODATION BILLS

03

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DEPRECIATION AND METHODS OF DEPRECIATION

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BLOCK 3: JOINT VENTURE, BILLS AND DEPRECIATION

Block Introduction

In this block, we will study joint ventures, bills of exchange, accommodation bills and depreciation. Let us get a brief idea of all of them one by one.

A joint venture is a business agreement in which parties agree to develop, for a finite time, a new entity and new assets by contributing equity. They exercise control over the enterprise and consequently share revenues, expenses and assets. A joint venture takes place when two parties come together to take on one project. In a joint venture, both parties invest equally in the project in terms of money, time and effort to build on the original concept. While joint ventures are generally small projects, major corporations also use this method in order to diversify. A joint venture can ensure the success of smaller projects for those that are just starting in the business world or for established corporations. Since the cost of starting new projects is generally high, a joint venture allows both parties to share the burden of the project as well as the resulting profits. A Bill of Exchange is a document contemplated by a contract, which (1) warrants the payment of money, the promise of or order for conveyance of which is unconditional; (2) specifies or describes the payee, who is designated on and memorialised by the instrument and (3) is capable of change through transfer by valid negotiation of the instrument. As payment of money is promised subsequently, the instrument itself can be used by the holder in due course as a store of value; although, instruments can be transferred for amounts in contractual exchange that are less than the instrument's face value (known as "discounting").

So in this block we will be studying joint venture and how we do its accounting as well as we will be covering the topics of bill of exchange and depreciation.

Block Objective

After learning this block, you will be able to understand:

- Joint Venture.
- Advantages and disadvantages of Joint Venture.
- bills of exchange and its classification.
- Accommodation bills, trade bill.
- Discuss trade bill.
- Joint ventures and partnerships.

Block Structure

Unit 1: Joint Venture, Bills of Exchange and Accommodation Bills

Unit 2: Depreciation and Methods of Depreciation

UNIT 1: JOINT VENTURE, BILLS OF EXCHANGE AND ACCOMMODATION BILLS

Unit Structure

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1.2.1 Joint Ventures Versus Partnerships

1.2.2 Joint Venture and Partnership

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1.5 Let Us Sum Up

1.6 Answer for Check Your Progress

1.7 Glossary

1.8 Assignment

1.9 Activities

1.10 Case Study

1.11 Further Readings

1.0 Learning Objectives

After learning this unit, you will be able to understand:

- State the meaning and definition of a Joint Venture.
- Enumerate the advantages and disadvantages of a Joint Venture.
- Define bills of exchange.
- Explain the features and classifications of bills of exchange.
- Record the transactions of Bills of exchange and accommodation bills.
- Describe an accommodation bill.
- Discuss the trade bill.
- Differentiate between joint ventures and partnerships.

1.1 Introduction

A joint venture is a strategic alliance where two or more people or companies agree to contribute goods, services and/or capital to a common commercial enterprise.

Sounds like a partnership. However, legally, joint ventures and partnerships are not the same thing. A joint venture is a strategic alliance between two or more individuals or entities to engage in a specific project or undertaking. Partnerships and joint ventures can be similar but in fact can have significantly different implications for those involved. A partnership usually involves a continuing, long-term business relationship, whereas, a joint venture is based on a single business project.

1.2 Meaning and Definition of Joint Venture

A joint venture is a contractual business undertaking between two or more parties. It is similar to a business partnership, with one key difference: a partnership generally involves an ongoing, long-term business relationship,

whereas a joint venture is based on a single business transaction. Individuals or companies choose to enter joint ventures in order to share strengths, minimise risks and increase competitive advantages in the marketplace. Joint ventures can be distinct business units (a new business entity may be created for the joint venture) or collaborations between businesses. In collaboration, for example, a high-technology firm may contract with a manufacturer to bring its idea for a product to market; the former provides the knowledge, the latter the means.

1.2.1 Joint Ventures Versus Partnerships

The main difference between a joint venture and a partnership is that the members of a joint venture have teamed together for a particular purpose or project, while the members of a partnership have joined together to run "a business in common".

Each member of the joint venture retains ownership of his or her property.

In addition, each member of the joint venture shares only the expenses of the particular project or venture.

Tax-wise, there are also differences between joint ventures and partnerships. As a member of a joint venture, you will receive a share of the profits, which will be taxed according to whatever business structure you have set up. So, for instance, if you operate a sole proprietorship, your joint venture profits will be taxed just as any other business income would.

Joint ventures enjoy tax advantages over partnerships, too. Capital Cost Allowance (CCA) is treated differently. While those in partnerships have to claim CCA according to partnership rules, those in joint ventures can choose to use as much or little of their CCA claim as they like. And joint ventures do not have to file information returns, unlike partnerships.

1.2.2 Joint Venture and Partnership

Though joint venture is in the nature of a temporary partnership, it is not a partnership in the strict legal sense. Both in joint venture and partnership, some business is carried on by two or more persons and the profits are shared by all of them. However, there are some basic differences between the two. They are as follows:

Difference between partnership and joint venture

Partnership	Joint Venture
<ol style="list-style-type: none"> 1. A partnership firm always has a name. 2. It is of a continuous nature. 3. Separate set of books have to be maintained 4. No partner can carry on a similar business. 5. Though the registration of partnership is not compulsory, but it is considered desirable. 6. A minor can also be admitted to the benefits of the firm. 	<ol style="list-style-type: none"> 1. There is no need of firm name. 2. It ends as soon as the work is completed. 3. There is no need for a separate set of books; the accounts can be maintained even in one of the co-venture's books. 4. The co-ventures are free to carry on the business of a similar nature. 5. There is no need for registration at all. 6. A minor cannot be a co-venture as he is incompetent to enter into a contract.

1.2.3 Creating a Joint venture

1. The first step to creating a joint venture is to set your goals and decide what you want your joint venture to do. If you need help getting started with this, look at the four things a joint venture can do is listed at the beginning of this article, pick one and then develop a goal that is as specific as possible.
2. Then it is time to look for the like-minded people or firms that might be interested in the same goal or goals you want to pursue. Look in the business groups you already belong to, both in person and virtually. Use your social networking connections. Study business listings in the phone book or on Web sites to find those that might share your goals.
3. Moreover, be open to being asked. Once you start talking to other people about what you might do together, a joint venture idea you have not even thought of might pop up; one with a lot of potential.

Once you have found the people to share in a joint venture, be sure to have it all put into writing in a joint venture agreement. It is strongly recommended that you hire a legal professional for this.

So instead of dismissing an opportunity as out of your reach, start thinking instead about how you could participate with a joint venture. Properly planned and executed, joint ventures can help your small business go where it is never been able to go before.

There are many good business and accounting reasons to participate in a Joint Venture (JV). Collaborating with a business that has complementary abilities and resources, such as finance, distribution channels or technology, makes good sense. These are just some of the reasons partnerships formed by joint venture are becoming increasingly popular.

Parties enter joint ventures to gain individual benefits, usually a share of the project objective. This may be to develop a product or intellectual property rather than joint or collective profits, as is the case with a general or limited partnership.

A joint venture, such as a general partnership is not a separate legal entity. Revenues, expenses and asset ownership usually flow through the joint venture to the participants, since the joint venture itself has no legal status. Once the Joint venture has met its goals, the entity ceases to exist.

1.2.4 Advantages of Forming a Joint Venture

Following are the various advantages of forming a Joint Venture:

- It provides companies with the opportunity to gain new capacity and expertise.
- It allows companies to enter related businesses or new geographic markets or gain new technological knowledge.
- It provides Access to greater resources, including specialised staff and technology.
- It helps in sharing of risks with a venture partner.
- Joint ventures can be flexible. For example, a joint venture can have a limited life span and only cover part of what you do, thus limiting both your commitment and the business' exposure.

- In the era of divestiture and consolidation, JV's offer a creative way for companies to exit from non-core businesses.
- Companies can gradually separate a business from the rest of the organisation and eventually, sell it to the other parent company. Roughly 80% of all joint ventures end in a sale by one partner to the other.

1.2.5 The Disadvantages of Joint Ventures

It takes time and effort to build the right relationship and partnering with another business can be challenging. Problems are likely to arise if:

- The objectives of the venture are not 100 per cent clear and communicated to everyone involved.
- There is an imbalance in levels of expertise, investment or assets brought into the venture by the different partners.
- Different cultures and management styles result in poor integration and co-operation.
- The partners do not provide enough leadership and support in the early stages.
- Success in a joint venture depends on thorough research and analysis of the objectives.

Joint venture agreement: It is a contractual agreement between two or more business partners to assume a common business strategy on a project. All partners generally agree to share the profits and losses through their common shareholdings. A contractual agreement between two or more business partners to assume a common business strategy on a project. All partners generally agree to share the profits and losses through their common shareholdings.

1.2.6 Joint Venture and Consignment

Even though both consignment and joint venture are in the nature of an agreement between different parties, there are many points of difference between the two. The main points of difference are as follows:

Difference between joint venture and consignment

Consignment	Joint Venture
<ol style="list-style-type: none"> 1. Normally two persons are involved – the consignor and the consignee. 2. The relationship between the consignor and the consignee is that of principal and agent. 3. The arrangement may continue for a long time. 4. The funds are provided by the consignor. 5. The consignee acts merely as an agent and has to follow the instructions of the consignor. 6. Consignment is generally concerned with the sale of movable goods. 	<ol style="list-style-type: none"> 1. Number of co-ventures is usually two, but it may also be more than two. 2. The relationship between co-ventures is that of partnership. 3. The relationship ends as soon as the venture is completed. 4. All the co-ventures contribute to a common pool. 5. The co-ventures have equal authority to take decisions. 6. Joint venture may be for sale of goods or for carrying on any other activity like construction of building, investment in shares, etc.

Check your progress 1

1. A _____ is a contractual business undertaking between two or more parties.
 - a. joint venture
 - b. partnership
 - c. sole proprietorship

1.3 Bill of Exchange

A bill of exchange or "draft" is a written order by the drawer to the drawee to pay money to the payee. A common type of bill of exchange is the cheque, defined as a bill of exchange drawn on a banker and payable on demand. Bills of exchange are used primarily in international trade and are written orders by one person to his bank to pay the bearer a specific sum on a specific date. Prior to the

advent of paper currency, bills of exchange were a common means of exchange. They are not used as often today.

1.3.1 Meaning and Definition of Bill of Exchange

A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at fixed or determinable future time a sum certain in money to order or to bearer. (Sec.126)

It is essentially an order made by one person to another to pay money to a third person.

A bill of exchange requires in its inception three parties: the drawer, the drawee and the payee.

The person who draws the bill is called the drawer. He gives the order to pay money to third party. The party upon whom the bill is drawn is called the drawee. He is the person to whom the bill is addressed and who is ordered to pay. He becomes an acceptor when he indicates his willingness to pay the bill. (Sec.62) The party in whose favour the bill is drawn or is payable is called the payee.

The parties' need not all be distinct persons. Thus, the drawer may draw on himself payable to his own order. (See Sec. 8)

A bill of exchange may be endorsed by the payee in favour of a third party, who may in turn endorse it to a fourth and so on indefinitely. The "holder in due course" may claim the amount of the bill against the drawee and all previous endorsers, regardless of any counter claims that may have disabled the previous payee or endorser from doing so. This is what is meant by saying that a bill is negotiable.

In some cases, a bill is marked "not negotiable". In that case, it can still be transferred to a third party, but the third party can have no better right than the transferor.

When a bill of exchange is negotiated i.e., transferred from one person to another person so as to constitute the transferee the holder of a bill, each person through whose hands it passes, must write his name on the back of the bill. This is known as the "endorsement of a bill of exchange". Some times the drawer of the bill does not keep the bill with him until the date of the maturity. He endorses it to

some other party in payment of the debt due from him. When the bill is endorsed to any other party the journal entries will be:

Drawer's Books

When a bill of exchange is endorsed:

Endorsee's personal account [Dr.]

To Bills receivable account [Cr.]

Acceptor's Books:

His books remain unaffected. He will pay it on the due date to the holder and usual entry for the payment will be passed:

Endorsee's Books:

When he will receive an endorsed bill, he will treat it just like an ordinary bill:

Bill receivable account [Dr.]

To Transfer's personal account [Cr.]

Example:

A bill for \$2,000 is drawn by P on Q and accepted by the later. P transfers it to his creditor R. On the due date, the acceptance is duly met.

Record the above transactions in the books of P, Q and R.

Journal Entries in the Books of P

Bills receivable account		2,000	
To Q			2,000
(Acceptance received)			
R		2,000	
To Bank for collection account			2,000
(Bill endorsed)			

Journal Entries in the Books of Q

P		2,000	
To Bills payable account			2,000
(Acceptance given)			
Bills payable account		2,000	
To Cash account			2,000
(Bill paid)			

Journal Entries in the Books of R

Bill receivable account		2,000	
To P			2,000
(Bill received from a debtor - Q)			
Cash account		2,000	
To Bill receivable account			2,000
(amount of the bill received)			

1.3.2 Features of Bill of Exchange

1. It must be in writing.
2. It must contain an order.
3. The order must be unconditional.

4. It must be signed by the maker of the instrument.
5. It is made by the creditor.
6. It must be for a specified amount and specified period.
7. It should be duly accepted by the debtor.

1.3.3 Classification of Bills of Exchange

For the purpose of accounting, bills are classified under two heads:

- Bills receivable
- Bills payable

1. **Bills Receivable** - A bill of exchange is treated as a bill receivable by one who is entitled to receive the sum due on it. When we draw a bill or receive it by endorsement from our debtors, it is our bill receivable (B/R) and on maturity of such bill if it is held up to that time, we shall receive specified amount from the acceptor.
2. **Bills Payable** - A bills payable is regarded as bill payable by one who has to pay it on the due date. When we accept a bill and thereby become liable to pay on its maturity, it is our bill payable (B/P).

It means the same bill is a bill receivable to one party and a bill payable to the other.

The accounting aspect of a bill of exchange can be divided into following parts:

- When a bill is drawn, accepted and discharged.
- When the drawer discounted it with the bank.
- When the drawer sends it for collection to the banker.
- When the drawer endorses it to a third party.
- When a bill is dishonoured.
- When a bill is renewed for another period of time.
- When a bill is retired.
- When there is an accommodation bill (including the insolvency of one of the parties).

1.3.4 Recording Transactions of Bill of Exchange

1. **Discounting a bill of exchange** - Make journal entries in the books of creditor and debtors at the time of discounting of bill of exchange.

If the holder of a bill is in need of money, before the due date of the bill, he may sell it to the bank. The bank (buyer) will give cash for it in consideration of a small charge. This is called discounting the bill. The amount deducted by bank of the bill from the face value of the bill is called "discount". The discount is usually calculated at a certain rate per annum on the amount of the bill. The accounting entries will be:

Creditor's Books

- a. When a bill of exchange is discounted:

Bank account (discounted value) [Dr.]

Discount account (amount of discount) [Dr.]

To Bills receivable account [Cr.]

Debtor's Books:

The acceptor has no concern with the discounting of the bill. He has to pay it on the due date to the holder. Whoever he may be, there will be no journal entry for discounting of the bill of exchange.

Example:

1. X draws a three month bill for Rs. 2,000 on Y on the 1st January, 1991 for the value received. Y accepts it and returns it to X, who discounts it on 4th January, 1991 with his bank at 6 per cent per annum. Y pays acceptance on the due date.

Record the transactions in the books of X and Y.

Journal Entries in the Books of X

1991				
Jan. 1	Bills receivable account		2,000	

	(Acceptance received)			
Jan. 4	Bank account		1,970	
	Discount account		30*	
	To Bills receivable account			2,000
	(Bill discounted at bank)			

Calculation of discount: $2000 \times 6/10 \times 3/12$

Journal Entries in the Books of Y

1991				
Jan. 1	X		2,000	
	To Bills payable account			2,000
	(Acceptance given)			
Apr. 2	Bills payable account		2,000	
	To Cash account			2,000
	(Acceptance paid)			

2. **Bill of exchange for Collection** - When a person receives a bill, he may keep it till the date of maturity in order to receive the full amount. But in order to ensure safety, he may send it to his bank with the instructions that the bill should be retained till maturity and should be realised on that date. This does not mean discounting of bill. The bank will not credit the customer or client until the amount is actually realised. If the bill is sent to the bank with such instructions it is known as "bill sent for collection". It will be recorded in the books of the creditor as under:

Creditor's Books

- a. When a bill of exchange is sent to the bank for collection:

Bank for collection account [Dr.]

To Bills receivable account [Cr.]

- b. On receipt of information from the bank as to collection of the bill on the due date:

Bank account [Dr.]

To Bank for collection account [Cr.]

Debtor's Books:

No entries are recorded in debtor's books. He has no concern with collection of bills.

Banker's Books:

If the bill is received by bank from its customer for collection, there will be no entry until the bill is collected, when the bill is collected, the following entry will be passed:

Cash account [Dr.]

To Customer's personal account [Cr.]

To Collection charges account [Cr.]

Example:

P sold goods worth \$1,000 to Q on credit for which a bill was drawn by P on Q. It was duly accepted by Q. P sent the bill to his banker for collection and the bank charged \$5 for collecting the bill. The bill was met by Q on the due date.

Record the above transactions in the books of P, Q and bank.

Journal Entries in the Books of P

Q		1,000	
To Sales account			1,000

Joint Venture,
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and
Accommodation
Bills

(Goods sold on credit)			
Bills receivable account		1,000	
To Q			1,000
(Acceptance received)			
Bank for collection account		1,000	
To Bills receivable account			1,000
(Bill sent to bank for collection)			
Bank account		995	
Bank charges account		5	
To Bank for collection account			1,000
(acceptance collected by the bank)			

Journal Entries in the Books of Q

Purchases account		1,000	
To P			1,000
(Acceptance given)			
P		1,000	
To Bills payable account			1,000
(Acceptance given)			
Bills payable account		1,000	
To Cash account			1,000
(Bill paid)			

Journal Entries in the books of bank

Cash account		1,000	
To P			995
To Collection charges account			5
(Being the proceeds of a bill is collected)			

Note: When the bill is received by the banker from P for collection, there will be no entry in the books of the bank until the bill is collected.

3. **Renewal of a Bill of Exchange** - When the acceptor of a bill finds himself unable to make payment of the bill on the due date, he may request the drawer of the bill, before it is due, to cancel the original bill and draw on him a new bill for an extended period. This is called renewing a bill of exchange. The acceptor has to pay interest for the extension of time. The new bill therefore, includes not only the amount of the original bill but also interest, etc. Journal entries in this case are:

Creditor's Books:

In this case, first of all, entries recording the original bill will be cancelled. Next entry for interest would be passed. A further entry will be passed for a new bill of exchange.

- a. When the old bill is cancelled:
- Personal account of the acceptor [Dr.]
 To Bill receivable account [Cr.]
- b. When interest is charged by the drawer:
- Personal account of the acceptor [Dr.]
 To Interest account [Cr.]
- c. When acceptance on new bill is received:
- Bill receivable account [Dr.]
 To Acceptor's personal account [Cr.]

Debtor's Books:

Debtor will make the following entries in his books:

- a. When the old bill is cancelled:

Bill payable account [Dr]

To drawer's account [Cr]

- b. When interest is charged by the drawer:

Interest account [Dr]

To drawer's account [Cr]

- c. When a fresh bill is accepted:

Drawer's account [Dr]

To bill payable account [Cr]

Example 1:

P draws a bill for \$2,000 on Q who accepts and returns it to P. When the bill was about to mature, Q expressed his inability to meet it and request to P to renew it. P agrees but adds \$10 to the new bill for interest. Give necessary journal entries in the books of P and Q when the bill is renewed.

Solution:

Journal Entries in the Books of P

Bills receivable account		2,000	
To Q			2,000
(Acceptance received)			
Q		2,000	
To Bills receivable account			2,000
(bill dishonoured)			
Q		10	
To Interest account			10

Joint Venture,
Bills and
Depreciation

(Being the interest charged for renewal of abill)			
Bills receivable account		2,010	
To Q			2,010
(Being the new bill accepted.)			

Journal Entries in the Books of Q

P		2,000	
To Bills payable			2,000
(Acceptance given)			
Bill payable		2,000	
To P			2,000
(bill dishonoured - cancelled)			
Interest account		10	
To P			10
(Being the interest charged for renewal of abill)			
P		2,010	
To bill payable			2,010
(Acceptance given.)			

Example 2:

X having accepted a bill for \$450 is unable to meet the same. Before the due date, he requests Y, the drawer of the bill, to receive \$310 in cash (\$10 being for

interest) and to draw on him a new bill for a period of 3 months for \$150 and cancel the old bill which is about to due. Y agrees to this proposal.

Show the journal entries in the books of X and Y.

Journal Entries in the Books of Y

X		450	
To Bills receivable account			450
(old bill cancelled)			
Cash account		310	
To X			300
To Interest account			10
(Being the amount received from X including interest)			
Bills receivable account		150	
To Q			150
(Acceptance received)			

Journal Entries in the Books of X

Bill payable account		450	
To Y			450
(Old bill cancelled)			
Y		300	
Interest account		10	
To Cash account			310

(Being the amount received from X including interest)			
Y		150	
To Bill payable			

Dishonour of a Bill of Exchange - A bill of exchange is said to be dishonoured when the drawee refuses to accept or make payment on the bill. A bill may be dishonoured by non-acceptance or non-payment.

Journal entries on the dishonour of the bill of exchange:

Creditor's Books:

At the time a bill is dishonoured, it may be either with the drawer or with his banker with whom he has discounted it or with a creditor of whose favour he may have endorsed it:

- a. When the bill of exchange is still in the drawer's possession:

Acceptor's personal account (full value of the bill and noting charges) [Dr.]

To Bills receivable account [Cr.]

To Cash account (noting charges) [Cr.]

- b. When the bill of exchange has been discounted with the bank:

Acceptor's personal account [Dr.]

To Bank [Cr.]

Note: The amount will include the noting charges. No separate entry will be passed for noting charges as in case (a) above.

- c. When the bill of exchange has been sent for collection:

Acceptor's personal account [Dr.]

To Bank for collection account [Cr.]

- d. When the bill of exchange has been sent for collection:

Acceptor's personal account [Dr.]

To Personal account of creditor [Cr.]

It may be noted that in all four cases the drawer debits the acceptor's credits that party's account who presents the bill for payment.

Debtor's Books:

When the bills payable is dishonoured the debtor has to pass the same journal entry in all the cases the journal entry is:

Bill payable account (full value of the bill) [Dr.]

Trade expenses account (noting charges) [Dr.]

To personal account of drawer [Dr.]

Example 1:

P draws a bill on Q for \$2,000 who accepts and returns it to P on the same date. The bill is dishonoured by Q on the due date. P pays \$30 as noting charges.

Record the above transactions in the books of P and Q.

Solution:

Journal Entries in the Books of P

Bills receivable account		2,000	
To Q			2,000
(Acceptance received)			
Q		2,030	
To bills receivable account			2,030
To cash account			30
(Bill endorsed)			

Journal entries in the Books of Q

P		2,000	
To bills payable account			2,000
(Acceptance given)			
Bills payable account		2,000	
Trade expense account		30	
To P			2,030
(Acceptance dishonoured and noting charges paid)			

Journal Entries in the Books of R

Bill receivable account		2,000	
To P			2,000
(Bill received from a debtor - Q)			
Cash account		2,000	
To bill receivable account			2,000
(amount of the bill received)			

Example 2:

On 1st January, 1991, P draws on Q a three months bill for \$2,000 who accepts and returns it to P on the same date. On 4th January, P discounts it with his bank at 6% per annum. The acceptance is dishonoured in the due date and bank pays \$30 as noting charges.

How these transactions should be recorded in the journal of P and Q.

Solution:

Journal Entries in the Books of P

1991				
Jan. 1	Bills receivable		2,000	
	To Q			2,000
	(Acceptance received)			
Jan. 4	Bank account		1,970	
	Discount account		30	
	To bills receivable account			2,000
	(bill discounted)			
April 4	Q		2,030	
	To bank account			2,030
	(Q's acceptance dishonoured)			

Journal entries in books of Q

1991				
Jan. 1	P		2,000	
	To bills payable account			2,000
	(Acceptance given)			
April 4	Bills payable account			
	Trade expense			
	To P			
	(Bill dishonoured, noting charges paid.)			

Example 3:

P draws a bill for \$2,000 on Q who accepts and returns it to P on the same date. P sent the bill to his banker for collection. On the due date, the bill is dishonoured by Q. Give journal entries in the books of P.

Solution:

Bills receivable account		2,000	
To Q			2,000
(Acceptance received)			
Bank for collection account		2,000	
To bills receivable account			2,000
(Bill sent for collection)			
Q			
To bank for collection account			

Check your progress 2

1. A bill of exchange is treated as a _____ by one who is entitled to receive the sum due on it.
 - a. bill payable
 - b. bill receivable

1.4 Accommodation Bill

Generally, a bill of exchange is drawn by a creditor on his debtor to settle a trade debt. A creditor is a person who has sold goods on credit basis and a debtor is a person who has purchased goods on credit basis. Thus, a bill, which is drawn by a creditor and accepted by a debtor, is known as a trade bill of exchange. On the other hand, a bill of exchange, which is drawn to oblige a friend, to give him a temporary assistance, to provide him a loan, or to accommodate one or more parties, is called 'an accommodation bill'. Such a bill is drawn and accepted without any sale and purchase of goods, as the bill is drawn to fulfill the temporary need of money. The bill will be discounted and cash will be received immediately.

1.4.1 Difference between Trade Bill and Accommodation Bill:

Following is the distinction between a trade bill of exchange and an accommodation bill of exchange.

Difference between trade bill and accommodation bill

Trade Bill		Accommodation Bill	
1	Trade bills are drawn for trade purposes.	1	Accommodation bills are drawn and accepted for financial assistance.
2	These are drawn against proper consideration.	2	These are drawn in absence of any consideration.
3	These bills are proof of debt.	3	These are not a proof of debt.
4	If discounted, full sum retains with holder of the bill.	4	If discounted the amount may be divided between drawer and acceptor in pre-determined ratio.
5	For obtaining the debt from drawee, drawer can resort to legal action.	5	Legal action cannot be resorted to for recovery of amount against these bills by the immediate parties.

1.4.2 Recording Transactions of Accommodation Bills

The bookkeeping entries in connection with accommodation bills are made in the same way as for genuine bills. Generally, there are three methods of raising money on accommodation bills. They are as under:

- When accommodation bill is written for the accommodation of the drawer.
- When accommodation bill is written for the mutual accommodation of the drawer and the drawee.
- When the drawer and the drawee write accommodation bills on each other.

All these bills have been discussed below.

1. **Accommodation of the drawer:** When a bill is written for the accommodation of the drawer then the drawee of the bill accepts the bill without any consideration and returns the bill to the drawer. The drawer gets the bill discounted with his bank and uses the amount in his business. On the due date, he remits the amount to the acceptor or the bill to enable him to honour the bill on the due date.

Example (Accommodation of the Drawer):

A accepts a bill drawn by B for his accommodation on 1st January, 1991 for \$500 at 3 months. The bill is discounted \$ 490 on 4th January. On due date B sends a cheque to A to meet the bill. A duly honours his acceptance.

Pass journal entries in the books of both the parties.

Solution:

Journal Entries in the books of B				
1991			500	
Jan. 1	Bills receivable account			500
	To A			
	(Bills drawn on A)			
Jan. 4	Bank account		490	
	Discount account		10	

	To Bill receivable account			500
	(Bill discounted)			
April 4	A		500	
	To bank account			500
	(Cheque sent to A)			
Journal entries in the books of A				
1991				
Jan. 1	B		500	
	To bill payable account			500
	(Acceptance given)			
April 4	Cash account		500	
	To B			500
	(Cheque received)			
April 4	Bills payable account		500	
	To cash account			500
	(Acceptance met)			

- 2. Accommodation of the Drawer and the Drawee:** When a bill is drawn by one party for the mutual accommodation then the drawee after accepting the bill returns to the drawer. The drawer gets the bill discounted with his banker and after retaining the agreed portion of the proceeds of the bill remits rest of the proceeds to the acceptor of the bill. On the date of maturity, the drawer of the bill remits rest to the acceptor the amount retained by him earlier to enable the acceptor to honour the bill. The expenses of discount are shared by the parties.

Example (Accommodation of the Drawer and the Drawee):

For mutual convenience of X and Y, X draws a bill for \$1,000 on Y at three months on 1st January, 1991. The bill is discounted on 4th January by X at 6 per cent per annum with his bank: half the proceeds being handed over to Y. On the bill falling due date, X remits \$500 by cheque to Y who then pays the bill.

Pass journal entries in the books of X and Y.

Solution:

Journal Entries in the Books of X				
1991				
Jan. 1	Bills receivable account		1,000	
	To Y			1,000
	(Bill drawn on Y)			
Jan. 4	Bank account		985	
	Discount account		15	
	To Bills receivable account			1,000
	(Bill discounted)			
April 4	Y		500	
	To cash account			492.5
	To discount account			7.5
	(Half the proceeds remitted)			
April 4	Y		500	
	To cash account			500
	(Cheque sent to him)			

Journal entries in the books of X				
1991				
Jan. 1	X		1,000	
	To bills payable account			1,000
	(Acceptance given)			
Jan. 4	Cash account		492.5	
	Discount account		7.5	
	To X			500
	(Half the proceeds received)			
April 4	Cash account		500	
	To X			500
	(Cheque received from him)			
April 4	Bills payable account		1,000	
	To cash account			1,000
	(Acceptance given)			

- 3. Accommodation Bills Written on Each Other:** In this case, both the parties draw bills on each other and get them discounted from their bankers. On the due date, each meets his own bill. The expenses of discount are to be paid by each on other's bill.

Example (Accommodation bills written on Each Other):

On 1st January 1991, P draws a bill on Q at four months for \$500 and Q draws on P for similar amount and term. Both the bills are accepted and discounted respectively at 6 per cent. At maturity both the parties meet their respective acceptances. Show the journal entries in the books of both the parties.

Solution:

Journal Entries in the Books of P				
Jan. 1	Bills receivable account		500	
	To Q			500
	(Bill drawn on Q)			
	Q		500	
	To bill payable account			500
	(Acceptance given)			
	Bank account		490	
	Discount account		10	
	To bill receivable account			500
	(Bill discounted)			
May 4	Bill payable account		500	
	To cash account			500
	(Acceptance met)			

Journal Entries in the Books of Q				
Jan 1	P		500	
	To bill payable account			500
	(Acceptance given)			
	Bill receivable account		500	
	To P			500
	(Acceptance received)			
	Bank account		490	
	Discount account		10	
	To bill receivable account			500
	(Bill discounted)			
May 4	Bill payable account		500	
	To cash account			500
	(Acceptance met)			

Check your progress 3

1. _____ bills are drawn and accepted for financial assistance.
 - a. Accommodation
 - b. trade

1.5 Let Us Sum Up

In this unit, we learnt few of the very new topics and how accounting is done in the particular case. Here in this unit we discussed the joint venture.

We learnt in this unit about the meaning and concepts of joint venture. How is joint venture different from partnership and consignment. The various advantages and disadvantages of joint venture were even discussed here in detail. In the later part of the unit we even learnt about the bills of exchange and the accommodation bills. We learnt how to record the transactions of bills of exchange and accommodation bills.

This unit will prove to be of great help for the students in understanding the concepts of joint venture and bill of exchange.

1.6 Answer for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-b)

Check your progress 3

Answers: (1-a)

1.7 Glossary

1. **Memorandum Joint Venture Account** - An account prepared for ascertaining the profit or loss of a joint venture where no Joint Venture Account is prepared by co-ventures.

1.8 Assignment

Explain how a joint venture is different from a partnership firm.

1.9 Activities

Explain the need of providing depreciation. According to you which method is most preferable?

Joint Venture,
Bills of Exchange
and
Accommodation
Bills

1.10 Case Study

On 1st January 1997, a company acquired a lease of building for a period of five years. An amount of Rs. 2, 00,000 was paid on signing the lease deed. It is proposed to depreciate lease by the Annuity Method by charging interest @5% p.a. A reference to the annuity table shows that an amount of Re.0.230975 invested for a period of 5 years at 5% interest will accumulate Re.1.Prepare the Lease Account for a period of five years.

1.11 Further Readings

- 1 Advanced Accountancy, J. R. Botliboi.
- 2 Advanced Accountancy, R. R. Gupta.
- 3 Advanced Accountancy, Shuklaand Grewal.
- 4 Advanced Accounting, R. L. Gupta, V.K. Gupta.
- 5 Higher Science of Accounting, A.N. Agrawal.

UNIT 2: DEPRECIATION AND METHODS OF DEPRECIATION

Unit Structure

2.0 Learning Objectives

2.1 Introduction

2.2 Depreciation

2.2.1 Meaning and Definition of Depreciation

2.2.2 Characteristics of Depreciation

2.2.3 Depreciation and Other Related Concepts

2.2.4 Causes of Depreciation

2.3 Methods of Charging Depreciation

2.3.1 The Straight-Line/Equal Instalment Method

2.3.2 Written Down Value or Diminishing Balance Method

2.3.3 Annuity Method

2.3.4 Sinking Fund or Depreciation Fund Method

2.3.5 Illustrations

2.4 Let Us Sum Up

2.5 Answers for Check Your Progress

2.6 Glossary

2.7 Assignment

2.8 Activities

2.9 Case Study

2.10 Further Readings

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- Discuss and explain depreciation.
- Explain characteristics, causes and other concepts related to depreciation.
- Enlist various methods of charging depreciation.
- Define straight line, diminishing balance, annuity and sinking fund method of charging depreciation.

2.1 Introduction

Fixed Assets are acquired to be utilised in the process of providing goods and services to the customers. They are utilised for business operations for a number of accounting periods. Value of a fixed asset diminishes with passage of time and its utilisation over the period. This decrease in value of the fixed asset is taken care of in accounting system by way of charging depreciation to the asset.

The value of a fixed asset is spread over its lifetime and a proportionate amount is deducted from the asset's value in the form of depreciation at the end of each period. Thus, Depreciation is the portion of cost of a fixed asset allocated to a particular period.

Except for land, most fixed assets, such as building, plant, machinery, office equipments, etc. have a limited useful life. Depreciation denotes decrease in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident. Depreciation is one of the most important constituents of income determination. In order to ascertain the true profit for the business, it is necessary that depreciation is charged on the fixed assets of the business.

2.2 Depreciation

Depreciation refers to gradual decrease or loss in the value of asset due to usage, passage of time and normal wear and tear. This gradual fall in the value of the asset is of permanent nature, which cannot be made good by normal repair and maintenance.

2.2.1 Meaning and Definition of Depreciation

Accounting Standard (AS-6) issued by Institute of Chartered Accountants of India defines depreciation as follows:

“Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effusion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the assets.”

Whereas International Accounting Standard Committee defines, “Depreciation is the allocation of the depreciable amount of an asset over its estimated life”.

Depreciation is a process of allocation of the cost of depreciable assets’ over its useful life in a rational and systematic manner.

Some of the important definitions of Depreciations are:

- **J. R. Batliboi:** “The term depreciation represents loss or diminution in the value of an asset, consequent upon wear and tear, obsolescence and effluxion of time or permanent fall in the market value”.
- **Spicer and Pegler:** “Depreciation may be defined as a measure of the exhaustion of the effective life of an asset from any cause during a given period”.

We can summarise depreciation as a ‘process of allocation of the cost of depreciable assets’ over its useful life in a rational and systematic manner.

2.2.2 Characteristics of Depreciation

The important characteristics of depreciation are noted below:

- Depreciation is charged on fixed and tangible assets only.
- Depreciation refers to a permanent / gradual and continuous decrease in the utility value of a fixed asset and it continues till the end of the useful life of the asset.
- Depreciation is a charge against profit for a particular accounting period.
- Depreciation is always computed in a systematic and rational manner since it is not a sudden loss.

- Depreciation is a process of allocation of expired cost and not of valuation of fixed assets.
- Depreciation represents only an estimate and not the exact amount.
- Depreciation may be physical and functional.
- Total depreciation cannot exceed the cost of the depreciable asset.
- It is non-cash charge and hence does not involve outflow of cash.
- The basis of charging depreciation is economic life of the asset and the cost thereof. Market value has no relevance for calculating depreciation.
- Depreciation is different and distinct from Amortisation, Depletion, Obsolescence, Dilapidation and Fluctuation.

2.2.3 Depreciation and Other Related Concepts

Sometimes the terms depletion, amortisation, etc. are used interchangeably with depreciation. These terms in fact are used in a different context. Let us understand the distinction between depreciation and such related concepts.

Depreciation and Depletion: The term 'depletion' is used in respect of the extraction of natural resources from wasting assets such as quarries, mines, etc. and refers to the reduction in the available quantity of the material. In fact, depletion is regarded as a method of computing the depreciation on wasting assets. Thus, it has a limited application. Depreciation, on the other hand, is a wider term and refers to a reduction in the value of all kinds of fixed assets arising from their wear and tear.

Depreciation and Amortisation: The terms 'amortisation' refers to writing off the proportionate value of the intangible assets such as copyrights, patents, goodwill, etc., while depreciation refers to writing off the expired cost of the tangible assets like machinery, furniture, building, etc.

Depreciation and Obsolescence: Obsolescence refers to the decrease in usefulness arising because of the external factors like change in technology, new inventions, change of style, etc. Thus, it is caused mainly because of the asset becoming out of date or old fashioned. Depreciation, on the other hand, is a functional loss generally arising because of wear and tear. Obsolescence, in fact, is regarded as one of the causes of depreciation.

Depreciation and Fluctuation: Fluctuation refers to an increase or decrease in the Market price of an asset. Such a change is usually temporary. Depreciation differs from fluctuation in the following aspects.

- Depreciation is concerned with the book value of an asset while fluctuation is related to the market value.
- Depreciation refers only to the decrease while fluctuation refers to either increase or decrease.
- Depreciation reflects a permanent decrease while fluctuation is only a temporary phenomenon.

2.2.4 Causes of Depreciation

The causes of depreciation can be stated as follows:

Wear and Tear: Wearing out of the asset because of its constant use is called wear and tear. This causes a definite reduction in the value of the asset and is regarded as the major source of depreciation.

Lapse of Time: Normally, the passage of time also causes some reduction in the value of fixed assets because as they become old, their values stand reduced. That is why the depreciation usually is charged on time basis. In case of certain assets like lease, patents, etc. the value decreases with passage of time as they generally have a fixed number of years of legal life. For example, a building is taken on lease for a period of 10 years costing Rs 1,00,000. The yearly depreciation of lease will amount to Rs. 10,000 (1/10 of Rs 1,00,000 and charged as such to the Profit and Loss Account every year.

Obsolescence: The acquisition of an improved model may render the existing machine obsolete. As the new machine performs the same operation more quickly and/or more economically, the existing machine is said to have become out of date or obsolete. This causes a drastic reduction in the value of existing machinery and the amount of depreciation is bound to be heavy.

Depletion: Some assets are of wasting character, e.g. mines quarries, oil wells, etc. Due to continuous extraction of materials, the natural resources are depleted. Depreciation, in case of such assets, is often computed based on actual depletion. For example, a coal mine has the coal deposits of 200 million tons. In the first year, we extract 10m tons of coal. The depreciation in the first five years shall amount to 10/200 of the cost of mine.

On the basis of the causes mentioned above, it can be said that depreciation is a permanent and continuous reduction in the value of an asset due to wear and tear, passage of time, obsolescence, depletion or any other cause.

Check your progress 1

1. _____ refers to gradual decrease or loss in the value of asset due to usage, passage of time and normal wear and tear.
 - a. Depletion
 - b. Depreciation

2.3 Methods of Charging Depreciation

There are several methods of allocation of cost of the asset, which are known as methods of charging depreciation. These methods of depreciation are as under:

2.3.1 The Straight-Line / Equal Instalment Method

This is the most popular method because of its simplicity and consistency. The method requires an allocation of an equal amount to each period. A fixed amount of the original cost is charged as depreciation every year. Thus, the asset is written-down in value each year by the same amount. This amount is such that the book value of the asset may be reduced to zero or its residual value, as the case may be, at the end of its life. Since this method assumes that the cost of the asset expires at a steady (straight-line) function of time, the acquisition cost less salvage value is divided by the estimated economic life. The rate of depreciation is the reciprocal of the estimated useful life. This may be put in the shape of a formula as under:

$$\text{Annual Depreciation} = \frac{\text{Cost of the Asset} - \text{Residual Value}}{\text{Estimated Economic Life}}$$

$$\text{Rate of Depreciation} = \frac{\text{Annual Depreciation}}{\text{Cost of the Asset}} \times 100$$

Example

If a machine costs Rs.20000 on 1.1.1989, has a residual value at Rs.1000 and a life of 10 years, assuming the accounting year-ends on 31st December, the depreciation per annum will be:

$$\text{Annual Depreciation} = \frac{\text{Rs. 20000} - \text{Rs. 1000}}{10} = \text{Rs. 1900}$$

The profit will not be reduced by Rs.20,000 in 1989 but by Rs.1,900 in each of the years from 1989 to 1998.

The rate of Depreciation will be:

$$\text{Rate of Depreciation} = \frac{1900}{20000} \times 100 = 9.5\%$$

Advantages

- It is simple to calculate and easy to understand.
- It can reduce the book value of the asset to zero.
- The valuation of the asset each year in the balance sheet is reasonably fair.

Disadvantages

- This method ignores the fact that the service yielding ability of the assets tend to fall but the repairs and maintenance costs increase with the passage of time. Though each year's charge of depreciation is the same, the charge for repairs and renewal goes on increasing as the asset becomes older. Therefore, the charge to the Profit and Loss Account increases over the years.
- If an additional asset is acquired, the amount to be charged as depreciation needs to be recalculated.

Methods of Recording Depreciation

There are two ways of recording depreciation in the Books:

- **First Method:** When no provision for Depreciation Account is maintained
Under this method, depreciation is directly charged to an Asset Account by debiting Depreciation Account and crediting the Asset Account. At the end of the accounting period, Depreciation Account is closed by transferring it

to the Profit and Loss Account. In the Balance Sheet, the asset appears at its written-down value. Here, actual cost of an asset and the total amount of depreciation that has been provided cannot be ascertained from the Balance Sheet.

Journal Entries

1. Depreciation A/c Dr.
 To Asset A/c
 (Being the depreciation provided for the accounting year)

2. Profit and Loss A/c Dr.
 To Depreciation A/c
 (Being depreciation transferred to Profit and Loss Account)

- **Second Method:** When Provision for Depreciation Account is maintained.

In contrast to the above, depreciation is not directly charged to the Asset Account.

The Depreciation for the period is debited to Depreciation Account and credited to ‘Accumulated Depreciation Account’ or ‘Provision for Depreciation Account’. Depreciation Account is closed by transferring it to the Profit and Loss Account. In the Balance Sheet, asset appears at its original cost and the accumulated depreciation is shown as a deduction from the Asset Account. Here, from the Balance sheet, the original cost of the asset and the total depreciation to-date that has been charged on the asset can be easily ascertained. As the year passes, the balance of the accumulated depreciation goes on increasing since constant credit is given to this account in each accounting year. After the expiry of the useful life, these two accounts are closed by debiting Accumulated Depreciation Account and crediting Asset Account; any balance in Asset Account is transferred to the Profit and Loss Account.

Journal Entries

1. Depreciation A/c Dr.
 To Accumulated Depreciation A/c
 (Being the depreciation provided for the accounting year)

2. Profit and Loss A/c Dr.

To Depreciation A/c

(Being depreciation transferred to Profit and Loss Account)

Illustration 1

A machine was purchased on 1/1/02 for Rs.100,000. The life of the machine is of 10 years and the scrap value is estimated to be Rs.5000. The depreciation should be charged on Straight-line method. Prepare the machinery account for two year 2002 and 2003 and ascertain the balance at the end of second year.

Solution:

The depreciation to be charged every year is:

Purchase price of the machine less scrap value / no of years' life

$$(100000-5000)/10 = 95000/10 = 9500$$

Depreciation to be charged every year is Rs 9500

Machinery Account:-

Date	Particulars	L F	Amount	Date	Particulars	L F	Amount
1.1.02	To Bank		100000	31.12.02	By Depre.		9500
					By Bal.c/f		90500
	Total		100000		Total		100000
1.1.03	To bal b/d		90500	31.12.02	By Depre.		9500
					By Bal.c/f		81000
	Total		90500		Total		90500
1.1.04	To bal b/d		81000				

- a. Service Hours Method** - Under this method, depreciation is charged on the basis of running time of the asset. This method measures the use of asset in terms of effective productive hours for which an asset can be put to use throughout its economic life. That is the utility of the asset, which is directly related to working time. This method is useful where there are no chances of obsolescence. For instance, the cost of an asset is Rs.4,50,000 and salvages value is Rs. 50,000 and life in terms of effective working hours is 20,000 hrs.

$$D = \frac{C - S}{n} = \frac{4,50,000 - 50,000}{20,000} = \text{Rs. 20 per service hour}$$

Here, D = Depreciation per service hour

C = Cost of the asset

S = Salvage value

n = Economic life of the asset

If the asset worked for 2,500 hours in a year, the annual depreciation will be:

$$(\text{Rs.}20 \times 2,500 \text{ hrs.}) = \text{Rs. } 50,000$$

- b. Productive Output Method or Depletion Method:** This method measures the effective or useful life of the depreciating asset in terms of physical output, thereby directly relating the utility of the asset to its productive use. This method is useful where output can effectively be measured. It is applicable for the exhaustion of natural resources. These natural resources exhaust or deplete by exploitation. The cost of natural resources is the price paid for its acquisition plus price paid for the development of such asset.

Depletion per unit

$$= \frac{\text{Cost of Acquisition} + \text{Cost of Development}}{\text{Estimated physical output during the lease period}}$$

It is suitable in case of extracting minerals from mines or stone quarries, etc. where the output is easily estimated.

2.3.2 Written Down Value or Diminishing Balance Method

Under this method, a fixed percentage of written down value (cost less depreciation) of the asset is written off as depreciation every year till the amount is reduced to its scrap value. It should be remembered that while percentage of depreciation remains fixed but amount of depreciation goes declining year after year.

As more depreciation is charged during the initial years of use as compared to subsequent years, this method is known as reducing balance method of charging depreciation. This method is suitable in respect of those assets, which require an increasing amount of repairs and renewals with the passage of time, such as plant and machinery, vehicles.

Advantages:

- The impact of obsolescence is reduced to minimum as a major portion of cost is written off in earlier years.
- This method justifies the charging of less and less depreciation in succeeding years because of gradual decrease in service potential of the asset.
- The profit and loss account is charged almost uniformly because of declining depreciation and increasing cost of repairs and maintenance.
- It is recognised by income tax authorities.

Disadvantages:

- It is difficult to calculate the rate of depreciation and impossible when scrap value is presumed to be zero.
- This method neither provides for replacement of asset nor makes any provision for any loss of interest on capital invested in depreciating assets.
- The asset's written down value is never reduced to zero, which implies that the asset is hardly to be depreciated fully.

Illustration 2

A Company charge depreciation on machinery @20% on written down value. The machinery costing Rs. 50000 was purchased on 1/4/ 2003. Prepare machinery account for three years from 03-04 to 05-06 and find out the written down value of the machine.

Solution

Machinery Account

Date	Particulars	L F	Amount	Date	Particulars	L F	Amount
1.4.03	To Bank		50000	31.3.04	By Depre.		10000
					By Bal.c/f		40000
	Total		50000		Total		50000
1.4.04	To bal b/d		40000	31.3.05	By Depre.		8000
					By Bal.c/f		32000
	Total		40000		Total		40000
1.4.05	To bal b/d		32000	31.03.06	By Depre.		6400
					By Bal.c/f		25600
	Total		32000		Total		32000
1.4.06	To bal B/d		25600				

a. Sum of Year's Digits Method (SYD)

Sum of years digits depreciation

Sum of Years Digits is a historical depreciation method that results in a more accelerated write off than straight line, but less than declining balance or later methods. Salvage value is counted in the method. There are no property classes of later methods.

Given

N = Depreciable life of asset

B = Cost basis

S = Salvage value

$D(t)$ = Depreciation charge for year t

$$\text{Sum} = \frac{N(N + 1)}{2}$$

$$D(t) = (N - t + 1) \times \frac{(B - S)}{\text{Sum}} = (N - t + 1) \times \frac{2(B - S)}{N(N + 1)}$$

Example:

If an asset costs Rs.1000, has a depreciable life of 5 years and a salvage value of Rs. 90, compute its depreciation schedule.

Year	D(t)	Sum of D(t)	Remaining Book Value
1	Rs 303	Rs 303	Rs 697
2	Rs 243	Rs 546	Rs 454
3	Rs 182	Rs 728	Rs 272
4	Rs 121	Rs 849	Rs 151
5	Rs 61	Rs 910	Rs 90

The equation for year 1 would look like this:

$$D(t) = (5 - 1 + 1) \times \frac{(1000 - 90)}{\frac{5(5+1)}{2}} = 303.33$$

Note: Most depreciation schedules round to the nearest Rupees.

This method is also based on diminishing balance but the basis of charging depreciation year after year is entirely different. It does not use mathematical formula for calculating rate of depreciation but it sums up year's digits of an asset's life span to be used as denominator and individual year's digit as numerator to be put in reverse order.

Illustration 3

A company purchased an asset costing Rs. 50,000. It is estimated to have a useful life of 5 years and expected to realise Rs.5, 000 as scrap. Calculate the yearly depreciation based on sum of years-digit method.

Solution:

Sum of years-digits can be computed with the help of following formula:

$$SYD = \frac{n(n + 1)}{2}$$

Since life of asset is 5 years,

$$SYD = \frac{5(5 + 1)}{2} = 15$$

$$\text{Depreciation} = \frac{\text{Number of years of the remaining life}}{SYD}$$

Table showing calculation of depreciation under SYD method.

Year	Opening Book Value	Depreciable Cost	Rate	Amount of Dep. (Rs.)
	(Rs.)	(C-S) Rs.		
1.	50,000	(50,000-5,000) 45,000	_5_	15,000
		15		
2.	35,000	45,000	_4_	12,000
		15		
3.	23,000	45,000	_3_	9,000

			15	
4.	14,000	45,000	<u>2</u>	6,000
			15	
5.	8,000	45,000	<u>1</u>	3,000
			15	
Hence, scrap value is Rs.5, 000 (8,000 – 3,000)				

b. Double Declining Balance Method

Under this method, depreciation is charged on diminishing balance at double of the rate computed on the basis of straight-line method. However, scrap value of the depreciating asset is totally ignored and presumed to be zero for calculating depreciation. However, total depreciation should not exceed cost less scrap value. During the last year, only the difference between the written down value and scarp value will be taken as amount to be charged as depreciation.

Illustration 4

A plant was acquired at a cost of Rs. 80,000. It is estimated to realise Rs.6, 200 as scrap by the end of its useful life of 5 years. Calculate depreciation for each year according to double declining method.

Solution:

Step I: Computation of rate of depreciation on the basis of Straight-line method, scrap value to be ignored.*

$$D = \frac{C - S}{N} = \frac{80,000 - *Nil}{5} = 16,000$$

$$N = 5$$

$$r = \frac{D}{C} \times 100 = \frac{16,000}{80,000} \times 100 = 20\%$$

$$C = 80,000$$

Step II: Rate as per straight-line method x 2

$$= 20\% \times 2 = 40\%$$

Year	Book Value in the beginning (Rs.)	Rate of Dep. %	Amt of Depreciation (Rs.)
1.	80,000	40%	32,000
2.	48,000	40%	19,200
3.	28,800	40%	11,520
4.	17,280	40%	6,912
5.	10,368	40%	4,147**

**Depreciation in the fifth year will be taken to be the difference between written down value and the scrap value i.e. $(10,368 - 6,200) = \text{Rs. } 4,168$ and similarly if the salvage value of asset is estimated at Rs.6,500, the depreciation in the fifth year will be taken at Rs.3,868 $(10,368 - 6,500)$ and not Rs.4,147 as shown in the table.

2.3.3 Annuity Method

This method takes into account notional interest on the amount invested in the assets. It assumes that had the amount been invested outside it would have earned or yielded certain amount of interest. Thus, such a notional interest calculated on reducing balance is debited to asset account and depreciation, which is worked out on the basis of annuity table is credited to asset account by the end of each year. The amount of depreciation remains fixed but interest amount goes on declining.

In other words, this method considers the loss of notional interest on the capital, which is invested and blocked in an asset and thus this loss is included in the cost of asset by debiting the same to asset account. This is evident from the fact that depreciation charged includes not only the original cost but also the interest thereon.

It is suitable for lease hold assets where large sums are invested.

Accounting Entries

- On purchase of Asset:

Joint Venture,
Bills and
Depreciation

Asset A/c (at Cost price) Dr.

To Bank A/c

- On charging of National Interest:

Asset A/c Dr. (Int. on initial / or opening

To Interest A/c balance)

- On charging Depreciation:

Depreciation A/c Dr. (Amount of Dep.)

To Asset A/c

- For transferring depreciation:

Profit and Loss A/c Dr.

To Depreciation A/c

- For transferring Interest:

Profit and Loss A/c Dr.

To Interest A/c

2.3.4 Sinking Fund or Depreciation Fund Method

All the methods of charging depreciation discussed so far, none of the methods provides for the replacement provisions. This method not only charges depreciation but also makes provision for replacement of asset on the expiry of its useful life. Under this method, a certain sum calculated on the basis of cost of the asset and sinking fund tables, is written off every year by debiting Profit and loss account and crediting sinking fund or depreciation Fund Account throughout the useful life of the asset. The amount so transferred to Sinking Fund is invested outside securities every year. The interest on such investment is also invested in similar securities, which enjoy high liquidity. The amount that is annually set aside as depreciation is such that this, with compound interest will be sufficient to provide a sum equal to the cost of the asset less residual value if any, by the end of the useful life of the asset. When the asset becomes useless, the investments are sold and money so received is utilised for purchasing a new asset. The old asset Account standing at the original cost is closed by setting it off against the Depreciation Fund Account.

The asset (at cost) is shown in the assets side of the Balance Sheet. Depreciation Fund Account appears on the Liabilities side and Depreciation Fund Investment on the assets side.

The amount of depreciation can also be calculated by using the following formula:

$$\text{Depreciation} = \frac{1}{(1+r)^n - 1}$$

r = Rate of Interest

n = Life in number of years

Advantages

- Sinking Fund method provides necessary amount for the replacement of asset at the end of its useful life, because of annual investment in marketable securities. No other method provides funds for replacement.
- This method continues to show the original cost of the asset and total depreciation charged till date which may be of great importance for certain decision-making purposes.

Disadvantages

- Investment in securities is always subject to certain risk of price fluctuations, which create uncertainty about the actual amount at hand at the time of replacement.
- Annual investment in securities does affect the working capital within the business because of yearly outflow of cash for the purchase of securities.

Accounting entries at the end of first year

- a. Profit and Loss A/c Dr.
To Sinking Fund A/c or Depreciation Fund A/c
 (Being amount of annual depreciation transferred to sinking fund account)
- b. Sinking Fund or Depreciation Fund Investment A/c Dr.
To Bank A/c
 (Being investment purchased out of amount of yearly depreciation)

Joint Venture,
Bills and
Depreciation

Entries at end of subsequent years except the last year

- a. Bank A/c Dr.
To Interest on Sinking Fund Investment A/c
(Being interest on investment received)
- b. Interest on Sinking Fund Investment A/c Dr.
To Sinking Fund A/c
(Being interest on Sinking fund Investment transferred to Sinking Fund Account)
- c. Profitand Loss A/c Dr.
To Sinking Fund A/c
(Being depreciation provided and transferred to Sinking Fund Account)
- d. Sinking Fund Investment A/c Dr.
To Bank A/c
(Being Sinking Fund Investment purchased out of amount of yearly depreciation including interest)

Entries at the end of useful life of asset:

i, ii and iii entries shall be recorded as usual but the iv entry will not be recorded because in the last year, investments are not purchased but sold for the purpose of replacement of asset.

- Bank A/c Dr.
To Sinking Fund Investment A/c
(Being investments sold)
- Sinking Fund Investment A/c Dr.
To Sinking Fund A/c
(Being profit on sale of investments credited to Sinking Fund Account)

Or

- Sinking Fund A/c Dr.
To Sinking Fund Investment A/c
(Being loss on sale of investments charged to Sinking Fund Account)

2.3.5 Illustrations

Illustration 5

On 01-04-2000, Unique Commercial Ltd. Purchased a Computer for Rs. 90,000 including printer. It purchased another computer on 01-10-2000 costing Rs.60, 000 and on 01-07-2001 costing Rs.30,000. On 01-01-2002 the printer of the computer purchased on 01-04-2000 costing Rs.30, 000 became ineffective and was sold for Rs.10, 000.

- Prepare Computer A/c in the Books of Unique Commercial Ltd. whose accounting year is the calendar year and charges depreciation @10% p.a. on Straight Line Method.
- Will it make any difference if 'Provision for Depreciation A/c' is maintained?

Solution:

a.

Dr. Computer A/c Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2000			2000		
Apr 1	To Bank A/c	90,000	Dec. 31	By Depreciation A/c	8,250
Oct. 1	To Bank A/c	60,000	Dec. 31	By Balance c/d	1,41,750
		1,50,000			1,50,000
2001			2001		
Jan. 1	To Balance b/d	1,41,750	Dec. 31	By Depreciation A/c	16,500
July 1	To Bank A/c	30,000	Dec. 31	By balance c/d	1,55,250
		1,71,750			1,71,750
2002			2002		

Joint Venture,
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Depreciation

Jan. 1	To Balance b/d	1,55,250	Jan. 1	By Bank A/c	10,000
			Jan. 1	By Profit and Loss A/c	14,750
			Dec. 31	By Depreciation A/c	15,000
			Dec. 31	By balance c/d	1,15,500
		1,55,250			1,55,250
2003					
Jan. 1	To Balance b/d	1,15,500			

b. When 'Provision for Depreciation A/c' is maintained.

Dr. Computer A/c Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2000			2000		
Apr 1	To Bank A/c	90,000	Dec. 31	By Balance c/d	1,50,000
Oct. 1	To Bank A/c	60,000			
		1,50,000			1,50,000
2001			2001		
Jan. 1	To Balance b/d	1,50,000	Dec. 31	By balance c/d	1,80,000
July 1	To Bank A/c	30,000			
		1,80,000			1,80,000
2002			2002		

Jan. 1	To Balance b/d	1,80,000	Jan. 1	By Computer Disposal A/c	30,000
			Dec. 31	By balance c/d	1,50,000
		1,80,000			1,80,000
2003					
Jan. 1	To balance b/d	1,50,000			

Dr. Provision for Depreciation A/c Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs)
2000			2005		
Dec.31	To Balance c/d	8,250	Dec. 31	By Depreciation A/c	8,250
		8,250			8,250
2001			2001		
Dec. 31	To Balance c/d	24,750	Jan. 1	By Balance b/d	8,250
			Dec. 31	By Depreciation A/c	16,500
		24,750			24,750
2002			2002		
Jan. 1	To Computer Disposal A/c	5,250	Jan. 1	By Balance b/d	24,750
Dec. 31	To Balance c/d	34,500	Dec. 31	By Depreciation A/c	15,000

Joint Venture,
Bills and
Depreciation

		39,750			39,750
			2003		
			Jan. 1	By Balance b/d	34,500

Dr. Computer Disposal A/c Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs)
2002			2002		
Jan. 1	To Computer A/c	30,000	Jan. 1	By Provision for Depreciation A/c*	5,250
				By Bank A/c	10,000
				By Profit and Loss A/c	14,750
		30,000			30,000

Working Notes:

	Rs.
a. Depreciation on Rs. 90,000 @ 10% p.a. for 9 months	6,750
Depreciation on Rs. 60,000 @ 10% p.a. for 3 months	1,500
	8,250
b. Depreciation on first Computer for one Year	9,000
Depreciation on second Computer for one Year	6,000
Depreciation on third Computer for 6 months	1,500
(On Rs. 30,000 @ 10% p.a.)	16,500
c. Loss on sale of printer	
Cost Price of printer	30,000

Less: Accumulated Depreciation there on (2,250+3,000)	5,250*	Depreciation and Methods of
	24,750	
Less: Sale proceeds	10,000	Depreciation
	14,750	
d. Depreciation on First Computer excluding printer	6,000	
Depreciation on Second Computer	6,000	
Depreciation on Third Computer	3,000	
	15,000	
* Depreciation on Rs. 30,000 @ 10% p.a. for 9 months for the year 2000 (1-4-2000 to 31-12-2002)	2,250	
Depreciation for the year 2001 (Rs. 30,000 @ 10% p.a.)	3,000	
	5,250	

Illustration 6

On 1-1-1998, the machinery account of a company had a balance of Rs.1,40,000. on 1-7-1998 a part of the above Machinery whose book value on 1-1-1998 was Rs.28,000 was surrendered to the vendor at an agreed price of Rs.11,200 in part exchange for a new machinery costing Rs.23,800. The net invoice of Rs.12,600 was passed through the Purchase Book. At the same time Rs.1,400 incurred on installation of new machine wrongly debited to wages account. Record Journal Entries and prepare Machinery Account for the year ended 31st December 1998. Depreciation is charged @ 10% p.a. on Diminishing Balance.

Solution:

Journal Entries

Date	Particulars	LF	Amt. (Dr.) (Rs.)	Amt (Cr.) (Rs.)
1998 July 1	Vendors A/c Dr. Depreciation A/c Dr. P & L A/c (Loss on Sale) Dr. To Machinery A/c (Being part of old machinery transferred to vendor)		11,200 1,400 15,400	28,000
	Machinery A/c Dr. To Vendor's A/c To Purchases A/c (Being new machinery acquired)		23,800	11,200 12,600
	Machinery A/c Dr. To Wages A/c (Being installation expenses debited to Wages A/c corrected)		1,400	1,400
Dec. 31	Depreciation A/c Dr. To Machinery A/c (Being Depreciation charged)		12,460	12,460

Dr.

Machinery A/c

Cr.

Depreciation
and Methods
of
Depreciation

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs)
1998			1998		
Jan.1	To Balance b/d	1,40,000	July 1	By Vendor's A/c	11,200
July 1	To Vendor's A/c	11,200	"	By Depreciation A/c(1)	1,400
"	To Purchases A/c	12,600	"	By P & L A/c (Loss on Sale)(2)	15,400
"	To Wages A/c	1,400	Dec. 31	By Depreciation A/c(3)	12,460
			"	By Balance c/d	1,24,740
		1,65,200			1,65,200
1999					
Jan. 1	To Balance b/d	1,24,740			

Working Notes:

*Depreciation on part of machinery surrendered

Book Value as on 1-1-1998	28,000	
Less: Depreciation @ 10% p.a. for 6 months	1,400(1)	
	26,600	
Less: Exchange value	11,200	
*Loss on Surrender of machine	15,400	(2)

*Depreciation for the year ending 31st Dec. 1998

Joint Venture,
Bills and
Depreciation

Depreciation @ 10% p.a. on Rs. 1, 12,000	11,200	
(Rs. 1, 40,000 – Rs. 28,000)		
Depreciation on new machine of Rs. 25,200		
(Cost 23,800 + Installation 1,400) @ 10% p.a. for 6 months	1,260	
	12,460	(3)

Illustration 7

X Ltd. Commenced business on 1st January 1998. On the same date a plant costing Rs.3, 50,000 was purchased. Depreciation was charged @15% p.a. on diminishing balance basis and charging full years depreciation on additions. Over the years following additions were made:

On 1-8-1999	Rs. 75,000
On 30-9-2002	Rs.1, 00,000

On 1-1-2002, it was decided to change the method and rate of depreciation to 10% on straight-line basis with retrospective effect from 1-1-1998, the adjustment being made in the account for the year ending 31st December 2002.

Prepare plant account for the year 2002 only.

Solution:

Dr. Plant A/c Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs)
2002			2002		
Jan. 1	To Balance c/d (1)	2,28,761	Dec. 31	By Depreciation (3)	52,500
“	To Excess Depreciation Charged	33,739	“	By Balance c/d	3,10,000

	adjusted (2)				
Sep. 30	To bank A/c	1,00,000			
		3,62,500			3,62,500
2003					
Jan.	To Balance b/d	3,10,000			

Working Notes:

		Rs.	
1.	Calculation of written down value of the plant on 1-1-2002		
	Book Value (cost) as on 1-1-1998	3,50,000	
	Less Depreciation @ 15% on diminishing Balance	52,500	
	W.D.V. as on 1-1-1999	2,97,500	
	Addition made during 1999	75,000	
		3,75,500	
	Less Depreciation for the year 1999 @ 15%	56,325	
	W.D.V. as on 1-1-2000	3,18,675	
	Less Depreciation for the year 2000 @ 15%	4,78,011	
	W.D.V. as on 1-1-2001	2,70,874	
	Less Depreciation for the year 2001 @ 15%	40,631	
	W.D.V. as on 1-1-2002	2,30,243	(1)

Joint Venture,
Bills and
Depreciation

2.	Difference in Depreciation		
	Depreciation already charged @ 15 % as per Diminishing Balance Method (52,500 + 55,875 + 47,494 + 40,370)	1,97,257	
	Depreciation as per New method i.e. Straight Line Method @ 10%	1,62,500	*
		33,739	(2)
	* Cost of 1st Plant	3,50,000	
	Depreciation @ 10% for 4 years (i.e., 1998, 1999, 2000 & 2001) on 1st Plant	1,40,000	(a)
	Cost of 2nd Plant	75,000	
	Depreciation @ 10% for 4 years (i.e., 1998, 1999, 2000 & 2001) on 1st Plant	22,500	(b)
	Total Depreciation = (a + b)	1,62,500	*
	3	Depreciation for the year 2002	
Cost of 1st Plant		3,50,000	
Cost of 2nd Plant		75,000	
Cost of 3rd Plant		1,00,000	
		5,25,000	
Depreciation @ 10% on original cost		52,500	(3)

Illustration 8

On 1st January 1997, a company acquired a lease of building for a period of five years. An amount of Rs. 2, 00,000 was paid on signing the lease deed. It is proposed to depreciate lease by the Annuity Method by charging interest @5% p.a. A reference to the annuity table shows that an amount of Re.0.230975 invested for a period of 5 years at 5% interest will accumulate Re.1.

Prepare the Lease Account for a period of five years.

Annual Depreciation = $0.230975 \times 2, 00,000 = \text{Rs. } 46,195 \text{ p.a.}$

Solution:

Dr.			Lease A/c			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs)			
1997			1997					
Jan. 1	To Bank A/c	2,00,000	Dec. 31	By Depreciation A/c	46,195			
Dec. 31	To Interest 5% p.a	10,000	“	By balance c/d	1,63,805			
		2,10,000			2,10,000			
1998			1998					
Jan. 1	To Balance b/d	1,63,805	Dec. 31	By Depreciation A/c	46,195			
Dec. 31	To Interest 5% p.a.	8,190	“	By Balance c/d	1,25,800			
		1,71,995			1,71,995			
1999			1999					
Jan. 1	To Balance b/d	1,25,800	Dec. 31	By Depreciation A/c	46,195			

Joint Venture,
Bills and
Depreciation

Dec. 31	To interest 5% p.a.	6,290	“	By Balance c/d	85,895
		1,32,090			1,32,090
2000			2000		
Jan. 1	To Balance b/d	85,895	Dec. 31	By Depreciation A/c	46,195
Dec. 31	To Interest 5% p.a.	4,295	“	By Balance c/d	43,995
		90,190			90,190
2001			2001		
Jan. 1	To Balance b/d	43,995	Dec. 31	By Depreciation A/c	46,195
Dec. 31	To Interest 5% p.a.	2,200*			
		46,195			46,195

Check your progress 2

1. The Depreciation for the period is _____ to Depreciation Account.
 - a. Debited
 - b. credited

2.4 Let Us Sum Up

In this unit, we have studied in detail about depreciation focussed on the depreciation in very detail. We have defined and stated the characteristics of depreciation, why we make provisions for depreciation, what causes depreciation and many other related concepts of depreciation have even been explained, enumerated various methods of charging depreciation. Along with this we even discussed the various methods of charging depreciation such as Straight-line, Diminishing Balance Method, Annuity Method and Sinking Fund Method. We even explained the various entries which are made in the different methods of depreciation.

This unit is going to be of great help for the students in understanding few of the very basic concepts associated with depreciation.

2.5 Answer for Check Your Progress

Check your progress 1

Answers: (1-b)

Check your progress 2

Answers: (1-a)

2.6 Glossary

1. **Obsolete** - no longer produced or used; out of date.

2.7 Assignment

On 1st January 1992, A draws a bill on B at three months for Rs. 900 and B draws on A for similar amount and term. Both the bills are accepted and discounted respectively at 3 per cent. At maturity, both the parties meet their respective acceptances. Show the journal entries in the books of both the parties.

2.8 Activities

X, having accepted a bill for Rs.500, is unable to meet the same. Before the due date, he requests Y, the drawer of the bill, to receive Rs.320 in cash (Rs.20 being for interest) and to draw on him a new bill for a period of 3 months for Rs.250 and cancel the old bill that is about to due. Y agrees to this proposal. Show the journal entries in the books of X and Y.

2.9 Case Study

On 1/04/1999, Angel Manufacturing Co. Ltd. purchased six machines of Rs.30,000 each. On 1/4/2000, one machine became defective and was sold for Rs.25, 000 and again on 1/4/2001, a second machine was sold for Rs.25, 000. On 1/10/2000, a new machine of higher technical reliability was acquired for Rs.56, 000. Depreciation is charged @10% on initial cost and debited to profit and Loss A/c and credited to provision for depreciation account on 31st march each year. Prepare necessary accounts in the books of the company.

2.10 Further Readings

1. Advanced Accountancy, J. R. Botliboi
2. Advanced Accountancy, R. R. Gupta
3. Advanced Accountancy , Shuklaand Grewal
4. Advanced Accounting , R. L. Gupta, V.K. Gupta

Block Summary

A joint venture some times seem to be very similar to a partnership firm but it is very different from partnership although their nature seems to be similar but then too there is a difference between the two.

The joint venture unlike partnership is not for an indefinite period. Joint ventures are made for a particular project i.e. they are a business agreement in which parties agree to develop, for a finite time, a new entity and new assets by contributing equity. They exercise control over the enterprise and consequently share revenues, expenses and assets. In a joint venture, both parties invest equally in the project in terms of money, time and effort to build on the original concept. While joint ventures are generally small projects, major corporations also use this method in order to diversify. Since the cost of starting new projects is generally high, a joint venture allows both parties to share the burden of the project as well as the resulting profits. A Bill of Exchange which is generally known as a negotiable instrument is a document contemplated by a contract, which warrants the payment of money, the promise of or order for conveyance of which is unconditional, it specifies or describes the payee, who is designated on and memorialised by the instrument and is capable of change through transfer by valid negotiation of the instrument.

Block Assignment

Short Answer Questions

Write a short note on the following:

1. Bill of exchange
2. WDV method of depreciation
3. Joint venture
4. Partnership

Long Answer Questions

1. Discuss the use of joint venture account.
2. What do you understand by depreciation?
3. Explain the use bill of exchange.

Enrolment No.

1. How many hours did you need for studying the units?

Unit No	1	2	3	4
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Language and Style	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Illustration used (Diagram, tables etc)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Conceptual Clarity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Check your progress Quest	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____
Feed back to CYP Question	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	_____

3. Any Other Comments.

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“

*Education is something
which ought to be
brought within
the reach of every one.*

”

- Dr. B. R. Ambedkar



Dr. Babasaheb Ambedkar Open University
'Jyotirmay Parisar', Opp. Shri Balaji Temple, Sarkhej-Gandhinagar Highway, Chharodi,
Ahmedabad-382 481.

FINANCIAL ACCOUNTING

PGDF-101

BLOCK 4: CAPITAL AND FINANCE MANAGEMENT



**Dr. Babasaheb Ambedkar Open University
Ahmedabad**

FINANCIAL ACCOUNTING



Knowledge Management and
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ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)



PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included many tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!



FINANCIAL ACCOUNTING

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FINANCIAL ACCOUNTING

BLOCK 4: CAPITAL AND FINANCE MANAGEMENT

UNIT 1

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BLOCK 4: CAPITAL AND FINANCE MANAGEMENT

Block Introduction

In any business finance plays a very important role. Finance is that much important for a business just as blood flowing into our body. As blood carried vital nutrients all over our body in the same way finance is required to nourish our body. Without adequate finance a business can't survive as we cannot survive without blood. In this block we shall study the different methods of evaluating the need and amount of finance requirement for short term and long term use.

In financial accounting, a cash flow statement, also known as statement of cash flows or funds flow statement is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents and break the analysis down to operating, investing and financing activities. Essentially, the cash flow statement is concerned with the flow of cash in and cash out of the business. On the other hand working capital (abbreviated WC) is a financial metric, which represents operating liquidity available to a business, organisation or other entity, including governmental entity. Along with fixed assets such as plant and equipment, working capital is considered a part of operating capital. Net working capital is calculated as current assets minus current liabilities. It is a derivation of working capital, which is commonly used in valuation techniques such as DCFs (Discounted cash flows). If current assets are less than current liabilities, an entity has a working capital deficiency, also called a working capital deficit. The need for finance may be for long-term, medium-term or short-term. Financial requirements with regard to fixed and working capital vary from one organisation to other. To meet out these requirements, funds need to be raised from various sources. Some sources such as issue of shares and debentures provide money for a longer period. These are therefore, known as sources of long-term finance. On the other hand, sources like trade credit, cash credit, overdraft, bank loan, etc., which make money available for a shorter period of time, are called sources of short-term finance.

In this unit, you will study various sources of short-term finance and their relative merits and demerits.

Block Objective

After learning this unit, you will be able to understand:

- Meaning of cash and fund flow statements.
- Concepts of cash and fund flow statements.
- Distinguish between cash and fund flow statement.
- Working capital management.
- The need of working capital and its determinants
- Cash budget.
- Sources of short term finance.
- Purpose and factors of long term finance.
- Shares, debentures and term loans.

Block Structure

Unit 1: Cash Flow and Fund Flow Statement

Unit 2: Working Capital Management

Unit 3: Sources of Finance

UNIT 1: CASH FLOW AND FUND FLOW STATEMENT

Unit Structure

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1.2.2 Operating Activities

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1.2.4 Financing Activities

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1.4.2 Preparing Fund Flow Statement

1.5 Distinction between Cash Flow and Fund Flow Statement

1.6 Let Us Sum Up

1.7 Answers for Check Your Progress

1.8 Glossary

1.9 Assignment

1.10 Activities

1.11 Case Studys

1.12 Further Readings

1.0 Learning Objectives

After learning this unit, you will be able to understand:

- The meaning of cash and fund flow statements.
- The concepts of cash and fund flow statements.
- Outline the steps in preparing cash and fund flow statement.
- Distinguish between cash and fund flow statement.

1.1 Introduction

In every concern, the funds flow in from different sources and similarly funds are invested in various sources of investment. It is a continuous process. The study and control of this funds-flow process (i.e., the uses and sources of funds) is the main objective of financial management to assess the soundness and the solvency of the enterprise.

Three major financial statements are ordinarily required for external reports—an income statement, a balance sheet and a statement of cash flows. The purpose of the statement of cash flow is to highlight the major activities that directly and indirectly affect cash flows and hence affect the overall cash balance. Managers focus on cash for a very good reason; without sufficient cash balance at the right time, a company may miss golden opportunities or may even fall into bankruptcy. The cash flow statement answers questions that cannot be answered by the income statement and balance sheet. For example a statement of cash flows can be used to answer questions like where did the company get the cash to pay dividend of nearly Rs.140 million in a year in which, according to income statement, it lost more than Rs.1 billion? To answer such questions, familiarity with the statement of cash flows is required.

1.2 Cash Flow Statement and their Analysis

As the name suggests, the cash flow statement shows the inward and outward flow of cash of a company within a fixed period. The general practice that is followed by most companies is to report their cash flow statement on a quarterly or monthly basis. The cash flow is broken out into three reporting areas: (1) Operating, (2) Investing and (3) Finance. The cash flow statement was

originally known as the flow funds statement or statement of changes in financial position.

1.2.1 Purpose of the Cash Flow Statement

The cash flow statement is intended to provide information on a firm's liquidity or solvency. The cash flow provides a clear understanding of a company's financial resources at a given point in time.

1.2.2 Operating Activities

Operating activities represent the incoming and outgoing cash activities to run the day-to-day operation of a business. The net cash flow from operating activities represents the money made from the sales of products and services. These items include receipts from goods sold, tax payments and interest received from loans. Operating activities is the most critical component of the cash flow statement, because it shows if a company is able to turn a profit based on its current business model at this exact moment in time. If a company is unable to turn a profit from their business activities, odds are that the company will be experiencing finance issues and or making investments in hardware or software without any proof of success.

1.2.3 Investing Activities

Investment activities represent the cash flow from the purchase of long-term assets required to make or sell goods and services. Investment activities also include purchases of stocks or other securities. A major issue that potential investors have with the investing activities section is that the money listed here represents activities paid for in cash. Therefore, if a company were to purchase Rs.5 million dollars worth of equipment with only Rs.1 million cash and Rs.4 million in financing, only the Rs.1 million will show up under investing activities.

1.2.4 Financing Activities

Financing cash flow is related to money in and out to investors and shareholders. When a company raises funds from bonds or stock, it is considered

cash in. Dividends paid out to investors and interest paid to bondholders is considered cash out.

Example of a Cash Flow Statement

Cash provided (or used) by:	
Operating activities	Rs.XXX
Investing activities	Rs.XXX
Financing activities	Rs.XXX
Net increase (decrease) in cash and cash equivalents	Rs.XXX
Cash and cash equivalents at beginning of year	Rs.XXX
Cash and cash equivalents at end of year	Rs.XXX

The cash flow statement shows how much cash comes in and goes out of the company over the quarter or the year. At first glance, that sounds a lot like the income statement in that it records financial performance over a specified period. But there is a big difference between the two.

What distinguishes the two is accrual accounting, which is found on the income statement. Accrual accounting requires companies to record revenues and expenses when transactions occur, not when cash is exchanged. At the same time, the income statement, on the other hand, often includes non-cash revenues or expenses, which the statement of cash flows does not include.

Just because the income statement shows net income of Rs.10, it does not mean that cash on the balance sheet will increase by Rs.10. Alternatively, when the bottom of the cash flow statement reads Rs.10 net cash inflow, that is exactly what it means. The company has Rs.10 more in cash than at the end of the last financial period. You may want to think of net cash from operations as the company's "true" cash profit.

Because it shows how much actual cash a company has generated, the statement of cash flows is critical to understanding a company's fundamentals. It shows how the company is able to pay for its operations and future growth.

Indeed, one of the most important features you should look for in a potential investment is the company's ability to produce cash. Just because a company shows a profit on the income statement, it does not mean it cannot get into trouble later because of insufficient cash flows. A close examination of the cash flow statement can give investors a better sense of how the company will fare.

1.2.5 Three Sections of the Cash Flow Statement

Companies produce and consume cash in different ways, so the cash flow statement is divided into three sections: cash flows from operations, financing and investing. The sections on operations and financing show how the company gets its cash, while the investing section shows how the company spends its cash.

1. **Cash Flows from Operating Activities** - This section shows how much cash comes from sales of the company's goods and services, less the amount of cash needed to make and sell those goods and services. Investors tend to prefer companies that produce a net positive cash flow from operating activities. High growth companies, such as technology firms, tend to show negative cash flow from operations in their formative years. At the same time, changes in cash flow from operations typically offer a preview of changes in net future income. Normally it is a good sign when it goes up. Watch out for a widening gap between a company's reported earnings and its cash flow from operating activities. If net income is much higher than cash flow, the company may be speeding or slowing its booking of income or costs.
2. **Cash Flows from Investing Activities** - This section largely reflects the amount of cash the company has spent on capital expenditures, such as new equipment or anything else that needed to keep the business going. It also includes acquisitions of other businesses and monetary investments such as money market funds.

You want to see a company re-invest capital in its business by at least the rate of depreciation expenses each year. If it does not re-invest, it might show artificially high cash inflows in the current year, which may not be sustainable.

3. **Cash Flow from Financing Activities** - This section describes the goings-on of cash associated with outside financing activities. Typical sources of cash inflow would be cash raised by selling stock and bonds or by bank borrowings. Likewise, paying back a bank loan would show up as a use of cash flow, as would dividend payments and common stock repurchases.

1.2.6 Cash Flow Statement Considerations:

Savvy investors are attracted to companies that produce plenty of free cash flow (FCF). Free cash flow signals a company's ability to pay debt, pay dividends, buy back stock and facilitate the growth of business. Free cash flow, which is essentially the excess cash produced by the company, can be returned to shareholders or invested in new growth opportunities without hurting the existing operations. The most common method of calculating free cash flow is:

Net Income
+ Amortisation/Depreciation
- Changes in Working capital
- Capital Expenditure _____
= Free Cash Flow _____.

Check your progress 1

1. The _____ shows the inward and outward flow of cash of a company within a fixed period.
 - a. cash flow statement
 - b. fund flow statement

1.3 Concept of Fund Flow Statement

The funds-flow-statement is a report on financial operations changes, flow or movements during the period. It is a statement, which shows the sources and application of funds or it shows how the activities of a business are financed in a particular period. In other words, such a statement shows how the financial resources have been used during a particular period. It is thus, a historical statement showing sources and application of funds between the two dates designed especially to analyse the changes in the financial conditions of an enterprise.

In the words of Foulke, it is: “A statement of Sources and Application of Funds is a technical device designed to analyse the changes in the financial condition of a business enterprises between two dates.”

Funds Flow Statement is not an income statement. Income statement shows the items of income and expenditure of a particular period, but the Funds flow statement is an operating statement as it summarizes the financial activities for a period. It covers all movements that involve an actual exchange of assets.

Various titles are used for this statement such as 'Statement of sources and Application of Funds', 'Summary of Financial operations,' 'Changes in Financial Position', 'Fund received and Disbursed', 'Funds Generated and Expended', 'Changes in Working Capital', 'Statement of Fund', etc. Title of Funds Flow Statement has been modified from time to time. A new interpretation of the term 'funds, has now been adopted as to include assets or financial resourceful which do not flow through the working capital accounts. It seems to be the most suitable meaning for the term 'funds' but the most commonly used interpretation of the term 'funds' is 'working capital'.

1.3.1 Meaning of Fund Flow

The term "flow" means change or movement of funds in terms of net working capital. It means inflow or increase and outflow or decrease of fund, i.e. net working capital, as a result of certain financial transactions that have taken place in the firm during the specific period. All financial transactions finally affect the balance sheet, but they all do not affect the net working capital of the firm. There is a certain class of transactions, which cause an increase of funds, while the other causes a decrease of funds in the firm. Therefore, identifying changes in net working capital requires an understanding of the effects of the financial transactions on net working capital. The financial transactions, which increase current assets or decrease current liabilities with corresponding decrease in fixed assets or increase in long-term liabilities and capital create inflow or increase in funds or net working capital. On other hand, the transaction which decrease current assets or increase current liabilities with corresponding increase in fixed

assets or decrease in long-term liabilities and capital cause outflow or decrease in funds or net working capital. The types of transactions other than these do not affect net working capital and hence do not cause flow of funds in and out of the firm.

1.3.2 Causes of Flow of Funds

The following types of transactions cause change (increase or decrease) of funds:

- Transactions involving current liabilities and non-current liabilities.
- Transactions involving current liabilities and non-current assets.
- Transactions involving current assets and non-current assets.
- Transactions involving current assets and non-current liabilities and owner's equity.
- Transactions involving non-operating receipts and non-operating loss.

Check your progress 2

1. The _____ is a report on financial operations changes, flow or movements during the period.
 - a. funds-flow-statement
 - b. cash flow statement

1.4 Preparation of Cash Flow and Fund Flow Statement

1.4.1 Preparation of Cash Flow Statement

Cash flow statement is divided in two parts:

- Sources of cash
- Application of cash

All transactions involving inflow of cash are designated as 'sources of cash' and all transactions resulting in outflow of cash are summarised under the heading 'application of cash'. Cash Flow Statement may be prepared in two forms:

- Report form
- Account form

Cash Flow Statement (Report Form)

Cash Balance in the beginning		.....
Add- Source of cash (or Cash Inflows)		
(i) Cash from operations	.....
(ii) Cash from operations	.....
(iii) Sale of Investment and any other Fixed Asset	.....
(iv) Issue of Share Capital/Debentures	.....
(v) Loans raised during the year.	.....
Total cash available		.....
Less- Application of Cash (or Cash outflows)		.....
(i) Purchase of Machinery of any other	.....	.....
(ii) Fixed Asset	.....
(iii) Dividend Paid	.....
(iv) Decrease in Account Payable	.....
(v) Repayment of Loans	.....
(vi) Redemption of Preference shares or debentures in cash	.....
Total Cash Payments		.....
Cash balance at the end		.....
	
	
	

Cash Flow Statement (Account Form)

Cash balance at the beginning	.....	(i) Decrease in Accounts Payable	
(i) Cash from operations	.....	(ii) Purchase of Machinery or other Asset	.....
(ii) Collection form debtors	.....	(iii) Dividend Paid	.....
(iii) Sale of Investment	.....	(iv) Repayment of Loan	.....
(iv) Sale of Fixed Asset	.....	(v) Redemption of Pref. Shares or Debentures	.....
(v) Insurance of share capital or debentures	.....		.....
(vi) Loan	.....	Cash Balance at the end	.....

1.4.2 Preparing Fund flow statement

Generally, changes in assets and liabilities lead to inflows or outflows of cash (or funds). Increase in assets or liabilities, however does not always lead to flow of funds, for instance, depreciation or any kind of revaluation. Therefore, all increases/decreases in asset or liabilities will not form part of fund flow statement but only those that result in the flows of funds. The following table encapsulates the fund flow implications of changes in asset/liabilities values.

Asset	Liability	Type of fund flow	Non-fund based adjustments
Increase		Outflows	Upward revaluation
Decrease		Inflows	Depreciation
	Increase	Inflows	Upward revaluation (as in the case foreign currency liabilities)
	Decrease	Outflows	Depreciation (as in the case foreign currency liabilities)

When preparing a fund flow statement we have to nullify the non-fund based adjustments in order to capture only those changes in the values of assets and liabilities that are accompanied by flows of fund. Increase in the item 'reserves and surplus' indicate the amount of retained profits for the year. If we add profits distributed to this figure we will get the amount of net profit for the year after taxes. We need to adjust the net profit figure for all non-cash expenses and non-cash incomes. As a rule, we have to add all non-cash expenditure to and deduct all non-cash income from the figure of net profit. For depreciation in assets: Add depreciation to the change in reserve and surplus and correspondingly to the value of assets concerned. The opposite holds for appreciation. For write offs: Add the amount of write offs to net profits.

Income accrued but received and expenses incurred but not received reckoned in the profit and loss account should not be excluded from the profit figure for the purpose of Fund Flow Statement. The rationale for this rule is that so long as accrued incomes are expected to be received and outstanding expenses are expected to be paid in the normal course of business there is no harm in treating these as inflow or outflow of funds, albeit with a lag.

As regards changes in items of current assets and liabilities, we can either show the items separately or net them to arrive at the figure of "change in net working capital". It is however more informative to show the current items separately.

The following example illustrates the preparation of fund flow statement.

Liabilities	31-3-06	31-Mar-07	Assets	31-3-06	31-3-07
	Rs. lakh	Rs. lakh		Rs. lakh	Rs. lakh
Capital	90	110	Fixed Assets	135	221
Res. and Sur	35	50	Inv. In Associates	30	86
Term Loan	110	150	Inventory	140	175
Cash Credit	75	90	Receivables	20	25
Trade Crs.	20	100	Cash and Bank	10	8
Bank Borr.	15	20	Other CA	10	5
TOTAL	345	520	TOTAL	345	520

The enterprise has made a profit of Rs. 95,00,000 during the year. A provision for tax of Rs. 30,00,000 has been made from the profit. An amount of Rs.50,00,000 was withdrawn by the proprietor from the profits during the year.

Besides, the following additional information in respect of the fixed asset items of the enterprise is also available

Rs. Lakh				
	31-3-06	Addition	Disposal	31-3-07
Gross FA	225	125	Nil	350
Total Depreciation	90		Nil	129
Net FA	135	125	Nil	221

The first step in working out fund flows is to compute the changes in assets and liabilities during 2006-07.

This is shown in the following table.

Liabilities	Change	Type	Assets	Change	Type
Capital	+20	LTS	Fixed Assets	+86	LTU
Res. and Sur	+15	LTS	Inv. In Associates	+56	LTU
Term Loan	+40	LTS	Inventory	+35	STU
Cash Credit	+15	STS	Receivables	+5	STU
Trade Crs.	+80	STS	Cash and Bank	-2	STS
Other CL	+5	STS	Other CA	-5	STS
Total	175			175	

Note that increase in assets is use of funds (outflows) while decrease in assets is source of funds (inflows) and so forth as shown in Table-1. Further, depending on which 'box' the items belong, the change can represent either a long term or short-term source/use. Accordingly, the changes have been categorised as LTS, LTU, STS, STU in the table above. This is our skeleton fund flow statement. We now have to nullify the impact of non-fund based adjustments hidden in the above numbers. Also, certain adjustments are made just in order to make a more meaningful presentation. For example, we are told that the proprietor has withdrawn Rs.50,00,000 from Capital A/c. The withdrawal is fund-based adjustment not requiring any adjustment, strictly speaking. However, according to our skeleton fund flow statement increase in reserve and surplus (that is, profit for the year) is Rs.15,00,000. This figure is obviously after the withdrawal of Rs.50,000. The true profit is not therefore Rs.15,00,000 but Rs. 65,000. Therefore, a better presentation would be to show profit from operations as Rs. 65,00,000 on the Source side and Rs. 15,00,000 as profits withdrawn on the Uses side. This is arithmetically same as showing just Rs. 15,00,000 on the Source side.

Fund Flow Statement

Rs. Lakh			
Long term Sources		Long Term Uses	
Increase in capital	20	Purchase of fixed assets	125
Profit from operations	104	Investment in associates	56
Increase in long term loan	40	Profit withdrawn	50
Long term deficit	67		
Total	231	Total	231
Short Term Sources		Short Term Uses	
Increase in CC	15	Increase in inventory	35
Increase in Trade Creditors	80	Increase in receivables	5

Increase in Other Current Liabilities	5	Short term surplus	67
Decrease in cash	2		
Decrease in other current assets	5		
Total	107	Total	107

Check your progress 3

1. For preparing fund flow statement we need to adjust the _____ figure for all non-cash expenses and non-cash incomes.
 - a. gross profit
 - b. net profit

1.5 Distinction between Cash Flow and Fund Flow Statement

Following are the differences between Cash Flow and Fund Flow Statement:

1. Funds Flow Statement is concerned with all items constituting funds (Working Capital) for the business while Cash Flow Statement deals only with cash transactions. In other words, a transaction affecting working capital other than cash will affect Funds statement and not the Cash Flow Statement.
2. In Funds Flow Statement, net increase or decrease in working capital is recorded while in Cash Flow Statement; individual item involving cash is taken into account.
3. Funds Flow statement is started with the opening cash balance and closed with the closing cash balance. It records only cash transactions.

Cash Flow Statement is started with the opening cash balance and closed with the closing cash balance while there is no opening or closing balances in Funds Flow Statement.

Check your progress 4

1. _____ is concerned with all items constituting funds.
 - a. Cash flow statement
 - b. Funds Flow Statement

1.6 Let Us Sum Up

In this unit, we have studied in very detail about the meaning and concepts of cash and fund flow statements and the various role played by them. We have studied the purpose of preparing the cash and fund flow statements. How both these are different from each other and what are the objectives of both of these statements.

We learnt that both fund flow and cash flow are showing the movement of funds and cash respectively for a particular period of time. The fund is a broader concept to cash flow statement.

After going through this unit a reader would certainly have got a detailed insight of what exactly is this unit all about.

1.7 Answer for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-a)

Check your progress 3

Answers: (1-b)

Check your progress 4

Answers: (1-b)

1.8 Glossary

1. **Interpretation** - Explaining the meaning and significance of the financial data.
2. **Financial Analysis** - Critical evaluation of data given in the financial statements.
3. **Financial Statement** - An organised collection of data according to logical and consistent accounting procedures conveying an understanding of some financial aspects of a business firm.

1.9 Assignment

Bring out the uses of cash flow statement.

1.10 Activities

Discuss how a cash flow statement is different from a fund flow statement.

1.11 Case Study

Discuss the method of preparing a cash flow statement.

1.12 Further Readings

1. Business Finance, Srivastava Reddy.
2. Essentials of Financial Management, I. M. Pandey.

UNIT 2: WORKING CAPITAL MANAGEMENT

Unit Structure

- 2.0 Learning Objectives**
- 2.1 Introduction**
- 2.2 Definition, Nature and Concept of Working Capital Management**
- 2.3 Need of Working Capital**
- 2.4 Determinants of Working Capital**
- 2.5 Computation of Working Capital**
- 2.6 Management of Cash and Receivables**
- 2.7 Cash Budget**
- 2.8 Let Us Sum Up**
- 2.9 Answers for Check Your Progress**
- 2.10 Glossary**
- 2.11 Assignment**
- 2.12 Activities**
- 2.13 Case Study**
- 2.14 Further Readings**

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- Define working capital management.
- Clarify the need of working capital.
- Discuss the determinants and computation of working capital.
- Explain cash and receivables management.
- Specify cash budget.

2.1 Introduction

Working Capital is an amount of money borrowed from a bank or other lender and used by a new business for money to keep operations going and pay business bills during the start-up period, when income is usually less than expenses. For many new businesses, having enough working capital means the difference between the success and failure of the business.

2.2 Definition, Nature and Concept of Working Capital Management

Definition

Working capital is a balance sheet item, which equals the sum of cash and cash equivalents, accounts receivable, inventory, marketable securities, prepaid expenses and other assets that could be converted to cash in less than one year. A company's creditors will often be interested in how much that company has in current assets, since these assets can be easily liquidated in case the company goes bankrupt. In addition, current assets are important to most companies as a source of funds for day-to-day operations.

Working capital is the lifeblood and nerve centre of a business. Just as circulation of blood is essential in the human body for maintaining life, working capital is very essential to maintain the smooth running of a business. No business can run successfully without an adequate amount of working capital.

Nature of Working Capital

Working capital management is concerned with the problems that arise in attempting to manage the current assets, the current liabilities and the inter-relationship that exists between them. The term current assets refers to those assets which in the ordinary course of business can be or will be, converted into cash within one year without undergoing a diminution in value and without disrupting the operations of the firm. The major current assets are Cash, Marketable Securities, Accounts Receivables and Inventory. Current liabilities are those liabilities, which are intended at their inception, to be paid in the ordinary course of business, within a year out of the current assets or the earnings of the concern. The basic current liabilities are Accounts Payable, Bills Payable, Bank Overdraft and outstanding expense. The goal of working capital management is to

manage the firm's assets and liabilities in such a way that a satisfactory level of working capital is maintained. This is so because if the firm cannot maintain a satisfactory level of working capital, it is likely to become insolvent and may even be forced into bankruptcy. The Current assets should be large enough to cover its current liabilities in order to ensure a reasonable margin of safety. Each of the current assets must be managed efficiently in order to maintain the liquidity of the firm while not keeping too high a level of any one of them. Each of the short-term sources of financing must be continuously managed to ensure that they are obtained and used in the best possible way. The interaction between current assets and current liabilities is, therefore, the main theme of the theory of management of working capital.

Concept

Working capital refers to that part of a firm's capital required for financing short term or current assets such as cash, marketable securities, debtors and inventories. In other words, working capital is the amount of funds necessary to cover the cost of operating the enterprise. Working capital means the funds (i.e. capital) available and used for day-to-day operations (i.e. working) of an enterprise. It consists broadly of that portion of assets of a business, which are used in or related to its current operations. It refers to funds, which are used during an accounting period to generate a current income of a type, which is consistent with a major purpose of a firms existence.

Every business needs some amount of working capital. It is needed for following purposes:

- For the purchase of raw materials, components and spares.
- To pay wages and salaries.
- To incur day-to-day expenses and overhead costs such as fuel, power, office expenses, etc.
- To provide credit facilities to customers, etc.

The more permanent needs (fixed assets and the fixed element of working capital) should be financed from permanent sources (e.g. equity and loan stocks); the fluctuating element should be financed from a short-term source (e.g. a bank overdraft), which can be drawn on and repaid easily and at short notice. A firm must have adequate working capital, i.e. as much as needed by the firm. It should be neither excessive nor inadequate. Both situations are dangerous. Excessive

is not provided for the purpose, the business operations will be effected. Hence, this part of finance is to be managed well.

The primary objective of working capital management is to ensure that sufficient cash is available.

This can be summarised as:

- Meet day-to-day cash flow needs.
- Pay wages and salaries when they fall due.
- Pay creditors to ensure continued supplies of goods and services.
- Pay government taxation and provider of capital dividends.
- Ensure the long-term survival of the business entity.

Businesses with a lot of cash sales and few credit sales should have minimal trade debtors. Supermarkets are good examples of such businesses.

- It helps the business concern in maintaining the goodwill.
- It can arrange loans from banks and others on easy and favourable terms.
- It enables a concern to face business crisis in emergencies such as depression.
- It creates an environment of security, confidence and over all efficiency in a business.
- It helps in maintaining the solvency of the business.

Businesses that exist to trade in completed products will only have finished goods in stock. Compare this with manufacturers who will also have to maintain stocks of raw materials and work-in-progress. Some finished goods, notably foodstuffs, have to be sold within a limited period because of their perishable nature. Larger companies may be able to use their bargaining strength as customers to obtain more favourable, extended credit terms from suppliers. By contrast, smaller companies, particularly those that have recently started trading (and do not have a track record of credit worthiness) may be required to pay their suppliers immediately. Some businesses will receive their money at certain times of the year, although they may incur expenses throughout the year at a consistent level. This is often known as “seasonality” of cash flow. The amount of funds tied up in working capital would not typically be a constant figure throughout the year.

Only in the most unusual of businesses would there be a constant need for working capital funding. For most businesses, there would be weekly fluctuations.

Many businesses operate in industries that have seasonal changes in demand. This means that sales, stocks, debtors, etc. would be at higher levels at some predictable times of the year than at others.

In principle, the working capital need can be separated into two parts:

- A fixed part and
- A fluctuating part

Check your progress 2

1. Fixed and fluctuating are two parts of _____
 - a. Cash flow
 - b. Working capital
 - c. Fund flow

2.4 Determinants of Working Capital

There are many factors in the determinants of working capital:

- **Nature of business:** Working capital requirement of a firm influenced by the nature of its business trading and financial firms have a very small investment in fixed assets, but require a large sum of money to be invested in working capital. Retail stores, for example must carry large stock of a variety of goods to satisfy varied and continuous demand of their customer.
- **Market and demand condition:** It is difficult to precisely determine the relationship between the volume of sales and working capital need. Current assets will have to be employed before growth takes place. Then it will be necessary to make planning of working capital for a growing firm on a continuous basis.
- **Technology and manufacturing policy:** The manufacturing cycle comprises of the purchase and use of raw material and the production of finished goods. Longer the manufacture cycle, larger will be the firm's working capital requirement. For example, the manufacturing cycle in the case of a boiler, depending on its size, may range between six to twenty-four

months. On the other hand, the manufacturing cycle of a product such as detergent powder, soap, ice creams, etc. may be few hours.

- **Credit policy of the firm:** It affects the working capital by influencing the level of debtors. The credit term to be guaranteed to customers may depend upon the norm of the industry to which the firm belongs. However, a firm has the flexibility of shaping its credit policy within the constraint of industry norms and practice. The firm should use discretion in granting credit terms to its customers.
- **Operating efficiency:** The operating efficiency of the firm relates to the optimum utilisation of all its resource at minimum costs. The efficiency in controlling operating cost and utilising fixed and current assets leads to operating efficiency. The use of working capital is improved and pace of cash conversion cycle is accelerated with operating efficiency. Better utilisation improves profitability and helps the releasing of working capital.
- **Working Capital Cycle:** Working capital cycle shows all the steps starting from cash purchase of raw material, creation of finished product, which is then converted into sale. In case of a credit sale, debtors will also become part of working capital cycle. Receiving money from the debtors is the final part of working capital cycle. If the debtors are fast and prompt in paying up, the company would need small amount working capital. Otherwise, for purchasing new raw material, we need more amount of working capital.
- **Manufacturing Cycle:** Manufacturing cycle means the process of converting raw material into finished product. Long manufacturing cycles lead to requirement of large amounts of working capital. The construction of a building complex, for example, could take some years to complete. Accordingly, the builder would need working capital to meet all the expenses during this period, as the returns will start coming in much later.
- **Business Cycle:** There are two main parts of the business cycle, one is boom and other is recession. In boom, companies typically need high amounts of working capital for development of business but in recession, the amount marked as working capital goes down.
- **Price Level Changes:** If there is increasing trend of products prices, we need to store high amount of working capital, because next time, it is precisely that we have to pay more for purchasing raw material or other service expenses. Inflation and deflation are two major factors, which decide

Estimation of Current Assets

- **Raw Material Inventory** - The Investment in Raw Material can be computed with the help of the following formula:

[Budgeted production cost of raw material(s) (in units)] X [average inventory holding per unit] X [period (months/days)]

12months / 365 days

- **Work-in-Progress Inventory** - The Investment in Work-in-Progress Inventory can be computed with the help of the following formula:-

Budgeted Production (In Units) X Estimated Work-in-Progress cost per unit X Average time span of Work-in- Progress Inventory (months/days)

12months / 365 days

- **Finished Goods Inventory** - The Investment in Finished Goods Inventory can be computed with the help of the following formula:

Budgeted Production Cost of Goods (In Units) X Finished Goods Holding Produced per unit X Period (months/days)

12months / 365 days

- **Debtors** - The Investment in Debtors can be computed with the help of the following formula:

Budgeted Credit Sales (In Units) X Cost of Sales Average Debt Collection per unit X Period (months/days)

12months / 365 days

- **Cash and Bank Balances** - Apart from Working Capital needs for Financing Inventories and Debtors, Firms also find it useful to have such minimum cash balances with them. It is difficult to lay down the exact procedure of determining such an amount. This would primarily be based on the motives of holding cash balances of the business firm, attitude of management towards risk, the access to the borrowing sources in times of need and experience.

Estimation of Current Liabilities

The Working Capital needs of business firms are lower to the extent that such needs are met through the Current Liabilities (other than Bank Credit) arising

in the ordinary course of business. The important Current Liabilities in this context are:

- **Trade-Creditors**
- **Wages and**
- **Overheads**

- **Trade Creditors** - The Funding of Working Capital from Trade Creditors can be computed with the help of the following formula:

Budgeted Yearly Production (In Units) X Cost of Raw Material(s) per unit
X Credit Period allowed by Creditors (months/days)

12months / 365 days

Note:-Proportional adjustment should be made to cash purchases of Raw Materials

- **Direct Wages** - The Funding of Working Capital from Direct Wages can be computed with the help of the following formula:-

Budgeted Yearly Production (In Units) X Direct Labour Cost per unit X
Average Time Lag in Payment of Wages (months/days)

12months / 365 days

Note:-The average Credit Period for the payment of wages approximates to half-a-month in the case of monthly wage payment. The first days monthly wages are paid on the 30th, extending credit for 29 days, the second day's wages are, again, paid on the 30th day, extending credit for 28 days and so on. Average credit period approximates to half-a-month.

- **Overheads (other than Depreciation and Amortisation)** - The Funding of Working Capital from Overheads can be computed with the help of the following formula:

Budgeted Yearly Production (In Units) X Overhead Cost per unit X
Average Time Lag in Payment of Overheads (months/days)

12months / 365 days

Note:-The amount of Overheads may be separately calculated for different types of Overheads. In the case of Selling Overheads, the relevant item would be sales volume instead of Production Volume.

Check your progress 4

1. The two components of _____ are current assets and current liabilities.
 - a. Working Capital
 - b. Fund flow
 - c. Cash flow

2.6 Management of Cash and Receivables

2.6.1 Cash

Cash is needed not only for paying everyday expenditure, but also for the purchase of fixed assets. Excellent cash planning makes it easy to hold an organisation's expenditures and proper spending. The plan, which helps to use cash systematically, is called cash budget. Technique of making a cash budget is called cash budgeting. In cash budgeting, all estimated cash to be received in the future is summed up and all estimated cash to be paid for removing the liabilities is deducted. The difference will show estimated cash that will be gained by the organisation. After spending of a year, this cash budget is compared with actual receipts and payments. If the real cash receipt is more than budgeted cash receipt, the organisation is considered to be in a favourable position. On the other hand, if budget cash receipt is more than actual, then this will be an unfavourable position. We can also evaluate budgeted payments with actual payment.

Cash management is one of the key areas of working capital management. Cash is the liquid current asset. The main duty of the finance manager is to provide adequate cash to all segments of the organisation. The important reason for maintaining cash balances is the transaction motive. A firm enters into variety of transactions to accomplish its objectives, which have to be paid for in the form of cash. Receivables constitute a significant portion of the total assets of the business. When a firm sells goods or services on credit, the payments are postponed to future dates and receivables are created. If they sell for cash, no receivables are created.

Objectives of cash management

There are two basic objectives of cash management:

- To meet the cash disbursement needs as per the payment schedule.
- To minimise the amount locked up as cash balances.

Basic problems in Cash Management

Cash management involves the following four basic problems.

- Controlling level of cash
- Controlling inflows of cash
- Controlling outflows of cash
- Optimum investment of surplus cash

Determining safety level for cash

The finance manager has to take into account the minimum cash balance that the firm must keep to avoid risk or cost of running out of funds. Such minimum level may be termed as 'safety level of cash'. The finance manager determines the safety level of cash separately both for normal periods and peak periods. Under both cases, he decides about two basic factors. They are-

- **Desired days of cash:** It means the number of days for which cash balance should be sufficient to cover payments.
- **Average daily cash flows:** This means average amount of disbursements, which will have to be made daily.

Criteria for investment of surplus cash

In most of the companies, there are usually no formal written instructions for investing the surplus cash. It is left to the discretion and judgement of the finance manager. While exercising such judgement, he usually takes into consideration the following factors-

- **Security:** This can be ensured by investing money in securities whose price remains more or less stable.
- **Liquidity:** This can be ensured by investing money in short term securities including short-term fixed deposits with banks.
- **Yield:** Most corporate managers give less emphasis to yield as compared to security and liquidity of investment. Therefore, they prefer short-term government securities for investing surplus cash.

Receivables

Receivables are asset accounts representing amounts owed to the firm because of sale of goods or services in the ordinary course of business.

Purpose of receivables

Accounts receivables are created because of credit sales. The purpose of receivables is directly connected with the objectives of making credit sales. The objectives of credit sales are as follows-

- Achieving growth in sales
- Increasing profits
- Meeting competition

Factors affecting the size of Receivables:

The main factors that affect the size of the receivables are-

- Level of sales
- Credit period
- Cash discount

Costs of maintaining receivables

The costs with respect to maintenance of receivables are as follows-

- **Capital costs:** This is because there is a time lag between the sale of goods to customers and the payment by them. The firm has, therefore to arrange for additional funds to meet its obligations.
- **Administrative costs:** Firms incur this cost for manufacturing accounts receivables in the form of salaries to the staff kept for maintaining accounting records relating to customers.
- **Collection costs:** The firm has to incur costs for collecting the payments from its credit customers.
- **Defaulting costs:** The firm may not able to recover the overdues because of the inability of customers. Such debts are treated as bad debts.

Receivables are the direct result of credit sales. The main objective of receivables management is to promote sales and profits until that point is reached where the ROI in further funding of receivables is less than the cost of funds raised to finance that additional credit (i.e. cost of capital). Increase in receivables

also increases the chances of bad debts. Thus, creation of receivables is beneficial as well as dangerous. Finally, management of accounts receivables means the process of making decisions relating to investment of funds in this asset, which results in maximising the overall return on the investment of the firm.

Maturity

It will be advisable to select securities according to their maturities so the finance manager can maximise the yield as well as maintain the liquidity of investments.

Check your progress 5

1. _____ is a liquid current asset.

a. machine

c. Cash

b. Stock

2.7 Cash Budget

Cash budgeting is a tool of finance. In finance, cash budgeting will control inflow and outflow of cash fund. You can plan how to pay and when to pay your expenses. With this, you can increase your future ability to pay your debts. The cash budget bases the plan on the cash that will be received in future from debtors and cash sales after deducting future expenses. The balance amount will show as closing balance of cash. But this is just an estimation that is useful for future planning.

Cash budget is a detailed plan showing how cash resources will be acquired and used over some specific period.

Cash budget is composed of four major sections:

- The receipts section
- The disbursements section
- The cash excess or deficiency section
- The financing section

The cash receipts section consists of a listing of all of the cash inflows, except for financing, expected during the budgeting period. Generally, the major source of receipts will be from sales. The disbursement section consists of all cash payments that are planned for the budgeted period. These payments will include raw materials purchases, direct labour payments, manufacturing overhead costs and so on as contained in their respective budgets. In addition, other cash disbursements such as equipment purchase, dividends and other cash withdrawals by owners are listed.

The cash excess or deficiency section is computed as follows:

Cash balance beginning	XXXX
Add receipts	XXXX
Total cash available	-----
Less disbursements	XXXX
Excess (deficiency) of cash available over disbursements	XXXX

	XXXX

If there is a cash deficiency during any period, the company will need to borrow funds. If there is cash excess during any budgeted period, funds borrowed in previous periods can be repaid or the excess funds can be invested.

The financing section deals the borrowings and repayments projected to take place during the budget period. It also includes interest payments that will be due on money borrowed. The cash budget should be broken down into periods that are as short as feasible. Considerable fluctuations in cash balances may be hidden by looking at a longer period. While a monthly cash budget is most common, many firms budget cash on a weekly or even daily basis.

The cash budget helps management keep cash balances in reasonable relationship to its needs. It aids in avoiding idle cash and possible cash shortages. The cash budget typically consists of four major sections:

- Receipts section, which is the beginning cash balance, cash collections from customers and other receipts.
- Disbursement section comprised of all cash payments made by purpose.
- Cash surplus or deficit section, showing the difference between cash

receipts and cash payments.

- Financing section, providing a detailed account of the borrowings and repayments expected during the period.

Cash budget is one of the key components of a master budget prepared by a company. It is actually a statement of planned cash receipt and disbursement activities which are expected to occur in the near future. The budget will determine whether the company will have enough cash to fund its future business operations.

If the company has surplus cash in the budget, action plans will be put up on how to utilise them. They can be divided out to the shareholders or can be reinvested to earn income. In any case, if there is no definite plan yet, the most common and safest way to handle them is to put it in the money market to earn interest.

In the event the budget shows that the company will have a deficit cash situation in the near future, plans must be prepared on how to get extra cash to fund the deficit situation. It is very important to ensure that the company has enough funds to cover the deficit situation so that the company can continue its operations smoothly. Some of the common ways to bring in funds would be fresh capital injection, obtaining loans from financial institutions or temporary loans from directors or other parties. In the case of loans, the company will be required to pay the lender some interests, which will be additional expense.

However, not all deficit cash budget means that losses to the company. Deficit cash budget could occur in a situation whereby cash is needed to fund the cost of a profitable business venture upfront before revenue can be collected in the later stage.

There are several ways of presenting the cash budget. One of the more straightforward presentation templates is as follows:

a. Cash from operations

- **Total Cash Inflow received from operations:** This refers to all cash collected from the business operations, which include collection from customer accounts.
- **Total Cash Outflow used in operations:** This refers to all cash used in funding the business operations, which includes disbursements to trade creditors, sundry suppliers, staff salary and other administrative

expenses.

- b. **Cash used in investing activities** - This includes cash used for capital expenditure, investment in subsidiary and public stocks.
- c. **Cash received from financing activities** - This includes cash received from capital injection, loans from banks and loans from third parties.
- d. **Ending cash balance** - This is a net total of the above A, B and C. This will reflect the net cash situation of the company. A surplus cash balance is usually represented by a positive number and a deficit cash balance would be a negative number.

Therefore, the cash budget format can be summarised as follows:

The total of all the receipts, less the total of all the payments equals the net receipt, if the answer is positive or net payment, if the answer is negative. This net receipt or payment is then added to the opening balance to give the closing balance, which becomes the opening balance in the next month.

Check your progress 6

1. _____ is one of key components of a master budget prepared by a company.
 - a. Cash budget
 - b. Fund flow
 - c. Cash flow

2.8 Let Us Sum Up

In this unit, we have studied about the nature and concepts of working capital. We have learnt about working capital here in very detail.

In this unit we learnt the various definitions of working capital, its nature and the concepts behind its management. We learnt why it is necessary to have working capital in a business. What are the various methods and various determinants of working capital. We even learnt about the management of cash and receivables. We even learnt about the cash budget.

This unit has given a detailed insight about working capital and is going to be of great help for the readers in understanding the concepts behind the topic.

2.9 Answer for Check Your Progress

Check your progress 1

Answers: (1-c)

Check your progress 2

Answers: (1-b)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-c)

Check your progress 6

Answers: (1-a)

2.10 Glossary

1. **Fixed Assets** - These consist of anything which a business owns or buys for use within the business and which retains a value at year-end. They usually consist of major items like land, buildings, equipment and vehicles but can include smaller items like tools.
2. **Working Capital** - Funds for meeting day to day requirement of a business.

2.11 Assignment

Explain the need of working capital. Also explain the types of working capital.

2.12 Activities

Explain the process of calculating the amount of working capital requirement.

2.13 Case Study

Explain cash budget with the help of an example.

2.14 Further Readings

1. Business Finance, Srivastava Reddy.
2. Essentials of Financial Management, I. M. Pandey.
3. Financial Management, Appannaiah Reddy.
4. Management Accounting, Hingo Rani Ramnathanand Grewal.
5. Management Accounting, Khan and Jain.

UNIT 3: SOURCES OF FINANCE

Unit Structure

3.0 Learning Objectives

3.1 Introduction

3.2 Short Term Finance

3.2.1 Purpose of Short-Term Finance

3.2.2 Sources of Short-Term Finance

3.3 Long Term Finance

3.3.1 Purpose of Long-Term Finance

3.3.2 Factors Determining Long-Term Financial Requirements

3.4 Sources of Long Term Finance

3.4.1 Shares

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3.4.3 Term Loans from Banks

3.5 Financial Institutions

3.5.1 Industrial Finance Corporation of India (Ifci)

3.5.2 Industrial Credit and Investment Corporation of India (Icici)

3.5.3 State Finance Corporation

3.5.4 Industrial Development Bank of India (Idbi)

3.6 Let Us Sum Up

3.7 Answers for Check Your Progress

3.8 Glossary

3.9 Assignment

3.10 Activities

3.11 Case Study

3.12 Further Readings

3.0 Learning Objectives

After learning this unit, you will be able to understand:

- The meaning, purpose and sources of short term finance.
- The meaning, purpose and factors of long term finance.
- The sources of long term finance.
- Define financial institutions.
- Discuss shares, debentures and term loans.

3.1 Introduction

Finance is the lifeblood of business. It is of vital significance for modern business, which requires huge capital. Funds required for a business may be classified as long-term and short-term.

We have learnt about short-term finance in the previous lesson. Finance is required for a long period also. It is required for purchasing fixed assets like land and building, machinery, etc. Even a portion of working capital, which is required to meet day-to-day expenses, is of a permanent nature. To finance it we require long-term capital. The amount of long-term capital depends upon the scale of business and nature of business. In this unit, you will learn about various sources of long-term finance and the advantages and disadvantages of each source.

3.2 Short Term Finance

This type of finance is required for a period of less than a year. It is required to provide working capital for the business. The working capital is needed for the purchase of raw material, payment of wages, salaries and meeting day-to-day expenses of the business. Short-term finance may be required to meet the seasonal requirements of the business. It is available at low rate of interest.

3.2.1 Purpose of Short-Term Finance

After the establishment of a business, funds are required to meet its day-to-day expenses. For example, raw materials must be purchased at regular intervals, workers must be paid wages regularly, water and power charges have to be paid

regularly. Thus, there is a continuous necessity of liquid cash to be available for meeting these expenses. For financing such requirements, short-term funds are needed. The availability of short-term funds is essential. Inadequacy of short-term funds may even lead to closure of the business.

Short-term finance serves following purposes:

- It facilitates the smooth running of business operations by meeting day-to-day financial requirements.
- It enables firms to hold stock of raw materials and finished product.
- With the availability of short-term finance, goods can be sold on credit. Sales are for a certain period and collection of money from debtors takes time. During this time gap, production continues and money will be needed to finance various operations of the business.
- Short-term finance becomes more essential when it is necessary to increase the volume of production at a short notice.

3.2.2 Sources of Short-term Finance

There are a number of sources of short-term finance, which are listed below:

1. **Trade credit**
2. **Bank credit**
 - a. Loans and advances
 - b. Cash credit
 - c. Overdraft
 - d. Discounting of bills
3. **Customers' advances**
4. **Instalment credit**
5. **Loans from co-operatives**

1. **Trade credit:** Trade credit refers to credit granted to manufactures and traders by the suppliers of raw material, finished goods, components, etc. Usually business enterprises buy supplies on a 30 to 90 days credit. This means that the goods are delivered but payments are not made until the expiry of period of credit. This type of credit does not make the funds

available in cash but it facilitates purchases without making immediate payment. This is quite a popular source of finance.

2. **Bank credit:** Commercial banks grant short-term finance to business firms, known as bank credit. When bank credit is granted, the borrower gets a right to draw the amount of credit at one time or in instalments as and when needed. Bank credit may be granted by way of loans, cash credit, overdraft and discounted bills.
 - a. **Loans:** When a certain amount is advanced by a bank repayable after a specified period, it is known as bank loan. Such advance is credited to a separate loan account and the borrower has to pay interest on the entire amount of loan irrespective of the amount of loan actually drawn. Usually loans are granted against security of assets.
 - b. **Cash Credit:** It is an arrangement whereby banks allow the borrower to withdraw money up to a specified limit. This limit is known as cash credit limit. Initially this limit is granted for one year. This limit can be extended after a review for another year. However, if the borrower still desires to continue the limit, it must be renewed after three years. Rate of interest varies depending upon the amount of limit. Banks ask for collateral security for the grant of cash credit. In this arrangement, the borrower can draw, repay and again draw the amount within the sanctioned limit. Interest is charged only on the amount actually withdrawn and not on the amount of the entire limit.
 - c. **Overdraft:** When a bank allows its depositors or account holders to withdraw money in excess of the balance in his account up to a specified limit, it is known as overdraft facility. This limit is granted purely based on credit-worthiness of the borrower. Banks generally give the limit up to Rs.20,000. In this system, the borrower has to show a positive balance in his account on the last Friday of every month. Interest is charged only on the overdrawn money. Rate of interest in case of an overdraft is less than the rate charged under cash credit.
 - d. **Discounting of Bill:** Banks also advance money by discounting bills of exchange, promissory notes and hundies. When these documents are presented before the bank for discounting, banks credit the amount to customer's account after deducting discount. The amount of discount is equal to the amount of interest for the period of bill.

3. **Customers' advances:** Sometimes businessmen insist on their customers to make some advance payment. It is generally asked when the value of order is quite large or things ordered are very costly. Customers' advance represents a part of the payment towards price on the product(s) to be delivered later. Customers generally agree to make advances when such goods are not easily available in the market or there is an urgent need of goods. A firm can meet its short-term requirements with the help of customers' advances.
4. **Instalment credit:** Instalment credit is now-a-days a popular source of finance for consumer goods like television, refrigerators as well as for industrial goods. You might be aware of this system. Only a small amount of money is paid at the time of delivery of such articles. The balance is paid in a number of instalments. The supplier charges interest for extending credit. The amount of interest is included while deciding on the amount of instalment. Another comparable system is the hire purchase system under which the purchaser becomes owner of the goods after the payment of last instalment. Sometimes commercial banks also grant instalment credit if they have suitable arrangements with the suppliers.
5. **Loans from co-operatives:** Co-operative banks are a good source to procure short-term finance. Such banks have been established at local, district and state levels. District Cooperative Banks are the federation of primary credit.
6. **Cooperative Banks in the state:** They are also governed by the Reserve Bank of India's regulations. Some of these banks like the Vaishya Co-operative Bank was initially established as a co-operative society and later converted into a bank. These banks grant loans for personal as well as business purposes. Membership is the primary condition for securing loan. The functions of these banks are largely comparable to the functions of commercial banks.

Check your progress 1

1. _____ is considered to be one of the short term sources of finance.
 - a. Shares
 - b. Cash credit
 - c. Term loan from bank

3.3 Long Term Finance

A business requires funds to purchase fixed assets like land and building, plant and machinery, furniture, etc. These assets may be regarded as the foundation of a business. The capital required for these assets is called fixed capital. A part of the working capital is also of a permanent nature. Funds required for this part of the working capital and for fixed capital are called long-term finance.

3.3.1 Purpose of Long-Term Finance

Long-term finance is required for the following purposes:

1. **To Finance fixed assets:** Business requires fixed assets like machines, building, furniture, etc. Finance required to buy these assets is for a long period, because such assets can be used for a long period and are not for resale.
2. **To finance the permanent part of working capital:** Business is a continuing activity. It must have a certain amount of working capital, which would be needed repeatedly. This part of working capital is of a fixed or permanent nature. This requirement is also met from long-term funds.
3. **To finance growth and expansion of business:** Expansion of a business requires investment of a huge amount of capital permanently or for a long period.

3.3.2 Factors Determining Long-Term Financial Requirements

The amount required to meet the long-term capital needs of a company depends upon many factors. These are:

- a. **Nature of Business:** The nature and character of a business determines the amount of fixed capital. A manufacturing company requires land, building, machines, etc. Therefore, it has to invest a large amount of capital for a long period. However, a trading concern dealing in, say, washing machines will require a smaller amount of long-term fund because it does not have to buy building or machines.

- b. **Nature of goods produced:** If a business is engaged in manufacturing small and simple articles it will require a smaller amount of fixed capital as compared to one manufacturing heavy machines or heavy consumer items like cars, refrigerators, etc. which will require more fixed capital.
- c. **Technology used:** In heavy industries such as steel, the fixed capital investment is larger than in the case of a business producing plastic jars using simple technology or producing goods using labour intensive technique.

Check your progress 2

1. _____ Finance is required to buy fixed assets is for a long period.
 - a. Short term
 - b. Long term

3.4 Sources of Long Term Finance

The main sources of long-term finance are as follows:

1. Shares
2. Debentures
3. Term loans from banks

Many industrial development banks, cooperative banks and commercial banks grant medium term loans for a period of three to five years.

3.4.1 Shares

Issue of shares is the main source of long-term finance. Shares are issued by joint stock companies to the public. A company divides its capital into units of a definite face value, say of Rs. 10 each or Rs. 100 each. Each unit is called a share. A person holding shares is called a shareholder.

Characteristics of shares

The main characteristics of shares are following:

1. It is a unit of capital of the company.

2. Each share is of a definite face value.
 3. A share certificate is issued to a shareholder indicating the number of shares and the amount.
 4. Each share has a distinct number.
 5. The face value of a share indicates the interest of a person in the company and the extent of his liability.
 6. Shares are transferable units. Investors are of different habits and temperaments. Some want to take lesser risk and are interested in a regular income. Others may take greater risk in anticipation of huge profits in future. In order to tap the savings of different types of people, a company may issue different 2 types of shares. These are:
 - **Preference shares**
 - **Equity Shares**
- **Preference Shares** - Preference Shares are the shares that carry preferential rights over the equity shares. These rights are (a) receiving dividends at a fixed rate (b) getting back the capital in case the company is wound-up. Investments in these shares are safe and a preference shareholder also gets dividend regularly.
 - **Equity Shares** - Equity shares are shares that do not enjoy any preferential right in the matter of payment of dividend or repayment of capital. The equity shareholder gets dividend only after the payment of dividends to the preference shares. There is no fixed rate of dividend for equity shareholders. The rate of dividend depends upon the surplus profits. In case of winding up of a company, the equity share capital is refunded only after refunding the preference share capital. Equity shareholders have the right to take part in the management of the company. However, equity shares also carry more risk.

Following are the merits and demerits of equity shares:

1. **Merits**

- a. **To the shareholders:**

- In case there are good profits, the company pays dividend to the equity shareholders at a higher rate.

- The value of equity shares goes up in the stock market with the increase in profits of the concern.
- Equity shares can be easily sold in the stock market.
- Equity shareholders have greater say in the management of a company as they are conferred voting rights by the Articles of Association.

b. To the Management:

- A company can raise fixed capital by issuing equity shares without creating any charge on its fixed assets.
- The capital raised by issuing equity shares is not required to be paid back during the lifetime of the company. It will be paid back only if the company is wound up.
- There is no liability on the company regarding payment of dividend on equity shares. The company may declare dividend only if there are enough profits.
- If a company raises more capital by issuing equity shares, it leads to greater confidence among the investors and creditors.

2. Demerits:

a. To the shareholders

- Uncertainly about payment of dividend: Equity shareholders get dividend only when the company is earning sufficient profits and the Board of Directors declare dividend. If there are preference shareholders, equity shareholders get dividend only after payment of dividend to the preference shareholders.
- Speculative: Often there is speculation on the prices of equity shares. This is particularly so in times of boom when dividend paid by the companies is high.
- Danger of over-capitalisation: In case the management miscalculates the long-term financial requirements, it may raise more funds than required by issuing shares. This may amount to over-capitalisation, which in turn leads to low value of shares in the stock market.

- Ownership in name only: Holding of equity shares in a company makes the holder one of the owners of the company. Such shareholders enjoy voting rights. They manage and control the company. But then it is all in theory. In practice, a handful of people control the votes and manage the company. Moreover, the decision to declare dividend rests with the Board of Directors.
- Higher Risk: Equity shareholders bear a very high degree of risk. In case of losses, they do not get dividend. In case of winding up of a company, they are the very last to get refund of the money invested. Equity shares actually swim and sink with the company.

b. To the Management

- No trading on equity: Trading on equity means ability of a company to raise funds through preference shares, debentures, bank loans, etc. On such funds, the company has to pay at a fixed rate. This enables equity shareholders to enjoy a higher rate of return when profits are large. The major part of the profit earned is paid to the equity shareholders because borrowed funds carry only a fixed rate of interest. However, if a company has only equity shares and does not have preference shares, debentures or loans, it cannot have the advantage of trading on equity.
- Conflict of interests: As the equity shareholders carry voting rights, groups are formed to corner the votes and grab the control of the company. There develops conflict of interests, which is harmful for the smooth functioning of a company.

3.4.2 Debentures

Whenever a company wants to borrow a large amount of fund for a long but fixed period, it can borrow from the public by issuing loan certificates called Debentures. The total amount to be borrowed is divided into units of fixed amount say of Rs.100 each. These units are called Debentures. These are offered to the public to subscribe in the same manner as is done in the case of shares. A debenture is issued under the common seal of the company. It is a written acknowledgement of money borrowed. It specifies the terms and conditions, such as rate of interest, time repayment, security offered, etc.

Characteristics of Debentures

Following are the characteristics of Debentures:

- Debenture holders are the creditors of the company. They are entitled to periodic payment of interest at a fixed rate.
- Debentures are repayable after a fixed period of time, say five years or seven years as per agreed terms.
- Debenture holders do not carry voting rights.
- Ordinarily, debentures are secured. In case the company fails to pay interest on debentures or repay the principal amount, the debenture holders can recover it from the sale of the assets of the company.

Types of Debentures

Debentures may be classified as:

- Redeemable Debentures and Irredeemable Debentures
- Convertible Debentures and Non-convertible Debentures
 - **Redeemable Debentures:** These are debentures repayable on a pre-determined date or at any time prior to their maturity, provided the company so desires and gives a notice to that effect.
 - **Irredeemable Debentures:** These are also called perpetual debentures. A company is not bound to repay the amount during its lifetime. If the issuing company fails to pay the interest, it has to redeem such debentures.
 - **Convertible Debentures:** The holders of these debentures are given the option to convert their debentures into equity shares at a time and in a ratio as decided by the company.
 - **Non-convertible Debentures:** These debentures cannot be converted into shares.

Merits of debentures

Following are some of the advantages of debentures:

- **Raising funds without allowing control over the company:** Debenture holders have no right to vote or take part in the management of the company.

- **Reliable source of long-term finance:** Since debentures are ordinarily issued for a fixed period, the company can make the best use of the money. It helps long term planning.
- **Tax Benefits:** Interest paid on debentures is treated as an expense and is charged to the profits of the company. The company thus saves income tax.
- **Investors' Safety:** Debentures are mostly secured. On winding up of the company, they are repayable before any payment is made to the shareholders. Interest on debentures is payable irrespective of profit or loss.

Demerits

Following are the demerits of debentures:

- As the interest on debentures has to be paid every year whether there are profits or not, it becomes burdensome in case the company incurs losses.
- Usually the debentures are secured. The company creates a charge on its assets in favour of debenture holders. Therefore, a company that does not own enough fixed assets cannot borrow money by issuing debentures. Moreover, the assets of the company once mortgaged cannot be used for further borrowing.
- Debenture-finance enables a company to trade on equity. But too much of such finance leaves little for shareholders, as most of the profits may be required to pay interest on debentures. This brings frustration in the minds of shareholders and the value of shares may fall in the securities markets.
- Burdensome in times of depression: During depression, the profits of the company decline. It may be difficult to pay interest on debentures. As interest goes on accumulating, it may lead to the closure of the company.

Until now, you have learnt about issue of shares and debentures as two main sources of raising long-term finance. You have also learnt about the merits and demerits of the two. Now let us make a comparative study of shares and debentures for raising long-term capital.

3.4.3 Term Loans from Banks

Many industrial development banks, cooperative banks and Commercial banks grant medium term loans for a period of three to five years.

1) Retained Earnings

Like an individual, companies also set aside a part of their profits to meet future requirements of capital. Companies keep these savings in various accounts such as General Reserve, Debenture Redemption Reserve and Dividend Equalisation Reserve etc. These reserves can be used to meet long-term financial requirements. The portion of the profits, which is not distributed among the shareholders but is retained and is used in business is called retained earnings or ploughing back of profits. As per the Indian Companies Act., companies are required to transfer a part of their profits in reserves. The amount so kept in reserve may be used to buy fixed assets. This is called internal financing.

Merits

Following are the benefits of retained earnings:

1. **Cheap Source of Capital:** No expenses are incurred when capital is available from this source. There is no obligation on the part of the company to pay interest or pay back the money. It can safely be used for expansion and modernisation of business.
2. **Financial stability:** A company, which has enough reserves, can face ups and downs in business. Such companies can continue with their business even in depression, thus building up its goodwill.
3. **Benefits to the shareholders:** Shareholders may get dividend out of reserves even if the company does not earn enough profit. Due to reserves, there is capital appreciation, i.e. the value of shares goes up in the share market.

Limitation

Following are the limitations of Retained Earnings:

1. **Huge Profit:** This method of financing is possible only when there are huge profits and that too for many years.
2. **Dissatisfaction among shareholders:** When funds accumulate in reserves, bonus shares are issued to the shareholders to capitalise such funds. Hence,

the company has to pay more dividends. By retained earnings, the real capital does not increase while the liability increases. In case bonus shares are not issued, it may create a situation of under-capitalisation because the rate of dividend will be much higher as compared to other companies.

3. **Fear of monopoly:** Through ploughing back of profits, companies increase their financial strength. Companies may throw out their competitors from the market and monopolise their position.
4. **Mismanagement of funds:** Capital accumulated through retained earnings encourages management to spend carelessly.

2) Public Deposits

It is a very old source of finance in India. When modern banks were not there, people used to deposit their savings with business concerns of good repute. Even today, it is a very popular and convenient method of raising medium term finance. The period for which business undertakings accept public deposits ranges between six months to three years.

Procedure to raise funds through public deposits

An undertaking that wants to raise funds through public deposits advertises in the newspapers. The advertisement highlights the achievements and future prospects of the undertaking and invites the investors to deposit their savings with it. It declares the rate of interest, which may vary depending upon the period for which money is deposited.

It also declares the time and mode of payment of interest and the repayment of deposits. A depositor may get his money back before the date of repayment of deposits for which he will have to give notice in advance.

Features:

- These deposits are not secured.
- They are available for a period ranging between 6 months and 3 years.
- They carry fixed rate of interest.
- They do not require complicated legal formalities as are required in the case of shares or debentures.

Keeping in view the malpractices of certain companies, such as not paying interest for years together and not refunding the money, the Government has framed certain rules and regulations regarding inviting the public to deposit their savings and accepting them.

Rules governing Public Deposits

Following are the main rules governing public deposits:

- Deposits should not be made for less than six months or more than three years.
- Public is invited to deposit their savings through an advertisement in the press. This advertisement should contain all relevant information about the company.
- Maximum rate of interest is fixed by the Reserve Bank of India.
- Maximum rate of brokerage is also fixed by the Reserve Bank of India.
- The amount of deposit should not exceed 25% of the paid up capital and general reserves.
- The company is required to maintain Register of Depositors containing all particulars as to public deposits.
- In case the interest payable to any depositor exceeds Rs. 10,000 p.a., the company is required to deduct income tax at source.

Advantages

Following are the advantages of public deposits:

1. **Simple and easy:** The method of borrowing money through public deposit is very simple. It does not require many legal formalities. It has to be advertised in the newspapers and a receipt is to be issued.
2. **No charge on assets:** Public deposits are not secured. They do not have any charge on the fixed assets of the company.
3. **Economical:** Expenses incurred on borrowing through public deposits is much less than expenses of other sources like shares and debentures.
4. **Flexibility:** Public deposits bring flexibility in the structure of the capital of the company. These can be raised when needed and refunded when not required.

Disadvantages

Following are the disadvantages of public deposits:

1. **Uncertainty:** A concern should be of high repute and have a high credit rating to attract public to deposit their savings. There may be sudden withdrawals of deposits, which may create financial problems.
2. **Insecurity:** Public deposits do not have any charge on the assets of the concern. It may not always be safe to deposit savings with companies particularly those, which are not very sound.
3. **Lack of attraction for professional investors:** As the rate of return is low and there is no capital appreciation, the professional investors do not appreciate this mode of investment.
4. **Uneconomical:** The rate of interest paid on public deposits may be low but then there are other expenses like commission and brokerage, which make it uneconomical.
5. **Hindrance to growth of capital-market:** If more and more money is deposited with the companies in this form, there will be less investment in securities. Hence, the capital market will not grow. This will deprive both the companies and the investors of the benefits of good securities.
6. **Over-capitalisation:** As it is an easy, convenient and cheaper source of raising money, companies may raise more money than is required. In that case, it may not be able to make the best use of the funds or may indulge in speculative activities.

Check your progress 3

1. Issue of shares is the main source of _____ finance.
 - a. long-term
 - b. short term
 - c. medium term

3.5 Financial Institutions

There are many specialised financial institutions established by the Central and State governments, which give long-term loans at a reasonable rate of interest. Some of these institutions are:

- Industrial Finance Corporation of India (IFCI)
- Industrial Development Bank of India (IDBI)
- Industrial Credit and Investment Corporation of India (ICICI)
- Unit Trust of India (UTI)
- State Finance Corporations, etc.

3.5.1 Industrial Finance Corporation of India (IFCI)

At the time of independence in 1947, India's capital market was relatively under-developed. Although there was significant demand for new capital, there was a dearth of providers. Merchant bankers and underwriting firms were almost non-existent. In addition, commercial banks were not equipped to provide long-term Industrial Finance in any significant manner.

It is against this backdrop that the government established The Industrial Finance Corporation of India (IFCI) on July 1, 1948, as the first Development Financial Institution in the country to cater to the long-term Finance needs of the industrial sector. The newly established DFI was provided access to low-cost funds through the central bank's Statutory Liquidity Ratio or SLR, which in turn enabled it to provide loans and advances to corporate borrowers at concessional rates.

This arrangement continued until the early 1990s when it was recognised that there was need for greater flexibility to respond to the changing financial system. It was also felt that IFCI should directly access the capital markets for its funds needs. It is with this objective that the constitution of IFCI was changed in 1993 from a statutory corporation to a company under the Indian Companies Act, 1956. Subsequently, the name of the company was also changed to 'IFCI Limited' with effect from October 1999.

IFCI has fulfilled its original mandate as a DFI by providing long-term financial support to all segments of Indian Industry. It has also been chiefly

instrumental in translating the Government's development priorities into reality. Until the establishment of ICICI in 1956 and IDBI in 1964, IFCI remained solely responsible for implementation of the government's industrial policy initiatives. Its contribution to the modernisation of Indian industry, export promotion, import substitution, entrepreneurship development, pollution control, energy conservation and generation of both direct and indirect employment is noteworthy.

3.5.2 Industrial Credit and Investment Corporation of India (ICICI)

In 1955, The Industrial Credit and Investment Corporation of India Limited (ICICI) was incorporated at the initiative of World Bank, the Government of India and representatives of the Indian industry, with the objective of creating a development financial institution for providing medium-term and long-term project financing to Indian businesses. In 1994, ICICI established Banking Corporation as a banking subsidiary.

Formerly known as Industrial Credit and Investment Corporation of India, ICICI Banking Corporation was later renamed as 'ICICI Bank Limited'. ICICI founded a separate legal entity, ICICI Bank, to undertake normal banking operations - taking deposits, credit cards, car loans, etc. In 2001, ICICI acquired Bank of Madura (est. 1943). Bank of Madura was Chettiar bank and had acquired Chettinad Mercantile Bank (est. 1933) and Illanji Bank (established 1904) in the 1960s.

In 2002, The Boards of Directors of ICICI and ICICI Bank approved the reverse merger of ICICI, ICICI Personal Financial Services Limited and ICICI Capital Services Limited, into ICICI Bank. After receiving all necessary regulatory approvals, ICICI integrated the group's financing and banking operations, both wholesale and retail, into a single entity. At the same time, ICICI started its international expansion by opening representative offices in New York and London. In India, ICICI Bank bought the Shimla and Darjeeling branches that Standard Chartered Bank had inherited when it acquired Grindlays Bank.

In 2003, ICICI opened subsidiaries in Canada and the United Kingdom (UK) and in the UK it established an alliance with Lloyds TSB. It also opened an Offshore Banking Unit (OBU) in Singapore and representative offices in Dubai and Shanghai. In 2004, ICICI opened a representative office in Bangladesh to tap the extensive trade between that country, India and South Africa. In 2005, ICICI

acquired Investitsionno-Kreditny Bank (IKB), a Russian bank with about US \$ 4mn in assets, head office in Balabanovo in the Kaluga region and with a branch in Moscow. ICICI renamed the bank ICICI Bank Eurasia. Also, ICICI established a branch in the Dubai International Financial Centre and in Hong Kong.

In 2006, ICICI Bank UK opened a branch in Antwerp, in Belgium. ICICI opened representative offices in Bangkok, Jakarta and Kuala Lumpur. In 2007, ICICI amalgamated Sangli Bank, which was headquartered in Sangli, in Maharashtra State and which had 158 branches in Maharashtra and another 31 in Karnataka State. Sangli Bank had been founded in 1916 and was particularly strong in rural areas. With respect to the international sphere, ICICI also received permission from the government of Qatar to open a branch in Doha. Also, ICICI Bank Eurasia opened a second branch, this time in St. Petersburg.

In 2008, the US Federal Reserve permitted ICICI to convert its representative office in New York into a branch. ICICI also established a branch in Frankfurt. In 2009, ICICI made huge changes in its organisation like elimination of loss making department and re-stretching outsourced staff or renegotiate their charges in consequence to the recession. In addition to this, ICICI adopted a massive approach aimed for cost control and cost cutting. In consequence of it, compensation to staff was not increased and no bonus declared for 2008-09.

On 23rd May, ICICI Bank announced their merger with Bank of Rajasthan through share-swap in a non-cash deal that values the Bank of Rajasthan at about Rs 3,000 crore. Each 118 shares of Bank of Rajasthan will be converted into 25 shares of ICICI. It is said that this merger will also expand ICICI Bank's branch network by 25%.

The ICICI has a commendable record of assistance to industrial enterprises. The assistance has been provided in the form of rupee loans, foreign currency loans, guarantees, underwriting and direct subscriptions to securities.

Industrial Credit and Investment Corporation of India) is a major banking and financial services organisation in India. It is the 4th largest bank in India and the largest private sector bank in India by market capitalisation. The bank also has a network of 2,016 branches (as on 31 March 2010) and about 5,219 ATMs in India and presence in 18 countries, as well as some 24 million customers (at the end of July 2007).

ICICI Bank offers a wide range of banking products and financial services to corporate and retail customers through a variety of delivery channels and

specialisation subsidiaries and affiliates in the areas of investment banking, life and non-life insurance, venture capital and asset management. (These data are dynamic) ICICI Bank is also the largest issuer of credit cards in India. ICICI Bank's shares are listed on the stock exchanges at Kolkata and Vadodara, Mumbai and the National Stock Exchange of India Limited; its ADRs trade on the New York Stock Exchange (NYSE).

In the 24 years of its operation (i.e., over the period 1955 to 1978) the total assistance amounted to Rs. 9371 million. This was distributed to 1174 enterprises for setting up 2,235 projects. Of these, approximately 7.5% have been undertaken by those who had no previous experience of industry. About 30% of the enterprises were sanctioned assistance in both rupees and foreign currencies. Until the end of December 1978, the Corporation had disbursed assistance amounting to Rs. 7924.7 million. Assistance amounting to Rs. 4426.9 million was outstanding on that date.

According to the Directors Report released on March 19, 1970, the net sanctions made by the corporations during 1978 amounted to Rs. 1378.8 million against Rs. 1043 million in 1977. Fifty-seven projects located in areas designated backward by the Government received Rs. 489.4 million, (i.e. 35.5% of net sanctions) during the year. Thirty projects in the joint public sector were sanctioned assistance amounting to Rs. 252.1 million during 1978.

Besides its financing operations, the Corporation has conducted a study of the impact Gujarat State Fertilizer Co. on a predominantly agricultural community. The Corporation has also started taking interest in the promotion of rural development. It has already agreed to support a scheme for setting up Lift Irrigation Facilities and allied activities in Maharashtra.

The corporation has been associated with the establishments of regional and State industrial and technical consultancy organisations.

The Corporation is authorised to undertake the following activities to achieve these objects:

- Granting loans over a period of a year.
- Subscription to equity and preference share capital, normally in the form of underwriting of public issue.
- Guaranteeing of rupee payments required, for instance, in case of deferred payments.

- Advancing loans in foreign currency towards the cost of imported capital equipment.
- Furnishing technical and administrative assistance to the Indian industry.

Generally, the Corporation treats Rs. 0.5 million as the lower limit for its assistance. The upper limit for assistance is Rs. 10 million. In 1969, the Corporation decided to provide foreign currency loans to partnership and proprietary firm to strengthen entrepreneurship in small concerns.

The principal points, which the corporation considers in appraising a project submitted for obtaining finance, are:

- **The company to be financed:** The background, reputation, experience and capital structure of the company (or the worth and experience of the promoter) should inspire confidence that the project will be expeditiously carried out and efficiently managed.
- **The basic soundness of the project:** ICICI wishes to be satisfied with the reasonableness of the purpose of the investment; how it fits into the Indian economy; the availability of raw materials, essential services, technical and managerial personnel and labour; foreign technical or financial collaboration, if any; construction schedule, quality of equipment, etc.
- **Cost of the project:** ICICI seeks to satisfy itself of the reasonableness of estimated of cost to be incurred both at home and abroad, including appropriate provision for contingencies and for working capital.
- **Means of financing the project:** The source of finance, the relationship between various forms of capital and the contribution of the promoters are carefully examined in order to make sure that the funds required will be forthcoming when needed and that the enterprise will have a sound capital structure. The security is available in case a loan is required.
- **Market:** ICICI examines the size and prospective growth of the market, which the enterprise will supply; the means of marketing; nature of competition; the prospective prices; the degree to which the enterprise will depend on tariff protection; and the selling arrangements.
- **Profitability:** ICICI critically examines detailed estimates of production costs, sales and annual profits, the capacity of the enterprise to repay loans, to build up reserves and to pay reasonable dividends.

- **Management:** Above all, ICICI must be satisfied with the experience of those who will construct and operate the project and with the technical advice they will have.
- **Government consent:** There must be assurance that the licenses and consents required from Government to undertake the project have been or will be granted.

Based on the data thus submitted by an applicant, ICICI staff discusses the proposal in detail with the applicant, undertakes independent inquiries and usually visits the plant. ICICI also discusses the broad details of the project with other financial institutions where joint financing is envisaged.

The full appraisal of the project is then placed before ICICI's Board of Directors for decision. If the investment is approved, the contract covering it must be agreed upon within a period specified, generally not more than four months. ICICI reserves the right to reconsider the proposal if it is not embodied in a contract in a reasonable time. Until such a control is concluded, ICICI does not consider itself committed to the investment.

Object of Industrial Credit and Investment Corporation aims at

- Assisting in the creation, expansion and modernisation of industrial units in the private sector.
- Encouraging the inflow and participations of foreign capital in these units.
- The expansion of investment market in India.

3.5.3 State Finance Corporation

The Industrial Finance Corporation is expected to render assistance only to large industrial concerns. With a view to meeting the requirements of small concerns the State Finance Corporations Act of 1951 was passed. Under this Act, a State Government is empowered to establish a Finance corporation to operate within its area. The maximum capital allowed for a corporations Act of 1951 was passed.

Under this Act, a Stage Government is empowered to establish a finance Corporation to operate within its areas. The maximum, capital allowed for a corporation is Rs. 50 million. A State Finance Corporation is expected to grant

financial assistance to medium small and cottage industries. In order to see that there is no overlapping of the functions of the Industrial Finance Corporation and the State finance corporations, it has been agreed that assistance of Rs. 1 million or 10 percent of the paid-up capital of the corporation concerned, whichever is less, would be granted only by the State corporations. For public limited companies and co-operatives, the limit has been raised to Rs. 5 million.

Functions

A State Finance Corporation can transact the following types of business:

- Guaranteeing, on such terms and conditions as may be agreed upon:
 - Loans raised by industrial concerns which are repayable within a period not exceeding 20 years and are floated in public market.
 - Loans raised by industrial concerns from scheduled banks or State co-operative banks or other financial institutions.
- Guaranteeing deferred payments due from industrial concerns in connection with their purchases of capital goods within India. This power has been given under the amendment act of 1962;
- Underwriting the issue of stocks, shares, bonds or debentures by industrial concerns.
- The granting of loans or advances to or subscribing to the debentures of, an industrial concerns, repayable within a period not exceeding 20 years from the date on which they are granted or subscribed to, as the case may be.
- Subscribing the share capital of the borrower companies, in case they wish to rise additional capital.
- Generally, the doing of all such acts as may be incidental to or consequential upon the exercise of its powers or the discharge of its duties under this act.

A Central Industrial Finance Corporation was set up under the industrial Finance corporations Act, 1948 in order to provide medium and long-term credit to industrial undertakings, which fall outside normal activities of commercial banks. The State governments expressed their desire that similar corporations be set up in states to supplement the work of the Industrial financial Corporation.

State governments also expressed that the State corporations be established under a special statute in order to make it possible to incorporate in the constitutions necessary provisions regarding majority control by the government,

guaranteed by the State government about the payment principal. Statement of objects and reasons In order to provide medium and long-term credit to industrial undertaking which fall outside the normal activities of commercial banks, a central industrial Finance Corporation was set up under the Industrial Finance Corporations Act, 1948.

The State government wished that similar corporations should be set up in their states to supplement the work of industrial financial Corporation. The intention is that the State corporations will confine to financing medium and small scale industries and will as far as possible consider only such access, which is outside the prview of Industrial Finance Corporation.

The main Features of State financial Corporations Act 1951 are:

- The bill provides that the State government may, by notification in the official gazette, establish a financial Corporation for the State.
- The share capital shall be fixed by the State government but shall not exceed Rs 20 million. The issue of the shares to the public will be limited to 25% of the share capital and the rest will be held by the State Governments, The Reserve Bank, Scheduled Banks, Insurance Companies, Investment Trusts, Co-operative banks and other financial institutions.
- Shares of the Corporation: Corporation will be guaranteed by the Sate government as to the repayment of principal and the payment of a minimum dividend to be prescribed in consultation with the central government.
- The Corporation will be authorised to issue bonds and debentures for amounts, which together with the contingent liabilities of the corporations shall not exceed five times the amount of the paid-up share capital and the reserve fund of the corporations. These bonds and debentures will be guaranteed as to payment of the principal and payment of interest at such rate as may be fixed by the State government.
- The Corporation may accept deposits from the public repayable after not less than five years, subject to the maximum not exceeding the paid up capital.
- The Corporation will be managed by aboard consisting of a majority of Directors nominated by the Sate governments, The Reserve banks and the Industrial Finance Corporation of India

- The Corporation will be authorised to make long-term loans to industrial concerns, which are repayable within a period not exceeding 25 years. The Corporation will be further authorised to underwrite the issue of stocks, shares, bonds or debentures by industrial concerns, subject to the provision that the Corporation will be required to dispose off the shares, etc. acquired by it in fulfilment of its underwriting liability within a period of 7 years. Until a reserve fund is created equal to the paid-up share capital of the Corporation and until the State Governments has been repaid all amounts paid by them, if any, in fulfilment of the guarantee liability, the rate of dividend shall not exceed the rate guaranteed by the State government. Under no circumstances shall the dividend exceed 5% p.a. and surplus profits will be re-payable to the State governments. The Corporation will have special privileges in the matter of enforcement of its claims against borrowers.

Financial resources of the SFC's: The SFC's mobilise their financial resources from the following sources:

- Their own Share capital
- Income from investment and repayment of loans
- Sale of bonds
- Loans from the IDBI (To some extent)
- Borrowings from the Reserve Bank of India
- Deposits from the Public
- Loans from State Governments

In the act, financial corporations are established under Section 3 and include a Joint Financial Corporation established under Section 3 A of the Sate financial Corporations Act of 1951. The act applies to all 'Industrial Concerns', meaning any concern engaged or to be engaged in:

- The manufacturing, preservation or processing of goods.
- The mining or development of mines.
- The hotel industry.
- The transport of passengers or goods by road or by water or by air (or

ropeway or lift).

- The generation or distribution of electricity or any other form of power.
- The maintenance, repair, testing or servicing of machinery of any description or vehicles or vessels or motor boats or trailers or tractors.
- Assembling, repairing or packaging and article with the aid of machinery or power.
- The setting up or development of an industrial area industrial estate.
- Fishing or providing shore facilities for fishing or maintenance thereof.
- Providing weight bridge facilities.
- Providing engineering, technical, financial, management, marketing or other services or facilities for the industry.
- Providing medical, health or other allied services.
- Providing software or hardware services relating to information technology, telecommunication or electronics including satellite linkage.
- Setting up or development of tourism related facilities including amusement parks, conventions centres, restaurants travel and transport, tourist services agencies and guidance counselling services to tourists.
- Construction.
- Development, maintenance and construction of roads.
- Providing commercial complex facilities and community centres including conference halls.
- Floriculture.
- Tissue culture, fish culture, poultry farming, breeding and hatcheries.
- Service industry, such as altering ornamentation, polishing, finishing, oiling, washing, cleaning or otherwise treating or adapting and article or substance with a view to its use, sale transport, delivery or disposal.
- Research and development of any concept, technology, design process or product, whether in relation to any of the matters aforesaid including any activities approved by the Small Industries Bank State Financial Corporations also include industries which specialise in 'processing goods', which includes any art or process for producing, preparing or making an

article by subjecting any material to manual, mechanical, chemical, electrical or any other like operation.

Broad functions of State Financial Corporations

Project advisory and Finance as a catalyst: In small-scale industrial growth, the SFCs provide the following services:

a. Investment appraisal

- Project conceptualisation and related services, including guidance in relation to selection of projects, preparation of feasibility studies, capital structuring, techno-economic feasibility, financial engineering, project management design, etc.
- Credit Syndication including assistance in legal documentation, etc.
- Documentation of various project documents.
- Placement of debt-equity including design of the structure of instruments, placement of instruments with financial institutions, bank, etc.
- Assist in organisational structural changes such as follows:
 - Analysis of operational performance
 - Study of existing organisational structure
 - Study of the existing statutes and rules and regulations
 - Market analysis with respect to products
 - Review of domestic and international scenario
 - Valuation of fixed assets and inventory
 - Advising on formation of new entity
 - Preparation of relevant agreements/legal documents
- **Industry Research/Information Services:** A dedicated research team looks at macro-level issues as well as sector-specific, industry research. The expertise of the professional research team and a large diversified database enables SFC to provide erudite research reports to the corporate world.

3.5.4 Industrial Development Bank of India (IDBI)

The Industrial Development Bank of India (IDBI) was established on July 1, 1964 under an Act of Parliament as a wholly owned subsidiary of the Reserve Bank of India. On 16 February 1976, the ownership of IDBI was transferred to the Government of India and it was made the principal financial institution for coordinating the activities of institutions engaged in financing, promoting and developing industry in the country. Although Government shareholding in the Bank came down below 100% following IDBI's public issue in July 1995, the former continues to be the major shareholder (current shareholding: 52.3%).

During the four decades of its existence, IDBI has been instrumental in not only establishing a well-developed, diversified and efficient industrial and institutional structure but also adding a qualitative dimension to the process of industrial development in the country. IDBI has played a pioneering role in fulfilling its mission of promoting industrial growth through financing of medium and long-term projects, in consonance with national plans and priorities.

Over the years, IDBI has enlarged its basket of products and services, covering almost the entire spectrum of industrial activities, including manufacturing and services. IDBI provides financial assistance, both in rupee and foreign currencies for green-field projects as also for expansion, modernisation and diversification purposes. In the wake of financial sector reforms unveiled by the government since 1992, IDBI evolved an array of fund and fee-based services with a view to providing an integrated solution to meet the entire demand of financial and corporate advisory requirements of its clients.

IDBI also provides indirect financial assistance by way of refinancing of loans extended by State-level financial institutions and banks and by way of rediscounting of bills of exchange arising out of sale of indigenous machinery on deferred payment terms.

IDBI has played a pioneering role, particularly in the pre-reform era (1964–91), in catalysing broad based industrial development in the country in keeping with its Government-ordained 'development banking' charter. In pursuance of this mandate, IDBI's activities transcended the confines of pure long-term lending to industry and encompassed, among others, balanced industrial growth through development of backward areas, modernisation of specific industries, employment generation, entrepreneurship development along with support services for creating

a deep and vibrant domestic capital market, including development of apposite institutional framework.

Narasimham committee recommends that IDBI should give up its direct financing functions and concentrate only in promotional and refinancing role. But this recommendation was rejected by the government. Later RBI constituted a committee under the chairmanship of S H Khan to examine the concept of development financing in the changed global challenges. This committee is the first to recommend the concept of universal banking. The committee wanted to develop the financial institution to diversify its activity. It recommended to harmonise the role of development financing and banking activities by getting away from the conventional distinction between commercial banking and developmental banking.

In September 2003, IDBI diversified its business domain further by acquiring the entire shareholding of Tata Finance Limited in Tata Home finance Ltd., signalling IDBI's foray into the retail finance sector. The fully owned housing finance subsidiary has since been renamed 'IDBI Home finance Limited'. In view of the signal changes in the operating environment, following initiation of reforms since the early nineties, Government of India has decided to transform IDBI into a commercial bank without eschewing its secular development finance obligations.

The migration to the new business model of commercial banking, with its gateway to low-cost current, savings bank deposits, would help overcome most of the limitations of the current business model of development finance while simultaneously enabling it to diversify its client/ asset base. Towards this end, the IDB (Transfer of Undertaking and Repeal) Act 2003 was passed by Parliament in December 2003. The Act provides for repeal of IDBI Act, corporatisation of IDBI (with majority Government holding; current share: 58.47%) and transformation into a commercial bank. The provisions of the Act have come into force from July 2, 2004 in terms of a Government Notification to this effect.

The Notification facilitated formation, incorporation and registration of the Industrial Development Bank of India Ltd. as a company under the Companies Act, 1956 and a deemed Banking Company under the Banking Regulation Act 1949 and helped in obtaining requisite regulatory and statutory clearances, including those from RBI. IDBI would commence banking business in accordance with the provisions of the new Act in addition to the business being transacted under IDBI Act, 1964 from October 1, 2004, the 'Appointed Date' notified by the

Central Government. IDBI has firmed up the infrastructure, technology platform and reorientation of its human capital to achieve a smooth transition.

IDBI Bank, with which the parent IDBI was merged, was a vibrant new generation bank. The private bank was the fastest growing banking company in India. The bank was pioneer in adapting to policy of first mover in tier 2 cities. The Bank also had the least NPA and the highest productivity per employee in the banking industry.

On July 29, 2004, the Board of Directors of IDBI and IDBI Bank accorded in principle approval to the merger of IDBI Bank with the Industrial Development Bank of India Ltd. to be formed incorporated under the Companies Act, 1956 pursuant to the IDB (Transfer of Undertaking and Repeal) Act, 2003 (53 of 2003), subject to the approval of shareholders and other regulatory and statutory approvals. A mutually gainful proposition with positive implications for all stakeholders and clients, the merger process is expected to be completed during the current financial year ending March 31, 2005.

The immediate fall out of the merger of IDBI and IDBI Bank was the exit of employees of IDBI Bank. The difference in cultures in the two organisations has taken its toll. The IDBI Bank now is in a growing fold, with its retail banking arm expanding further after the merger of United Western Bank.

IDBI would continue to provide the extant products and services as part of its development finance role even after its conversion into a banking company. In addition, the new entity would also provide an array of wholesale and retail banking products, designed to suit the specific needs cash flow requirements of corporate and individuals. In particular, IDBI would leverage the strong corporate relationships built up over the years to offer customised and total financial solutions for all corporate business needs, single-window appraisal for term loans and working capital finance, strategic advisory and 'hand-holding' support at the implementation phase of projects, among others.

IDBI's transformation into a commercial bank would provide a gateway to low-cost deposits like Current and Savings Bank Deposits. This would have a positive impact on the bank's overall cost of funds and facilitate lending at more competitive rates to its clients. The new entity would offer various retail products, leveraging upon its existing relationship with retail investors under its existing Suvidha Flexi-bond schemes. In the emerging scenario, the new IDBI hopes to realise its mission of positioning itself as a one stop super-shop and most preferred brand for providing total financial and banking solutions to corporate and

individuals, capitalising on its intimate knowledge of the Indian industry and client requirements and large retail base on the liability side.

IDBI upholds the highest standards of corporate governance in its operations. The responsibility for maintaining these high standards of governance lies with its Board of Directors. Two Committees of the Board viz. the Executive Committee and the Audit Committee are adequately empowered to monitor implementation of good corporate governance practices and making necessary disclosures within the framework of legal provisions and banking conventions.

Check your progress 4

1. IFCI provides _____ term finance.
 - a. Short
 - b. Long

3.6 Let Us Sum Up

In this unit we had a detailed discussion on the long as well as short term finance, its meaning and finance. Here in this unit we had a detailed discussion on the need and importance of short as well as long term source of finance. What are the purpose of both of these statements were even learnt in detail.

In this unit various long term and short term finance source were also discussed in detail. Discussion has even been made on various financial institutions such as IFCI, ICICI, SFC AND IDBI. This unit is going to be of great help for the readers in understanding the topic of finance.

3.7 Answer for Check Your Progress

Check your progress 1

Answers: (1-b)

Check your progress 2

Answers: (1-b)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-b)

3.8 Glossary

1. **Long term Finance** - funds raised for acquisition of fixed assets.
2. **Short term finance** - funds raised for meeting short term funds need or for acquisition of current assets.

3.9 Assignment

Give the format for the Cash budget.

3.10 Activities

1. Give the format for the Cash budget.
2. Calculate the working capital ratio if:
Current assets: 180,000and
Current liabilities: 80,000

3.11 Case Study

The company started on January 1, 2003, when it issued 60,000 shares of Rs.1 par value common stock for Rs.60,000 cash. The company rented its office space, furniture and equipment and it performed tax consulting services throughout the first year. The comparative balance sheets at the beginning and at the end of the year 2003 appear as follows.

Tax Consultants Inc.				
Comparative Balance Sheets				
	Dec. 31 2003	Jan. 1 2003	Change	
Assets			Increase/Decrease	
	Rs.49,000	Rs.-0-	Rs.49,000	increase
Cash	Rs.36,000	Rs.-0-	Rs.36,000	increase
Accounts receivable	-----			
	Rs.85,000			
Total	=====	-----		
		Rs.-0-		
Liabilities and Stockholder's Equity		=====		
	Rs.5,000		Rs.5,000	increase
Accounts payable	Rs.60,000	Rs.-0-	Rs.60,000	increase
Common stock	Rs.20,000	Rs.-0-	Rs.20,000	increase
Retained earnings	-----	Rs.-0-		
	Rs.85,000	-----		
Total	=====	-----		
		Rs.-0-		
		=====		

The income statement and additional information for Tax Consultation Inc. are as follows.

Tax Consultants Inc.	
Income Statement	
For the year ended December 31, 2003	
Revenue	Rs.125,000
Operating expenses	Rs.85,000
Income before income taxes	-----
	Rs.40,000
Income tax expenses	Rs.6,000

Net income	Rs. 34,000

(Source: <http://www.accountingformanagement.com>)

Prepare a Cash Flow Statement.

3.12 Further Readings

1. Business Finance, Srivastava Reddy.
2. Essentials of Financial Management, I. M. Pandey.
3. Financial Management, Appannaiah Reddy.
4. Management Accounting, Hingo Rani Ramnathanand Grewal.
5. Management Accounting, Khan and Jain.

Block Summary

In this block we had a very detailed discussion on few of the very important topics. This block consists of three units. Unit 1 contains the discussion on cash and fund flow, where as unit 2 discuss on working capital management, whereas unit 3 discusses on the various sources of finance.

A cash flow statement is of great importance in financial accounting. It shows the flow of cash during a particular period of time. It helps us in understanding the the various sources through which cash was generated and the sources in which the cash has been utilized and the left over cash is the closing balance of cash for that very period. Similar is case with funds flow statement. Even it shows us the movement for a particular period of time. The only difference that lies here are that is shows us the movement of funds in place of cash. Funds are nothing but working capital. It is a much broader concept than the cash flow. The need for finance may be for long-term, medium-term or short-term. Financial requirements with regard to fixed and working capital vary from one organisation to other. To meet out these requirements, funds need to be raised from various sources. Some sources such as issue of shares and debentures provide money for a longer period. These are therefore, known as sources of long-term finance. On the other hand, sources like trade credit, cash credit, overdraft, bank loan, etc., which make money available for a shorter period of time, are called sources of short-term finance.

In this block, you studied various sources of short-term finance and their relative merits and demerits and certainly this block is going to be of great help on throwing some light over these important topics.

Block Assignment

Short Answer Questions

Write short notes on:

1. Cash flow statement
2. Fund flow statement
3. Working capital
4. Short term sources of finance
5. Long term sources of finance

Long Answer Questions

1. Discuss the use of a Cash flow statement.
2. How is a cash flow statement different from a fund flow statement?
3. Explain the need of working capital in an organisation.



“

*Education is something
which ought to be
brought within
the reach of every one.*

”

- Dr. B. R. Ambedkar



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Ahmedabad-382 481.