



# ACCOUNTING FOR MANAGERS

COURSE CODE: SGB24BB102MC

Major Course

Bachelor of Business Administration (Honours)



SELF LEARNING MATERIAL



SREENARAYANAGURU  
OPEN UNIVERSITY

## SREENARAYANAGURU OPEN UNIVERSITY

The State University for Education, Training and Research in Blended Format, Kerala



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To increase access of potential learners of all categories to higher education, research and training, and ensure equity through delivery of high quality processes and outcomes fostering inclusive educational empowerment for social advancement.

## Mission

To be benchmarked as a model for conservation and dissemination of knowledge and skill on blended and virtual mode in education, training and research for normal, continuing, and adult learners.

## Pathway

Access and Quality define Equity.

**Accounting for Managers**  
Course Code: SGB24BB102MC  
Semester - II

**Four Year Undergraduate Programme**  
**Bachelor of Business Administration (Honours)**  
**Major Course**  
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MESSAGE FROM  
VICE CHANCELLOR

Dear Learner,

It is with great pleasure that I welcome you to the Four Year UG Programme in Business Administration offered by Sreenarayanaguru Open University.

Established in September 2020, our university aims to provide high-quality higher education through open and distance learning. Our guiding principle, 'access and quality define equity', shapes our approach to education. We are committed to maintaining the highest standards in our academic offerings.

Our university proudly bears the name of Sreenarayanaguru, a prominent Renaissance thinker of modern India. His philosophy of social reform and educational empowerment serves as a constant reminder of our dedication to excellence in all our academic pursuits.

The Four Year UG Programme in Business Administration covers all relevant areas aligned with management theory and organisational practices. We have incorporated the latest trends in business studies to ensure a comprehensive and up-to-date curriculum. Moreover, the programme encompasses flexible options for learners to choose from a range of Ability Enhancement Courses, Multi-disciplinary Courses, Value Added Courses, and Skill Enhancement Courses, complemented by discipline-oriented Advanced and Additional Advanced Courses.

Our teaching methodology combines three key elements: Self Learning Material, Classroom Counselling, and Virtual modes. This blended approach aims to provide a rich and engaging learning experience, overcoming the limitations often associated with distance education. We are confident that this programme will enhance your understanding of business studies, preparing you for various career paths and further academic pursuits.

Our learner support services are always available to address any concerns you may have during your time with us. We encourage you to reach out with any questions or feedback regarding the programme.

We wish you success in your academic journey with Sreenarayanaguru Open University.

Best regards,



Dr. Jagathy Raj V.P.  
Vice Chancellor

01-01-2025

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**BLOCK**

**01**

# **Accounting Process and System**

# Unit 1

# Introduction to Accounting

## Learning Outcomes

Upon the completion of this unit, the learner will be able to:

- ◇ familiarise the basics of accounting
- ◇ acquaint with the GAAP (Generally Accepted Accounting Principles)
- ◇ explain the accounting concepts and conventions
- ◇ introducing the accounting standards
- ◇ comprehend on Bookkeeping, Double-entry system, and different types of Accounts

## Prerequisite

Jeff and Susan are a happily married couple. They both have jobs and contribute their incomes to pay for household expenses. They spend money on necessities and save whatever is left over. They have a system to write down all expenses and incomes and discuss any extra expenses regularly. Tracking personal transactions this way is like keeping a personal money journal. It involves recording and categorizing income and expenses. By doing this, Jeff and Susan gain insights into their spending habits, make informed choices, and work toward financial goals.

We can see accounting practices in their daily lives. For an individual, the number of transactions is limited. But for a business firm, there are many more transactions. How can a firm keep track of these transactions to know if the business made a profit or loss? Without a system for recording transactions, it would be impossible. Now, in this unit, let us understand how business entities keep records of transactions.

## Keywords

GAAP, Materiality, Conservatism, Consistency, Accounting Standard, Ind AS, Bookkeeping, Double-entry system, Personal account, Real account, Nominal account



## Discussion

Let us recall the case of Jeff and Susan, who are busy starting a new business with their savings. As a result of their hard work, they were able to start a shoe manufacturing firm and they named it 'Galaxy Shoes Pvt. Ltd.' At the beginning of their business, they handled financial matters easily and recorded the business transaction in an unsystematic manner. But as their business slowly began to grow, they could no longer handle financial transactions easily.

Remember Jeff and Susan, who started a shoe manufacturing business with their savings? Through hard work, they launched Galaxy Shoes Pvt. Ltd. In the beginning, they easily handled finances and recorded transactions in an unorganized way. But as their business grew, financial transactions became complex. With money constantly flowing in and out, they struggled to track income, expenses, and overall financial status without a proper system. Many transactions occur in business. To understand income levels, spending patterns, and financial health, companies must record transactions in a structured way. This organised system of tracking financial information is called accounting. Jeff and Susan realised accounting is crucial as their business expanded. Likewise, all companies need accounting to monitor transactions and measure performance.

### 1.1.1 Accounting

Accounting acts as a language in business because it helps to express the financial information of a firm in a systematic manner. Accounting came into force to support human memory by recording, classifying, and summarising daily business transactions. This has been explained in the forthcoming sections. We can consider accounting as an information system because it receives, processes, and converts financial data into useful information.

According to the Committee on the Terminology of the American Institute of Certified Public Accounts (AICPA), "Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions, and events which are, in part at least, of a financial character and interpreting the result thereof".

Accounting is like keeping score in a game. It is about recording, organising, and being aware of the money coming in and going out of a business. By doing this, we can create reports that show how well the business is doing and make smart choices to keep things running smoothly.

#### 1.1.1.1 Accounting Process

Proper accounting involves several key steps, as we can see with Jeff and Susan's shoe business Galaxy Shoes:

- a. Recording Transactions - All financial transactions must be recorded in a timely and accurate way. Otherwise important details will be missed.



- b. **Classifying Transactions** - Similar transactions are grouped together using ledgers. This helps track things like cash flow.
- c. **Summarizing Records** - Periodic financial statements summarize records to show profitability, financial position, cash flow, etc.
- d. **Analysing and Interpreting** - Just summarizing is not enough. Analyzing values and relationships through methods like ratio analysis provides business insights.
- e. **Communicating Results** - As the "language of business," reports are shared with stakeholders like owners, lenders, suppliers.

Following this accounting process of recording, classifying, summarizing, analysing, and communicating financial data is vital for any business like Galaxy Shoes. It helps Jeff and Susan make sound decisions and manage their growing company effectively.

### 1.1.2 Generally Accepted Accounting Principles (GAAP)

Financial accounts prepared by different companies follow similar guidelines and practices called accounting principles and standards. This introduces uniformity and allows comparison. Accounting standards provide authoritative rules for preparing and presenting financial statements which ensure consistency. Accordingly, Financial Accounting Standards Board (FASB) has introduced a commonly accepted accounting principles and standards to regulate accounting policies and procedures, called GAAP. GAAP means Generally Accepted Accounting Principles, refers to the standards, conventions and rules companies follow to prepare uniform financial statements. By following GAAP principles and standards, companies present financial information in a consistent, standardized way. This allows for easy comparison across businesses and industries. Also adhering to GAAP provide lending credibility, transparency and understandability to companies' financial statements. This builds trust and confidence among stakeholders like investors, lenders and regulators.



Figure 1.1.1 GAAP

#### 1.1.2.1 Accounting Assumptions

These are a set of assumptions related to business and accounting transactions that are helpful for recording transactions.

- ◇ Accounting entity concept: According to this concept the business is assumed as a separate or entity from its owners. Owner and business are considered separate persons.
- ◇ Money measurement concept: Accounting records show only monetary transactions. It cannot express the non-monetary events and transactions.
- ◇ Going concern concept: Going concern concept says that business will continue for a long period of time. So predicting the end of a business is impossible.
- ◇ Accounting Period Concept: In accounting, the lifespan of a business is divided into distinct time segments called accounting periods, such as April 1, 2020 to March 31, 2021 or January 1, 2020 to December 31, 2020. The financial performance and position of the business is analysed for each period separately in order to study the results over time.

### 1.1.2.2 Accounting Concepts/ Principles

Accounting concepts are a set of rules related to business and accounting transactions that are helpful for recording transactions in a systematic manner. Accounting concepts involve:

- ◇ Historical cost: Cost means the amount needed for acquiring something. Accounting will consider all such transactions at its cost price.
- ◇ Dual aspect concept: Dual aspect concept says that each financial transaction of a business has a receiving aspect and a giving aspect.
- ◇ Revenue recognition concept: Revenue recognition concept is also called the realisation concept and it says that revenue is recognised when it is earned and not when the related cash is collected.
- ◇ Matching concept: According to the matching concept, the cost and revenue of a business should be matched to calculate profit.
- ◇ Verifiable objective principle: This principle ensures the credibility and dependability of the recorded data. When recording transactions of a business, supporting documents like bills, vouchers, etc.. will be added for future verifications.

### 1.1.2.3 Accounting conventions

Accounting conventions include a “set of guidelines that helps the firm to prepare business records.”

Accounting conventions include:

- ◇ Materiality: The process of disclosing all material facts in the financial statements is the principle of materiality. Material items are important while preparing books of accounts. So, materiality convention gives the guideline to



classify material items (significant) and immaterial items (insignificant)

- ◇ Full disclosure: Accounting information is an unavoidable document of the business. An accountant prepares these documents honestly and has to provide detailed information to various parties like owners, creditors, government, etc..
- ◇ Consistency: Accounting practices are constant and remain unchanged from one period to another period, that is, whatever accounting practice has been adopted in one year; it should be continued during the subsequent years also.
- ◇ Conservatism (Prudence): Conservatism refers to the practice of accounting prudently when there is uncertainty or risk in a business. Since profits and losses are inherent in business, accountants should anticipate potential losses as much as possible. This conservative approach helps ensure the financial security and stability of the business by "playing it safe."

### 1.1.2.4 Accounting Standards

We learned how Susan and Jeff's Galaxy Pvt. Ltd. and how they implemented the accounting process in their form.

To ensure fairness, consistency, and transparency in reporting the financial information, it is necessary to follow a set of rules that everyone agrees on. Accounting standards are the authoritative bases for the preparation and presentation of the financial statement of the concern. Accounting standards are a set of rules that help to create uniformity in recording, presenting, and analysing accounting information.

According to the Institute of Chartered Accountants of India (ICAI) accounting standards are a set of rules and concepts that offer a uniform framework for creating and presenting financial statements. These guidelines guarantee uniformity, comparability, and transparency in financial reporting, making it simpler for interested parties to comprehend and assess an organisation's financial performance.

### Indian Accounting Standards (Ind AS)

These are a set of accounting rules and guidelines followed by companies in India for preparing their financial statements. In order to improve comparability, openness, and consistency in financial reporting, Indian accounting standards are being brought into line with international standards through a process known as convergence of IFRS (International Financial Reporting Standards) with 'Ind AS' (Indian Accounting Standards). This convergence attempts to speed up international trade, draw in foreign capital, and raise the standard of financial data in India. Following is an inclusive list of important standards under Ind AS.

**Table 1.1.1 Indian Accounting Standards (Ind AS)**

<b>Accounting Standard</b>	<b>Title</b>
Ind AS 1	Presentation of Financial Statements and Schedule III
Ind AS 2	Inventories
Ind AS 7	Statement of Cash Flows
Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
Ind AS 10	Events occurring after the Reporting Period
Ind AS 12	Income Taxes
Ind AS 16	Property, Plant and Equipment
Ind AS 19	Employee Benefits
Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
Ind AS 21	The Effects of Changes in Foreign Exchange Rates
Ind AS 23	Borrowing Costs
Ind AS 24	Related Party Disclosures
Ind AS 27	Separate Financial Statements
Ind AS 28	Investments in Associates and Joint Ventures
Ind AS 29	Financial Reporting in the Hyperinflationary Economies
Ind AS 32	Financial Instruments – Presentation
Ind AS 33	Earnings Per Share
Ind AS 34	Interim Financial Reporting
Ind AS 36	Impairment of Assets
Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
Ind AS 38	Intangible Assets
Ind AS 40	Investment Property
Ind AS 41	Agriculture
Ind AS 101	First -Time Adoption of Indian Accounting Standards



Ind AS 102	Share- Based Payment
Ind AS 103	Business Combinations
Ind AS 104	Insurance Contracts (to be replaced by Ind AS 117 which is under formulation)
Ind AS 105	Non-current Assets Held for Sale and Discontinued Operations
Ind AS 106	Exploration for and Evaluation of Mineral Resources
Ind AS 107	Financial Instruments: Disclosures
Ind AS 108	Operating Segments
Ind AS 109	Financial Instruments
Ind AS 110	Consolidated Financial Statements
Ind AS 111	Joint Arrangements
Ind AS 112	Disclosure of Interests in other Entities
Ind AS 113	Fair Value Measurement
Ind AS 114	Regulatory Deferral Accounts
Ind AS 115	Revenue from Contracts with Customers
Ind AS 116	Leases

### 1.1.3 Basic Accounting Terms

We have seen the need for Susan and Jeff to implement systematic accounting. But before that, it is important to know a few basic terms in accounting, because that helps to understand the accounting process easily. Let us go through some of the important terminologies in accounting.

#### 1.1.3.1 Business Transactions

We engage in many financial activities in our daily lives. The most common is paying money for goods purchased at shops, which represents a transaction - an event with a monetary value. Sometimes in transactions, money is exchanged simultaneously with goods and services, called cash transactions. Other times payment is postponed to a later date, called credit transactions. In the past, the barter system was used instead of cash or credit transactions, where goods and services were directly exchanged for other goods and services rather than money. Overall, transactions refer to measurable monetary exchanges, either with immediate cash payment or deferred credit payment, as opposed to direct exchange of goods and services without money as in the historical barter system.

### 1.1.3.2 Assets

If an individual owns land, that land has value and can be used by the owner to pay off debts and meet other obligations. Similarly, companies own assets such as machinery, equipment, facilities, etc. that have value and are owned by the company. These assets can be used by the company to pay expenses and satisfy other business obligations. Just as privately owned land is considered an asset to an individual because it has worth and can be utilized to cover financial responsibilities, assets owned by a company, like property and equipment, represent value that belongs to the business and can be leveraged to take care of business commitments.

Assets are resources of value owned and controlled by the business. Assets are an important part of a firm, which include cash, plant and machinery, goodwill, and other valuable things owned by a business. Assets can be transformed into cash if the business requires.

We can classify assets into two, i.e., tangible assets and intangible assets.

Tangible assets are those assets like machinery and furniture, which can be touched, seen, or felt. Intangible assets (assets which are not in physical form and cannot be touched, seen, or felt) like copyright, trademark, goodwill, etc..

### 1.1.3.3 Liabilities

An individual can owe money to a bank by taking out a loan. Similarly, companies can also have debts like loans, unpaid bills owed to suppliers, and other financial obligations. All of these amounts that a business owes to external parties are considered liabilities. A liability is any kind of financial debt or obligation that one business must pay to another entity or person. Just as an individual may have a liability like a bank loan, a company can also have liabilities in the form of credit that it has taken on from banks, bills owed, or other unpaid debts that the company is responsible for paying back.

### 1.1.3.4 Purchases

Suppose Galaxy Pvt. Ltd. bought leather and other raw materials to manufacture shoes. Such transactions must be recorded in the books of accounts. Generally, this can be included in the purchase category. Purchase indicates the total goods purchased by the firm for manufacturing or sale.

### 1.1.3.5 Sales

Galaxy Pvt. Ltd.'s primary business is selling shoes. Once the shoes are manufactured, Galaxy must sell them to various customers. These sales transactions involve Galaxy selling their produced or purchased shoe inventory to customers in exchange for payment. In accounting, sales refer to the total amount of goods that a company sells to customers for monetary compensation. Since Galaxy's main activity is selling the shoes they produce, their revenues from selling their shoe products to customers are considered sales in their accounting records.



### 1.1.3.6 Capital

Jeff and Susan are the owners of the company called Galaxy Pvt. Ltd. We saw that they started the company by investing their savings. This initial investment made by the owners is called capital. Capital is considered as a liability (as per business entity concept) of the firm because it is the money contributed by the owners which is to be repaid at the time of winding up or closure of business.

### 1.1.3.7 Drawings

Sometimes owners of the firm withdraw cash or goods from the business for their personal needs. For instance, it Susan and Jeff withdraw cash or goods from their firm for their personal needs. This is accounted as drawings and considered as a reduction from capital most of the time.

### 1.1.3.8 Debtors

Once Galaxy Pvt. Ltd. manufactures shoes, various retail stores purchase shoes from them under agreements that allow the stores to pay for the shoes some time after they are delivered. Since these retail stores now owe money to Galaxy for the shoe purchases, they are considered debtors to the company. Because Galaxy is allowing the stores to buy the shoes on credit and pay for them later, the stores are essentially debtors that owe payment back to Galaxy for the shoes. So in Galaxy's accounting records, these retail stores would be tracked as debtors that have outstanding debt owed back to Galaxy resulting from the shoes purchased on credit.

In every business, there are groups of people who buy goods or services and agree to make the payment in the future. Such people are called debtors. "Debtors are persons or other companies who owe something to the business." They are considered the assets of the business.

### 1.1.3.9 Creditors

Suppose Galaxy Pvt. Ltd. has purchased leather from another company called ABC Ltd. for manufacturing shoes and promised to pay the money after a week. Here ABC Ltd. will be a creditor because Galaxy Pvt. Ltd. owes money to them.

In most of the firms, there are suppliers or other persons who supply goods to the business. The firms agree that their payment will be made on a future date. Such suppliers to whom the company owe the amount is called creditors. Creditors can be defined as "Persons to whom something is owed by the business."

### 1.1.3.10 Stock

Stock means the value of goods that are available for sale during a particular period.

Galaxy Pvt. Ltd. has manufactured 1000 shoes, and they are ready to be sold. So, the available stock will be 1000 units. Let us consider a situation, Galaxy Pvt. Ltd. has

1000 shoes in their stock. Two new orders with the quantity of 700 and 200 shoes are received respectively. So, the firm can meet the requirements of these two orders as they have sufficient stock. The remaining unsold goods are their new stock ( $1000-700-200=100$ ).

### 1.1.3.11 Income

Here is an example situation: Galaxy Pvt. Ltd. rented out a small portion of their office space to a Cafeteria so the Cafeteria could run their business of serving Galaxy employees. As part of the rental agreement, the Cafeteria pays Galaxy a fixed monthly rent payment. This rent money received by Galaxy from the Cafeteria is considered rental income for Galaxy. By renting out part of its office to the Cafeteria, Galaxy has generated a rental income stream through the regular monthly payments the Cafeteria makes in order to occupy the space. So, the rent Galaxy receives would be accounted for as income in their records.

Companies can earn income from various sources such as interest, rent, dividends, and revenue generated from sales and services. Any interest, rent, or dividend payments received by a business are considered income. Additionally, revenues coming in from sales of products or services represent income for the business. All of these types of earnings that a company takes in are categorized as income, which serves to increase the overall value and worth of the business. The different forms of income allow a business to grow its assets and value.

### 1.1.3.12 Expenses

From day one, Galaxy Pvt. Ltd. has incurred various expenses such as: employee wages, purchasing stationery and supplies, and more. The money Galaxy spends on these items are considered expenses for the company. In order for a business to generate revenue, it must spend money. So any money spent in the effort of earning revenue is categorized as an expense. Some examples of common business expenses include rent, employee wages and salaries, insurance premiums, advertising costs, phone service charges, and more. Galaxy must spend money to operate on a daily basis, like paying worker wages and buying office supplies, and these costs are recorded as expenses in Galaxy's accounting.

### 1.1.3.13 Expenditure

Are expense and expenditure the same?

No, both the terms are different in nature. Expenditure is the amount paid to acquire assets and maintain the earning potential of the business. Expenditure can be classified into two; capital expenditure and revenue expenditure. Capital expenditure means “the amount required for acquiring fixed assets”. The revenue expenditure is the amount needed for day-to-day activities of the business or maintaining the earning capacity of the business.



As Galaxy Pvt. Ltd.'s business expanded, they had trouble meeting customer demand with their existing production capacity. To increase output, they purchased new machinery to replace older equipment. The money Galaxy spent to obtain this new production machinery is considered a capital expenditure for the company. Because Galaxy invested in new long-term equipment to boost production capacity and growth, the cost of purchasing the new machinery is categorized as a capital expenditure rather than a regular operating expense.

### 1.1.4 Bookkeeping

As a first step, Galaxy Shoes company began to keep all financial transactions of their firm in a set of books. In accounting, this process is called Bookkeeping, which means recording financial transactions systematically in a set of books.

Here, Galaxy Pvt. Ltd. wants to record their transactions in number of books such as journal, ledger, and Trial Balance. They can record their data in journal, classify those data by preparing a ledger, and can summarize all the transactions through preparing Trial Balance.



Figure 1.1.2: Bookkeeping process

In bookkeeping, the company gathers data from source documents such as receipts, invoices, and vouchers. This information is first entered into a journal where transactions are initially recorded. The data is then transferred from the journal into the ledger, where account balances are maintained over time. Finally, the ending balances in the ledger accounts are compiled into a trial balance, which summarizes the balance sheet and income statement account balances at a certain point in time. This multi-step process of transaction documentation, journalizing, posting to the ledger, and preparing a trial balance is the foundations of the bookkeeping system.

### 1.1.5 Double-entry System

Suppose Jeff purchased machinery for his firm by paying ₹50000. This transaction has two aspects, one is the receiving aspect and the other is the giving aspect. When he purchased the machinery, machinery came to his firm and cash was given to the supplier. That means machinery is considered the receiving aspect and cash is the giving aspect. Every transaction is accounted for a 'receiving aspect' and a 'giving aspect.' This is called the double-entry system of accounting.

The double-entry accounting method requires that each business transaction be recorded in a minimum of two accounts. It also states that the total debits and credits

for a transaction must be equal, or else the record is considered out of balance. These rules ensure a company's accounting equation remains properly balanced at all times. We will study this topic in-depth in the upcoming lessons.

## 1.1.6 Types of Accounts

Galaxy Pvt. Ltd. uses bookkeeping to record thousands of transactions. With everything recorded together, Susan and Jeff would have trouble identifying the status of specific items like cash and sales. The solution is to classify the entries by grouping similar transactions into accounts. For example, all cash transactions can go into a cash account, while all sales transactions can go into a sales account. This allows Galaxy to separate transactions of a similar nature into distinct accounts. Now Susan and Jeff can easily track cash flows in the cash account and sales activity in the sales account, rather than sifting through all transactions at once. Creating separate accounts for different transaction types makes it easier to monitor and manage specific aspects of the business.

A company can have many different accounts depending on its transactions. Usually two approaches are followed to classify the accounts viz, English Accounting Approach and American Accounting Approach. Let us understand these categories of accounts in detail.

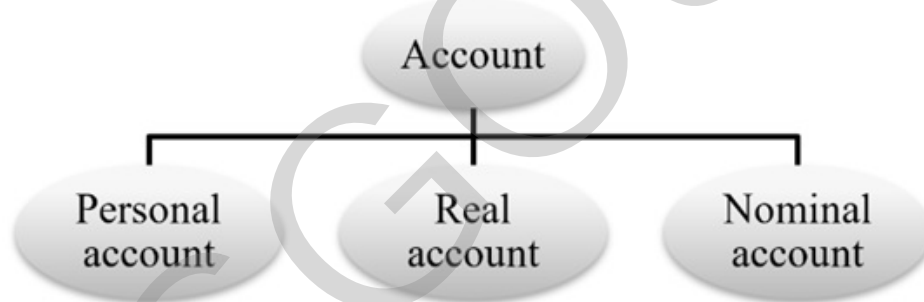


Figure 1.1.3. Types of accounts

### 1.1.6.1 Personal Account

Galaxy Pvt. Ltd. conducts credit transactions like purchases and sales with other individuals and companies, resulting in personal liabilities. To accurately record these transactions, Galaxy can open accounts related to specific persons, firms, etc. These are known as personal accounts. In summary, personal accounts record transactions and track liabilities involving people and entities that the company does business with. By keeping these transactions separate in personalized accounts, Galaxy can closely monitor credit relationships and obligations associated with the different customers, vendors, employees, or other parties it interacts with. Having clearly defined personal accounts allows Galaxy to keep tight control over its business dealings with other individuals and organizations.

The accounting rule for personal account is;

***“Debit the receiver***

***And credit the giver”***

### **1.1.6.2 Real Account**

Real accounts, also called permanent accounts, have balances that carry over year after year rather than being closed out at the end of each accounting period. In other words, the ending balance on the Balance Sheet becomes the beginning balance for the next accounting year. Real accounts record transactions related to tangible property and assets owned by the company, such as machinery, furniture, land, buildings, inventory, and cash. They are considered “real” because they represent actual, physical things of value that the business possesses. Unlike temporary accounts like income and expenses that start with a zero balance each year, real accounts maintain their running balance over time. The asset values in real accounts like cash, equipment, and inventory appear on the company’s Balance Sheet, reflecting resources the business has available to operate.

The accounting rule for the real account is;

***“Debit what comes in***

***Credit what goes out”***

### **1.1.6.3 Nominal Account**

Organizations have many expenses, losses, revenues and gains. To track these income statement activities, nominal accounts are used. Nominal accounts record transactions related to expenses like rent, salaries, utilities, etc. as well as revenues, gains and losses. Their purpose is to capture the company’s incomes and expenses over a set accounting period, typically one year. At the end of the year, the nominal account balances are closed out and start the next period with a zero balance. This allows the business to easily track periodic profitability by providing annual snapshots of the revenues earned and expenses incurred. Major examples of nominal accounts include salary expense, rent expense, utilities expense, sales revenue, interest income, and gain/loss on asset disposal. By separating these income and expense flows into distinct nominal accounts, a company can clearly track its financial performance over time across periods.

The accounting rule for the nominal account is;

***“Debit all expenses and losses***

***Credit all incomes and gains”***

As a conclusion, Personal accounts record transactions related to people the company deals with, such as customers, suppliers, employees, etc. Real accounts record transactions related to assets like land, buildings, equipment, inventory, etc. that the

company owns. Nominal accounts record transactions related to expenses, revenues, gains, losses (basically the income and expenses of the business). So rather than having all transactions jumbled together, separating them into these three account types allows for easier tracking and management of transactions involving people, assets, and income/expenses respectively. The number of accounts in each category will vary based on the size and activities of the specific company. But this three-way classification provides an organized structure for recording the many different types of business transactions.

### **Classification of Accounts based on American Approach**

The American approach classifies accounts into five categories:

1. **Assets** - These accounts track tangible or intangible property owned by the company, as well as anything else of value that the company owns that has a monetary value. Examples include cash, accounts receivable, inventory, land, buildings, equipment, trademarks, and goodwill. Assets represent resources available to support business operations.
2. **Liabilities** - These accounts reflect debts, obligations, or other amounts owed by the company. Common examples are accounts payable, wages payable, taxes payable, loans payable, and mortgages payable. Liabilities represent claims on company assets by creditors and obligations that must be paid at some point.
3. **Owners' Equity** - Also called capital or net worth, these accounts reflect the residual interest or shareholders' claims on the company's assets after deducting liabilities. This includes amounts invested by shareholders plus accumulated profits.
4. **Revenue** - These accounts track income generated from the company's operations and other sources. Revenue arises from sales of products or services, interest, dividends, and gains on asset sales. Revenues increase owners' equity.
5. **Expenses** - These accounts reflect costs incurred by the company to generate revenue. Expenses reduce owners' equity. Common expenses include wages, raw materials, interest, rent, utilities, depreciation, and taxes.

These five categories of classification provides a clear and complete structure for capturing all business transactions that affect a company's financial position. The table below shows the accounting rules for the above said accounts.

### **Debit and Credit Rules for different Account types:**

- ◇ Asset accounts normally have a debit balance. To increase an asset, debit the asset account. To decrease an asset, credit the asset account.
- ◇ Expense accounts normally have a debit balance. To increase an expense, debit the expense account. To decrease an expense, credit the expense account.



- ◇ Capital, liability, and income accounts normally have a credit balance. To increase capital, liabilities, or income, credit those accounts. To decrease capital, liabilities, or income, debit those accounts.

### Summary of Debit and Credit Rules

- Debit to increase asset and expense accounts
- Credit to decrease asset and expense accounts
- Credit to increase capital, liability, and income accounts
- Debit to decrease capital, liability, and income accounts

### Recap

- ◇ Accounting: a tool for recording, classifying, and systematically summarizing daily transactions.
- ◇ The accounting standard is a common set of principles, standards, and rules.
- ◇ Accounting concepts: accounting entity concept, going concern concept, money measurement concept, dual aspect concept, etc.
- ◇ Accounting conventions: materiality, full disclosure, consistency, conservatism.
- ◇ Accounts: formal record of all transactions related to changes in a particular item.
- ◇ Accounts classified as personal account, real account, nominal account.
- ◇ Bookkeeping: systematic record of financial transactions of a business in a set of books.
- ◇ Double-entry system: includes receiving aspect and giving aspect.

### Objective Questions

1. What are the major functions of accounting?
2. Who introduced the GAAP?

3. What does accounting standard mean?
4. What are accounting conventions?
5. What does the accounting concept mean?
6. What are the two aspects of double-entry system?
7. What is personal account?
8. What is Bookkeeping?
9. What is the nominal account?
10. What is the real account?
11. What are the examples for the nominal account?
12. What is the accounting rule for personal account?
13. What is the accounting rule for the real account?
14. What is the accounting rule for the nominal account?

### Answers

1. Recording, classifying, summarising.
2. Financial Accounting Standards Board (FASB)
3. A set of rules and concepts that offer a uniform framework for creating and presenting financial statements.
4. Accounting conventions include a set of guidelines that helps the firm to prepare business records.
5. A set of assumptions related to business and accounting transactions that are helpful for recording transactions in a systematic manner.
6. 'Receiving aspect' and 'Giving aspect.'
7. Accounts related to persons, firms, etc..
8. Systematic record of financial transactions of a business in a set of books.



9. Account related to expenses, losses, incomes, and gains.
10. Accounts related to assets.
11. Rent account, Salary account, etc..
12. “Debit the receiver and credit the giver.”
13. “Debit what comes in and Credit what goes out.”
14. “Debit all expenses and losses and Credit all incomes and gains.”

### Self-Assessment Questions

1. Explain accounting.
2. Explain GAAP.
3. Explain accounting concepts and conventions.
4. Explain accounting standards.
5. Write a short note on Bookkeeping.
6. Write a short note on the Double-entry system.
7. Explain different types of accounts.
8. Explain the modern classification of accounts and its rule for debit and credit

### Assignments

1. Analyse the advantages and disadvantages of GAAP.
2. From your real life transactions, find out what all items comes under real account.
3. Find out what all items comes under nominal account in case of the transactions in your daily life.

## Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
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# Unit 2

# Journal

## Learning Outcomes

After the completion of this unit, the learner will be able to:

- ◇ familiarise the concept of journal
- ◇ make an awareness on journal preparation
- ◇ observe the necessary points to consider while journalising
- ◇ explain different subsidiary books

## Prerequisite

Thinking back to when our parents would keep a diary at home to track household expenses and income helps us to understand journal entries. At the end of each month, they would review the diary to determine if they had any savings. Similarly, businesses need to keep records of their financial transactions. Recording transactions is an essential first step in the accounting process. Just as households track expenses in a diary, companies use journals to chronologically log all business transactions in one place. The journal provides a comprehensive look at every business event that impacts the finances. Reviewing the journal enables preparation of informative financial statements. We will learn how journal entries work to capture debits and credits for each transaction. Fundamentally, journals form the foundation of the accounting system by allowing systematic documentation of all key business activities. Understanding journal entries is vital for anyone interested in accounting and financial reporting.

## Keywords

Journal Entry, Journalising, Ledger Folio, Narration, Debit, Credit, Subsidiary Books, Journal Proper.

## Discussion

Recording transactions is vital for every business. It allows owners or other interested persons to monitor financial performance, calculate profits and losses, and make informed decisions. By maintaining transaction records, owners can understand customer preferences, tailor offerings, and foster loyalty. It brings transparency, accountability, and peace of mind, serving as evidence of financial activities. With concise record-keeping, businesses can effectively manage their finances, meet legal obligations, and build a solid foundation for the success of the business.

### 1.2.1 Journal

Financial data in an organization can be extensive, making analysis difficult without proper record keeping. To initially record transactions, firms use a journal, which is a chronological log of financial entries. Keeping this journal is crucial for organizations to systematically track their finances. Since Galaxy Pvt. Ltd. will have large amounts of financial data, they should ensure all their transactions are logged in a journal for future reference and analysis.

Journals are created based on supporting documentation like bills, vouchers, and invoices that provide the raw data for financial transactions. The process of logging business transactions in the journal is known as journalizing. Each recorded transaction in the journal is a journal entry. Below each entry, a brief narrative description of the transaction is included to provide context. This explanation of the entry is known as the narration. Narrations serve to summarize the journal entry and provide clarification on the transaction.

Table 1.2.1 Format of a Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount

### 1.2.2 Journalising Process

Recording all of a business's financial transactions in a journal as they occur is called journalizing. These journal entries are logged in the journal during this process. No transaction can happen without first being noted in the journal before entering the accounting records. Nowadays, companies may keep multiple types of journals since businesses vary greatly in size and function. Journals are divided into two categories: General and Special. The most common type is the general journal, which records every transaction within a company. The general journal is more common among smaller



businesses with fewer transactions. Larger trade or manufacturing companies find this record keeping cumbersome, so they require separate, specialized journals to efficiently log certain routine transactions. The format and content of specialized journals are not subject to any standards. They are customized based on the needs, activities, and assets of the business.

### 1.2.2.1 Preparation of Journal

A journal has 5 columns: date, details, ledger folio, debit amount, and credit amount. The ledger folio column shows the ledger page number where the journal entry will later be transferred. Therefore, the ledger folio is left blank when initially recording the journal entry. Journal entries follow specific rules for debiting and crediting the different types of accounts involved in a transaction.

Major steps in journalising, that you should remember while preparing the journal are:

- ◇ Read the given transaction carefully and identify the accounts related to the transaction.
- ◇ Then identify the type of accounts in the given transaction. Type of account includes personal account, real account, and nominal account.
- ◇ Identify which account to be debited and which account to be credited based on the rules of accounts.
- ◇ Enter the transaction date in the date column.
- ◇ In the particulars column write the debit entry (write Dr. at the end of the debit) and in the next line write the credit entry (after leaving little space from the left side and start with 'To') and give a narration below the entry.
- ◇ Enter the debit amount and credit amount in the respective columns.

### 1.2.3 Importance of Journalising

1. The main purpose of journalizing is to maintain accurate and organized financial records for a company. Information is entered into the journal chronologically using debits and credits, making it easy to review and catch accounting mistakes.
2. Financial statements creation by companies, which is the main goal of the accounting cycle, relies on this data. Auditors can examine the impact of transactions on a company using these records.
3. Transactions recorded chronologically in the journal allow us to get complete timely information about business transactions.



## Illustration 1.2.1

Journalise the following transactions:

01/01/2021	Started business with cash	₹95000
11/01/2021	purchased goods for	₹15000
24/01/2021	Purchased furniture for	₹30000
28/01/2021	Sold goods for cash	₹20000
30/01/2021	Paid wages for	₹15000

*Hints for easy preparation:*

Apply the rules of personal account for capital account (it is a personal account because it is an account of owners who are real persons),

Apply the rule of real account for cash account, the purchase account, furniture account, sales account and apply the rule of nominal account for wages.

## Solution

### Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
01/01/2021	Cash A/c Dr. To Capital A/c [ Started business with cash]		95000	95000
11/01/2021	Purchases A/c Dr. To Cash A/c [Purchased goods for cash]		15000	15000
24/01/2021	Furniture A/c Dr. To Cash A/c [Purchased furniture for cash]		30000	30000
28/01/2021	Cash A/c Dr. To Sales A/c [Sold goods for cash]		20000	20000
30/01/2021	Wage A/c Dr. To Cash A/c [Paid wages]		15000	15000

### Illustration 1.2.2

Journalise the following:

01/01/2021 Started business with ₹100000

02/01/2021 Deposit cash to bank ₹10000

03/01/2021 Bought goods for cash ₹25000

06/01/2021 Sold goods for cash ₹10000

08/01/2021 Paid ₹1000 for telephone charges

11/01/2021 Paid ₹2500 for advertisement

24/01/2021 Bought goods from M/s Manha Co for ₹30000 on credit

25/01/2021 Sold goods to M/r Arnav Co for ₹20000 on credit

26/01/2021 Paid rent ₹3000

27/01/2021 Sold goods to DZN Co for ₹4000 for cash

28/01/2021 Paid salaries ₹25000

30/01/2021 Withdraw from bank ₹15000 for private use

### Solution

#### Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
01/01/2021	Cash A/c Dr. To Capital A/c [ started business with cash]		100000	100000
02/01/2021	Bank A/c Dr. To Cash A/c [Cash deposited with bank]		10000	10000



03/01/2021	Purchases A/c To Cash A/c [purchased goods for cash]	Dr.		25000	25000
06/01/2021	Cash A/c To Sales A/c [Sold goods for cash]	Dr.		10000	10000
08/01/2021	Telephone charges A/c To Cash A/c [Paid telephone charges]	Dr.		1000	1000
11/01/2021	Advertisement A/c To cash A/c [Paid advertisement charges]	Dr.		2500	2500
24/01/2021	Purchases A/c To M/s Manha Co [purchased goods on credit]	Dr.		30000	30000
25/01/2021	M/r Arnav Co To Sales A/c [Sold goods for credit]	Dr.		20000	20000
26/01/2021	Rent A/c To Cash A/c [Paid Rent]	Dr.		3000	3000
27/01/2021	Cash A/c To Sales A/c [Sold goods for cash]	Dr.		4000	4000

28/01/2021	Salaries A/c To Cash A/c [Paid Salaries]	Dr.		25000	
					25000
30/01/2021	Drawings A/c To Bank A/c [Amount is withdrawn from bank for private use]	Dr.		15000	
					15000

### Illustration 1.2.3

From the following extract of a journal, find out the business transaction behind the entry.

<b>Purchases</b>		<b>3,000</b>	
Account Payable_ Bilal and Friends			<b>1,000</b>
Cash			<b>2,000</b>
(Purchases by cash and by credit)			
<b>Account Receivable_ Rehman &amp; sons</b>		<b>1,500</b>	
Cash		<b>5,000</b>	
Sales			<b>6,500</b>
(Purchases by cash and Credit from Ahmed)			

### Solution

- iii. Bought goods by giving cash ₹2000 and on credit from Bilal and Friends for ₹1000
- iv. Made a total sale of ₹6500 out of which ₹5000 is for cash and ₹1500 to Rahman and Sons for credit.

## 1.2.4 Subsidiary Books

As Jeff and Susan's number of transactions increased, they found it difficult to jour-



nalize them all. They realized most of their business transactions involved cash, purchases, and sales. Entering each of these transactions in a single journal book required a lot of effort. To reduce this work, they decided to keep separate books or registers for each transaction type. In accounting, these are known as subsidiary books. Subsidiary books simplify recording daily transactions directly. They are also called day books or special journals and are a subdivision of the general journal. Major advantages of subsidiary books are reduced clerical work, increased accuracy and reliability, and easier account maintenance. There are eight common types of subsidiary books: cash book, purchases book, sales book, purchases returns book, sales returns book, bills receivable book, bills payable book, and general journal proper.

### 1.2.4.1 Cash Book

The cash book records all cash receipts and payments related to cash sales, purchases, asset sales, expenditures, income, etc. conducted with cash or checks. Since transactions are recorded directly from source documents, the cash book is a book of original entry. The cash book lists transactions chronologically based on source documents, so it functions as a journal. However, the cash book is formatted like a ledger account, so it also serves as a ledger. In summary, the cash book acts as both a journal and ledger for cash transactions.

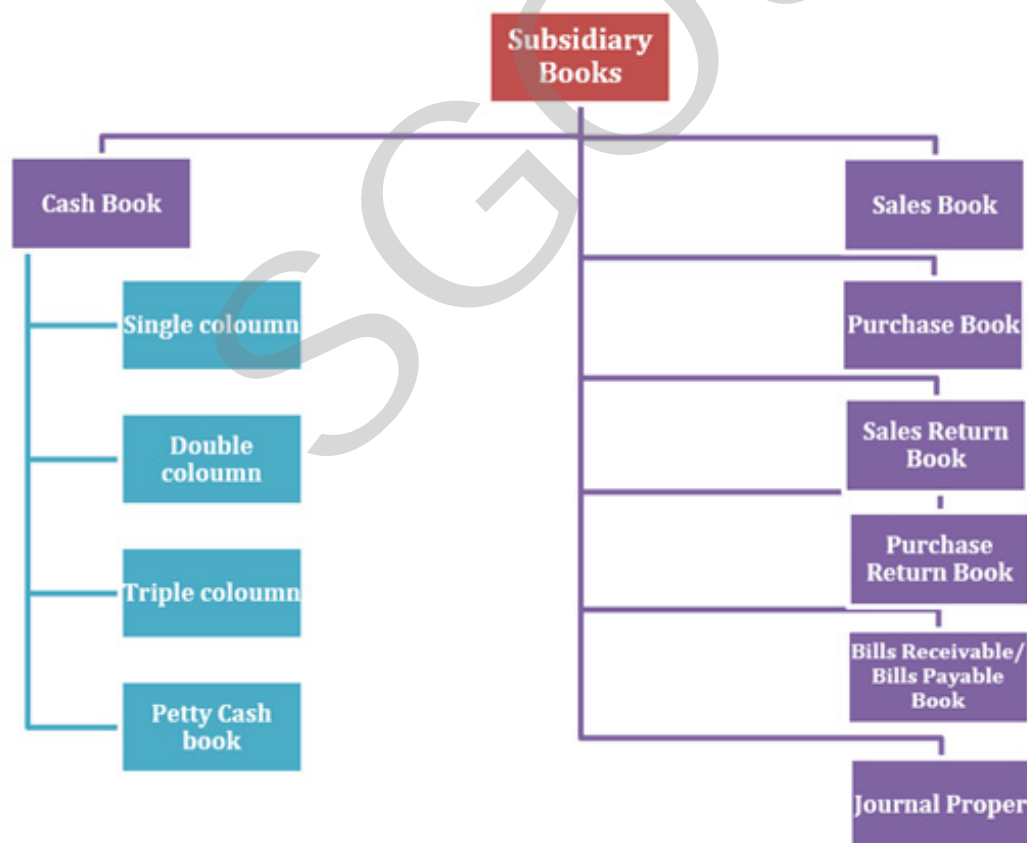


Figure 1.2.1: Subsidiary books

Following are the different types of cash books:

- ◇ *Single column cash book*: Cash book with only one amount column on both sides
- ◇ *Double column cash book*: A double column cash book is one that has two amount columns; a cash column and a bank column on both sides for documenting cash and bank transactions.
- ◇ *Triple column cash book*: A triple column cash book is one that has three amount columns on both sides. The columns are 'Cash', 'Bank', and 'Discount'.
- ◇ *Petty cash book*: This journal keeps track of all daily miscellaneous cash payments for petty expenses. Cash transfers for very modest sums do occur occasionally. Petty cash transactions are a number of these transactions that happen in a single day. Stationery, mail, meals, and other expenses are a few examples of these types of transactions.

#### 1.2.4.2 Sales Book

This book records all of the credit sales of products that the company makes throughout the accounting period. For recording sales deals, sales invoices serve as the foundation. Remember that asset credit transactions are recorded in the Journal Proper. It displays the names of those clients who are the business's debtors and to whom the goods are supplied on credit. The relevant sum must also be debited from the debtors' account.

#### 1.2.4.3 Purchase Book

All credit purchases of the products utilised by the company during the accounting period are recorded in this book. Purchase invoices serve as the foundation for entering transactions into the buy book for this reason.

However, credit purchases of the fixed assets are recorded in the journal proper.

#### 1.2.4.4 Sales Return Book

This book, which is also known as the return inward book, keeps track of the products that customers return which the company originally sold. When a customer returns products to a business, the business (creditor or seller) issues the customer (the buyer or debtor) a credit note. The deal is entered into the sales return book using these notes as a foundation.

As a result, the corresponding amount is credited to the debtor's account as a return inward, and the entire amount of the returned goods is posted to the sales return account's debit, column.



### 1.2.4.5 Purchase Returns Book

It also goes by the name “Return outward book” and records all product returns the company makes to its vendors. The business (debtor or buyer) issues the debit note to the supplier upon receiving the returned products from the supplier (creditor or seller). Transactions are entered in the purchase return book using the debit note as a starting point.

The appropriate amount is debited from the creditor’s account for this reason. Additionally, the entire value of this book is added to the purchase return ledger’s credit column. It should be remembered that returns for cash transactions need to be recorded in the cash book.

### 1.2.4.6 Bills Receivable Book

The book kept to record bills drawn by the company is known as the bills receivable book. It is maintained when the business draws bills on behalf of its clients. The sum will be recorded as bills payable on the credit side of each party’s account. At the end of the month, the total amount from the bills receivable book will be added to the debit side of the bills receivable account.

It should be mentioned that the transactions related to dishonoured bills, endorsements, etc. are recorded in the journal rather than this book.

### 1.2.4.7 Bills Payable Book

All bills accepted by the company and drawn by the suppliers for payment later are recorded in the bills payable book. The sum will be recorded on the debit side of individual party’s accounts. Additionally, at the end of the month, the total of these books is credited to the ledger account for bills payable.

### 1.2.4.8 Journal Proper

There are certain transactions which may not come under any books of accounts and such transactions are recorded in a specific book called Journal Proper. Journal proper include the Journal entries like opening and closing entries, rectification and transfer entries, adjustment and transfer entries, entries for unpaid bills, miscellaneous entries, etc.

#### Recap

- ◇ Journal: records daily transactions in chronological order.
- ◇ Journal preparation is based on the source document.
- ◇ Journalising; process of recording transactions in the Journal.

- ◇ Transactions recorded in Journal are called Journal entry.
- ◇ Subsidiary books: enter daily bulk transactions in separate journals.
- ◇ Cash book: cash transactions.
- ◇ Sales book/Purchase book: credit sales /credit purchases.
- ◇ Sales returns / Purchase returns book: returns inward /returns outward.
- ◇ Bills receivable/ Bills payable book: to account for bills.
- ◇ Journal Proper: general entries.

### Objective Questions

1. What is a journal?
2. Which is the book of prime entry?
3. What is the order of recording transactions in the journal?
4. What is journal entry?
5. Which are the columns involved in the journal?
6. What is the full form of L.F.?
7. What is journalising?
8. What is a narration in the journal?
9. What is Purchase book?
10. What is Bills receivable book?
11. What is Bills payable books?
12. What is Journal proper?



## Answers

1. It is the book of original entries where we record daily transactions in chronological order.
2. Journal
3. Chronological order.
4. The recorded business transaction in the Journal is called Journal entry.
5. Journal involves five different columns: date, particulars, L.F. (ledger folio), debit amount, and credit amount.
6. Ledger Folio.
7. The process of recording transactions in the Journal.
8. A simple explanation about the transaction.
9. It records credit purchase transactions. It considers only credit purchase dealings with goods not assets.
10. Bills receivable book deals with the information related to debtors who accepted the bills drawn.
11. Bills payable books deal with all the information related to the creditors to who have accepted the bill
12. A specific book to keep transactions which are not come under any other books of accounts such as opening entries, closing entries, adjusting entries etc.

## Self-Assessment Questions

1. Explain the concept of Journalising.
2. Write a short note on Journalising with suitable examples.
3. Write a short note on subsidiary book.
4. Explain different types of subsidiary books.
5. Explain Cash Book and its different types

6. What is Journal Proper?
7. Explain the need for multiple column cash books.

### Assignments

1. Prepare journal entries for your personal financial transactions from last month.
2. Journalise the following transactions of 2021,
  - March 1. Paid wages ₹1200
  - March 3. Purchased Land ₹5000
  - March 5. Sold goods ₹20000
  - March 7. Paid to Lal ₹3000
  - March 10. Drew from Bank ₹30000
3. Prepare Journal entries for X. Ltd for the month of January from the following details
  - Jan 2 – Purchased raw material for production for cash ₹ 6000
  - Jan 6 – Paid wages to carpenter for making chair for office ₹1500
  - Jan 10 – Sold goods worth ₹5000
  - Jan 12 – Mr. B purchased goods on credit for ₹1000
  - Jan 20 – Purchased material on credit from C for ₹2500
  - Jan 23 – Paid wages to factory workers ₹5000
4. From the entries below find out the underlying transaction and give the rules followed in each entry.

Year & Date	Particulars	L.F.	Amount	Amount
2021 March 1	Cash A/c <span style="float: right;">Dr.</span>		30000	
	To Capital A/c			30000



2	Plant A/c To Cash A/c	Dr.	25000	25000
3	Purchases A/c To Joy A/c	Dr.	40000	40000
7	Cash A/c To Sales A/c	Dr	20000	20000

### Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
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# Unit 3

## Ledger

### Learning Outcomes

After the completion of the unit, the learner will be able to:

- ◇ familiarise with the concept of ledger
- ◇ prepare the ledger accounts
- ◇ perform the process of posting entries in ledger

### Prerequisite

A bakery needs to track its finances in different accounts. These may include Cash - Money in the cash register and bank accounts, Accounts Receivable, Customer invoices that are owed, Accounts Payable, Bills owed to suppliers; Inventory, Flour, sugar, and other baking supplies, Sales - Revenue from selling cakes and pastries and Salaries and Payroll paid to employees. The ledger records all the bakery's transactions under the appropriate account headings. For example, cash deposits are credited to the Cash account, while checks to vendors are debited under Accounts Payable. Every day, transactions from the accounting journal are entered into the correct ledger accounts, listing debits, credits, dates, and transaction descriptions. Over time, the ledger reveals patterns - spikes in Sales for holidays, payroll peaks every Friday. In the past, ledgers were manual. Today's digital ledgers automatically update each time the bakery accepts a credit card or pays a bill online. But the core purpose of ledger is to capture the bakery's full financial history on a versatile canvas structured by accounts. This provides crucial business insights.

### Keywords

Posting, Ledger accounts, Debit, Credit, Balance



## Discussion

Keeping your room clean is easier when you sort everything into categories like clothes, books, and toys. Classifying business transactions works the same way - it means separating them into different groups based on what they are. Some common categories are sales, expenses, and investments. Sorting transactions this way helps businessmen see where money is coming from and where it's going. They can tell if the business is profiting or losing money. Classification also enables creating useful financial statements and reports. Businessmen can see which areas are performing well and which need improvement. They can make smarter decisions about spending and planning. In accounting, transactions are classified using ledger accounts. Each account groups similar transactions, like all sales or all payroll. This organization makes financial data clear and easy to understand, just like sorting your messy room into neat categories. With transactions classified, accountants can provide valuable insights into the business.

### 1.3.1 Ledger

Think back to the company Galaxy Pvt Ltd. After preparing their journal, the owners realized the data was well recorded but not well organized. With thousands of journal entries, finding a specific type of entry like purchases, cash, or sales was very difficult. To fix this, Galaxy needed to transfer the journal entries into a ledger through posting. Posting classifies the transactions by account.

A ledger does group and summarize all transactions of a similar type into an account. For example, all cash transactions go into the Cash account. This process of transferring the journal entries into the appropriate ledger accounts is called Posting. The main goal of a ledger is to categorize transactions based on their similarity. This makes data much easier to locate and understand. It allows for an organized classification of each transaction.

### 1.3.2 Preparation of Ledger Account

- ◇ A ledger account has two sides: one is a debit, which is visible on the left side of the account, and the other is a credit, which is visible on the right side of the account.
- ◇ All financial transactions have corresponding debit entries that are recorded on the account's debit side, and corresponding credit entries that are recorded on the account's credit side.
- ◇ The balance is represented by the difference between the debit and credit sides. The excess of the debit side over the credit side is represented by a debit balance, and the opposite is true for a credit balance.

The closing balance at the end of the accounting period is sent over to the succeeding year as an opening balance.

Table 1.3.1 Format of Ledger

Dr.				Name of the account				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount				

Ledger accounts can be prepared for numerous entries including cash, sales, purchase, capital, etc. The format of the ledger includes a debit side (Dr.) and a credit side (Cr.). Each side involves date, particulars, J.F. (journal folio), and amount. Journal folio indicates the page number of journal where the entry is recorded.

Enter data from the journals into the relevant accounts. For instance, in case of cash account while money paid out is recorded on the credit side, money received is recorded on the debit side. Similarly, the rules pertaining to different items should be applied while creating entries for the transaction.

Posting is the process of transferring debit and credit items from the journal to the designated accounts in the ledger. The rules should be observed while posting transactions to the ledger.

### 1.3.2.1 Rules for posting transactions in ledger accounts

- ◇ For each account, a distinct individual account is set up in the ledger book, and entries from the journal are correspondingly sent to the appropriate accounts.
- ◇ Using the terms “To,” “By,” “Dr,” or “Cr” when posting transactions to the ledger is customary. In the particulars column with the accounts recorded on the debit side, the word “To” or “Dr” is used, whereas “By” or “Cr” is employed for the accounts put in the specific column on the credit side.
- ◇ The relevant account that was debited in the journal must likewise be debited in the ledger, but with the appropriate credit account as the reference.

We can prepare ledger accounts based on the journal. Here, a journal entry of Galaxy Pvt. Ltd. is given below;

How to post this journal entry in the ledger?

Let us help the Galaxy Pvt. Ltd. to prepare the ledger





entering it as balance b/d (brought down). Here, in the cash account, the amount of 'By balance c/d' is in the credit column so you write it this as balance b/d in the next year on the debit column. Remember only Real and Personal accounts are balanced whereas nominal accounts are closed at the end of the year by transferring the balance to Trading or Profit and Loss Account.

### Cash Account

Dr.				Cr.				
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount	
20/03/2021	To Sales A/c		400	31/03/2021	By Balance c/d		400	
			400					400
01/04/2021	To Balance b/d		400					

Like this, we should prepare sales account for the entry.

### Sales Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
31/03/2021	To Balance transferred		400	20/03/2021	By Cash A/c		400
			400				400

### Illustration 1.3.1

From the following particulars, prepare a journal and post them in the ledger

05/03/2021 Started business with cash ₹250000

12/03/2021 purchased goods for ₹40000



29/03/2021	Sold goods for cash	₹35000
30/03/2021	Paid wages for	₹10000
31/03/2021	Paid rent	₹4000

## Solution

### Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
05/03/2021	Cash A/c To Capital A/c [ Started business with cash]	Dr.	250000	250000
12/03/2021	Purchases A/c To Cash A/c [Purchased goods for cash]	Dr.	40000	40000
29/03/2021	Cash A/c To Sales A/c [Sold goods for cash]	Dr.	35000	35000
30/03/2021	Wages A/c To Cash A/c [Paid wages]	Dr.	10000	10000
31/03/2021	Rent A/c To Cash A/c [Paid Rent]	Dr.	4000	4000

# Ledger

## Ledger

### Cash Account

Dr.					Cr.		
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
05/03/2021	To Capital A/c		250000	12/03/2021	By Purchases A/c		40000
29/03/2021	To Sales A/c		35000	30/03/2021	By Wages A/c		10000
				31/03/2021	By Rent A/c		4000
				31/03/2021	By Balance c/d		231000
							285000
01/04/2021	To Balance b/d		231000				

### Cash Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
05/03/2021	To Capital A/c		250000	12/03/2021	By Purchases A/c		40000
29/03/2021	To Sales A/c		35000	30/03/2021	By Wages A/c		10000
				31/03/2021	By Rent A/c		4000
				31/03/2021	By Balance c/d		231000
			285000				285000
01/04/2021	To Balance b/d		231000				

### Capital Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
31/03/2021	To Balance c/d		250000	05/03/2021	By Cash A/c		250000
			250000				250000
				01/04/2021	By Balance b/d		250000

### Purchases Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
12/03/2021	To Cash A/c		40000				
				31/03/2021	By Balance transferred		40000
			40000				40000

### Sales Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
31/03/2021	To Balance transferred		35000	29/03/2021	By Cash A/c		35000
			35000				35000

### Wages Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
30/03/2021	To Cash A/c		10000	31/03/2021	By Balance transferred		10000
			10000				10000

### Rent Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
31/03/2021	To Cash A/c		4000	31/03/2021	By Balance transferred		4000
			4000				4000

**Note:** Assets and liabilities account are balanced whereas accounts related to expenses and income are closed to trading or Profit and Loss Account.

From the following particulars, prepare a journal and post them in the ledger accounts

01/03/2021 Started business with capital	₹500000
08/03/2021 Purchase machinery	₹340000
09/03/2021 Sold goods for cash	₹200000
10/03/2021 Paid rent	₹3000
21/03/2021 paid salary	₹42000



### Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
01/03/2021	Cash A/c Dr. To Capital Account [ started business with cash]		500000	500000
08/03/2021	Machinery A/c Dr. To Cash A/c [Purchased machinery]		340000	340000
09/03/2021	Cash A/c Dr. To Sales A/c [Sold goods for cash]		200000	200000
10/03/2021	Rent A/c Dr. To Cash A/c [Paid Rent]		3000	3000
21/03/2021	Salary A/c Dr. To Cash A/c [Paid wages]		42000	42000

Next step is to pass these entries into appropriate ledger accounts. We must check the entries and identify which are the ledgers that need to be prepared to post each of them.

### Ledgers

#### Cash Account

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
01/03/2021	To Capital A/c		500000	08/03/2021	By Machinery A/c		340000
09/03/2021	To Sales A/c		200000	10/03/2021	By Rent A/c		3000
				21/03/2021	By Salary A/c		4000
				31/03/2021	By Balance c/d		353000
			700000				700000
01/04/2021	To Balance b/d		353000				

### Machinery Account

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
08/03/2021	To Cash A/c		340000	31/03/2021	By Balance c/d		340000
			340000				340000
01/04/2021	To Balance b/d		340000				

### Capital Account

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
31/03/2021	To Balance c/d		500000	01/03/2021	By Cash A/c		500000
			500000				500000
				01/04/2021	By Balanceb/d		500000

### Sales Account

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
31/03/2021	To Balance transferred		200000	09/03/2021	By Cash A/c		200000
			200000				200000

### Rent Account

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
10/03/2021	To Cash A/c		3000	31/03/2021	By Balance transferred		3000
			3000				3000



## Salary Account

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
21/03/2021	To Cash A/c		42000				
				31/03/2021	By Balance transferred		42000
			42000				42000

### Recap

- ◇ Ledger: book which contains the accounts
- ◇ Posting: process of transferring journal entries to ledger accounts
- ◇ Balance is the difference between the two sides of a ledger account
- ◇ Real and personal account balances are carried to next year
- ◇ Nominal accounts: transfer balance to Trading or Profit and Loss Account
- ◇ Debit balance: the debit side amount is more than the credit side amount
- ◇ Credit balance: the credit side amount is more than the debit side amount

### Objective Questions

1. What is a ledger?
2. What is posting in the ledger?
3. What is the major aim of the ledger?
4. What is the format of ledger?
5. What is debit balance?
6. What is credit balance?
7. Cash sales is entered in which accounts?
8. Which account is used to show the returns from a customer?

## Answers

1. The book which contains the accounts is known as ledger.
2. The process of transferring journal entries to ledger accounts.
3. Classifying transactions.
4. The format of the ledger includes a debit side (Dr.) and a credit side (Cr.). Each side involves date, particulars, J.F. (Journal Folio), and amount.
5. If the debit side amount is more than the credit side amount, it is called debit balance.
6. If the credit side amount is more than the debit side, it is known as credit balance.
7. Cash Account and Sales Account.
8. Sales Returns Account.

## Self-Assessment Questions

1. Explain the process of maintaining ledger with suitable examples.
2. Explain the process of balancing accounts.
3. What are the rules for posting in ledger accounts?
4. Explain the steps in preparation of ledger accounts.

## Assignments

1. Based on your personal journal entries of the last month, prepare ledger accounts.
2. Indicate whether to close or balance the following ledgers and give your reason

Capital Account

Wages Account



Drawings account  
 Machinery Account  
 Depreciation Account  
 Rent Account

3. Journalise the following transactions and post it in appropriate ledgers

- March 1. Paid wages ₹1200  
 March 3. Purchased Land ₹5000  
 March 5. Sold goods ₹20,000  
 March 7. Paid to Lal ₹3000  
 March 10. Drew from Bank ₹30000

4. Prepare ledger account for the following

Year & Date	Particulars	L.F.	Amount Dr.	Amount Cr.
2021 March 1	Cash A/c To Capital A/c	Dr.	30000	30000
2	Plant A/c To Cash A/c	Dr.	25000	25000
3	Purchases A/c To Joy A/c	Dr.	40000	40000
7	Cash A/c To Sales A/c	Dr.	20000	20000

### Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
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# Unit 4

## Trial Balance

### Learning Outcomes

After the completion of the unit, the learner will be able to:

- ◇ comprehend the Trial Balance
- ◇ prepare Trial Balance
- ◇ be aware of different types of accounting errors
- ◇ be accustomed with the methods of rectification of errors

### Prerequisite

As the fiscal year comes to a close, companies undertake important steps to verify their financial records are complete and accurate before preparing financial statements. But with countless transactions entered into journals and posted to ledgers across multiple accounts, how can accountants efficiently validate everything is in order? The solution is the trial balance. This handy accounting tool allows checking that all transactions have been recorded, properly journalized, and posted to the ledgers without error. It works by totalling all debit and credit balances from the ledger accounts into two separate columns. If the summed-up figures are matched, it indicates the records are arithmetically correct and the accounting equation remains in balance. The equality of debit and credit columns confirms, the double-entry system was followed, with every transaction having equal and balancing entries. When total columns mismatch or accounts are omitted, it can be identified that a problem occurred requiring investigation and correction. Only when the trial balance reconciles can accountants confidently compile end-of-year financial statements relying on the ledger data. This unit discusses how accountants summarise the records by preparing a Trial Balance.

### Keywords

Summarising, Error of Omission, Error of Commission, Error of Principle, Compensating Error.

## Discussion

A trial balance summarizes a company's financial records. It is like making a long list of every rupee the business owes. The trial balance totals all the numbers to ensure everything is balanced and accounted. It provides a quick snapshot of the company's financial position. So, in essence, a trial balance is a summary that adds up all the ledger accounts to check that debits equal credits. This verifies the accounting equation stays in balance and all transactions are recorded correctly. The trial balance is the important step of summing up all accounting entries before preparing financial statements. It lets accountants quickly see that the books are complete and accurate.

### 1.4.1 Trial Balance

Galaxy Pvt. Ltd. recorded their transactions in journals and posted them to ledgers. Now they want to check whether it is right. So, they prepare a trial balance, which summarizes the data to verify arithmetical accuracy. The trial balance lists all ledger account balances in two columns - debit and credit. The total of debit column must equal total of credit column for the trial balance to agree. If the two columns match, it indicates there are likely no arithmetical errors. However, some errors won't affect the agreement, so a balanced trial balance doesn't necessarily catch all mistakes. Additional analysis of the detailed transactions is still required.

Both columns (debit and credit) of the Trial Balance will be usually equal, in cases where the Trial Balance is unequal, it means some errors are involved in it. The amount of difference in the Trial Balance is put into a separate account known as the suspense account. "A suspense account is an account which is used for balancing the Trial Balance as a temporary adjustment." If the error is on the debit side, the journal entry will be;

Suspense A/c	Dr.	
		To Difference in Trial Balance A/c
Difference in Trial Balance A/c	Dr.	
		To Suspense A/c

After locating and rectifying the errors, the suspense account will be closed.

Following is the general format for preparing Trial Balance. Trial Balance is prepared at the end of a period on a specific date. Therefore, the caption of the Trial Balance should be mentioned like 'Trial Balance of XYZ. Ltd as on 31 March 2022'.

Table 1.4.1 Format of Trial Balance

Sl. No.	Name of Account	Dr. Amount	Cr. Amount



## 1.4.2 Methods of Preparing Trial Balance

The Trial Balance includes the debit column and the credit column. On the debit column, all the expenses, losses, and assets are written. On the credit column, all incomes, gains, and liabilities are entered.

There are mainly three methods which can be adopted to draft Trial Balance. They are;

- ◇ Total Method
- ◇ Balance Method
- ◇ Total and Balance Method

### 1.4.2.1 Total Method

This procedure totals each ledger account. It transfers the total of debit and credit columns for every account into a trial balance. The trial balance already contains the information regarding the balance amount of each account. The balance is the difference between the debit and credit totals. This method speeds up trial balance preparation since the account balances are already calculated. However, it is not commonly used. That is because the trial balance here does not help produce financial statements. Typically, accountants total the trial balance columns to derive each account balance. This allows linking the trial balance to the financial statements. While directly totalling ledger accounts, can accelerate trial balance preparation, but there is an increased chance to omit transaction details needed for financial reporting.

### 1.4.2.2 Balance Method

This procedure ensures that every ledger account is in balance, and only those balances are carried over to the Trial Balance. Accountants frequently employ this technique because it aids in the creation of financial statements. Based on the ledger account balances, financial statements are generated. The debit column displays all debit balances, and the credit column displays all credit balances. This approach is the more popular one.

### 1.4.2.3 Total and Balance Method

This approach combines two trial balance preparation methods such as Total method and Balance Method. It has four columns:

- a) Total debits for each ledger account
- b) Total credits for each ledger account
- c) Credit balances of each ledger account
- d) Debit balances of each ledger account

So, it includes both the account totals and balances. However, this four column approach is not commonly used. Most trial balances have just two columns - one for debit totals and the other for credit totals. The individual account balances can be calculated from those columns. Nevertheless, a four column trial balance is possible, it is not practical. The two column approach is simpler and provides the needed information - the equality of total debits and credits.

Accounting requires daily recording of transactions in journals, ledgers, and other books. Since staff perform these tasks manually, errors can occur. Human judgment means mistakes are inevitable when journalizing and posting transactions. These accounting errors could lead to poor business decisions. Bookkeeping involves high volume, repetitive data entry. So it's common for accidental omissions, duplication, or incorrect information to creep in. Even small errors throw off the accuracy of financial records.

### 1.4.3 Steps in preparation of Trial Balance

The steps to prepare Trial Balance using the most popular method, the balance method, are as follows;

- ◇ Step 1: Determine the balances of each ledger account, including cash book.
- ◇ Step 2: Write the name of accounts in the Particulars column. Enter the amounts (closing balance) of balance in the debit column if the account has debit balance similarly the closing balance of account having credit balance should be entered in credit side.
- ◇ Step 3: In the Ledger Folio column, enter the page number of the ledger from which the balance is derived.
- ◇ Step 4: Add the columns for debit and credit. It has to be fair. Find the errors and make the Trial Balance accord if they are not equal.

#### Illustration 1.4.1

From the following details for ABC Ltd. for the year ended on 31/02/2021 prepare Trial Balance.

Cash in hand	57000	Bad debts	3800
Debtors	28000	Drawings	3000
General expenses	2500	Plant and machinery	25000
Furniture	15000	Purchases	42000
Rent	1500	Sales returns	4500
Rate	2000	Capital	80000



Sales	52200	Interest received	2100
Dividend received	5000	Purchase returns	25000
Creditors	45000	Opening stock	25000

## Solution

Trial Balance of ABC Ltd. as on 31/03/2021

Sl. No	Name of Account	Dr. Amount	Cr. Amount
1	Opening stock	25000	
2	Furniture	15000	
3	Drawings	3000	
4	Plant and machinery	25000	
5	Purchases	42000	
6	Sales returns	4500	
7	Rent	1500	
8	Rate	2000	
9	Bad debts	3800	
10	Debtors	28000	
11	Cash in hand	57000	
12	General expenses	2500	
13	Capital		80000
14	Interest received		2100
15	Creditors		45000
16	Sales		52200
17	Purchase returns		25000
18	Dividend received		5000
		209300	209300

Accounting work involves recording transactions happening on a daily basis in journal, ledger and other books of accounts by staff who are responsible for keeping

the books. Since it involves human activity and judgment, it is prone to some human errors. Accounting errors are common while preparing and entering the business transactions in the books of accounts. Accounting errors may result in making wrong decisions.

Galaxy Pvt. Ltd. purchased furniture worth ₹50000, and it is debited to the purchase account instead of debiting the furniture account. Here, the debit balance of the purchases account is increased instead of increasing the debit balance of the furniture account. Likewise, sometimes errors can come into the accounts knowingly or unknowingly.

### 1.4.4 Accounting Errors

Accounting errors are mistakes that can happen when recording financial transactions. Some errors will make the trial balance debits and credits unequal. But other errors may not affect the agreement of the trial balance. If errors are not caught, they may or may not show up in an unbalanced trial balance. However, all errors reduce the accuracy of the financial records, even if the trial balance still balances. Inaccurate information leads to poor financial analysis and decisions, regardless of the trial balance outcome. So identifying and fixing errors is crucial for correct accounting and clear financial reporting, not just balancing the trial balance. When an unbalanced trial balance signals a definite error, a balanced trial balance does not guarantee the accounts are error-free. Additional checks are still needed because any mistakes distort the data and harm decision making.

Accounting errors can be classified as:

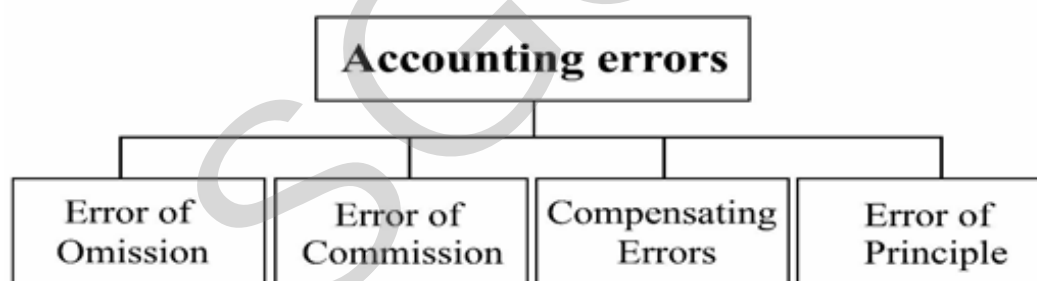


Figure 1.4.1: Accounting errors

#### 1.4.4.1 Error of Omission

Omission errors happen when transactions are left out of the accounting records completely or partially. A complete omission is when a transaction is not recorded at all. This will not affect the matching of trial balance totals. Partial omission is when a transaction is only partially recorded. For example, recording a debit but not the corresponding credit. Partial omissions will cause the trial balance to be out of balance. Both complete and partial omissions distort the financial data even if the trial balance agrees. So additional checks beyond the trial balance are essential to catch omitted transactions.

#### 1.4.4.2 Error of Commission

Galaxy Ltd. sells goods on credit but incorrectly records it as a cash sale. This error of recording a transaction incorrectly is called an error of commission. Errors of commission happen when transactions are recorded or posted wrongly, balances are inaccurate, etc. They may or may not affect the trial balance agreement. One example is duplicate errors, when the same transaction is recorded more than once. This won't impact the equality of debits and credits on the trial balance.

Hence, errors of commission are incorrect or duplicate entries. They arise from poor recording, posting, or calculations. While they may not unbalance the trial balance, errors of commission still distort the accuracy of the financial data and reporting. So extra checks beyond the trial balance totals are needed to identify and fix them.

#### 1.4.4.3 Compensating Error

Galaxy Ltd. receives \$500 less from a debtor than the full amount owed. The accountant fails to record this discount given. Also, Galaxy earns \$500 in income that the accountant forgets to log. Here two equal and offsetting errors occurred - missing a debit transaction and missing a credit transaction of the same amount. This is called a compensating error. A compensating error is when one mistake balances out another, leaving the trial balance still in agreement. In this case, the omitted debit and credit compensate to not affect the totals. But even though the trial balance matches, compensating errors still leave the records inaccurate. Transactions are missing and financial reports will be wrong. Compensating errors counterbalance each other on the trial balance but do not correct the underlying mistakes. Additional review is still required to catch and fix them to ensure accurate accounting.

#### 1.4.4.4 Error of principle

Galaxy Ltd purchases furniture worth Rs. 3000. Instead of debiting the Furniture account, the accountant debits Purchases. Technically this won't unbalance the books, it violates accounting principles. Assets like furniture should not be recorded in an expense account like Purchases. This is called an error of principle. Here, accounting rules or standards are violated but the trial balance still accurate. Even though the debit is recorded, using the wrong account goes against best practices. It distorts financial reporting even if the trial balance totals match. Errors of principle happen when transactions are mishandled despite the accounts balancing. Additional checks are needed to catch misapplications of accounting standards, not just trial balance mismatches. Following proper rules and principles is key for accurate books.

### 1.4.5 Rectification of Errors

If an error has been identified, we can rectify the errors in two ways.

- a. Rectification of errors before preparing the Trial Balance

If an error is identified before preparing Trial Balance the rectification of the error depends upon the nature of the errors. If the error is one-sided, means the error only

affects one side (debit side or credit side) of an account it does not require any journal entry for correction. Physical correction of wrong figures or an opposite entry in the same account can be made for its rectification.

If it affects two accounts in the opposite direction, it can be corrected by passing journal entries. We can go through a situation, the amount paid for repairs and maintenance of the building is debited to the building account and this is an error of principle. It can be corrected by debiting repairs and maintenance account and crediting the building account

b. Rectification of errors after the preparation of Trial Balance

If the error is identified at the time of preparing the Trial Balance, it does not tally automatically. It means that the total amount on the debit column and credit column of the Trial Balance is not equal. The difference in the Trial Balance is transferred to a temporary account called the suspense account and made the Trial Balance tally.

### Illustration 1.4.2

Here are some errors that occurred in the Galaxy Pvt. Ltd. Let us see how to rectify them.

Rectify the following errors:

- a. Sale of furniture is recorded in the sales day book ₹4000.
- b. Received ₹1000 from Binil credited to Jacob account.
- c. ₹600 paid as wages for the erection of a machine has been charged to Repairs Account
- d. ₹500 received from Ram, previously written off and has been credited to Ram's account
- e. The purchase of furniture for ₹7000 has been recorded in Purchase Day book.

### Solution

- a. Here, instead of crediting furniture account sales account is credited. It can be corrected by debiting the sales account and crediting the furniture account.

Sales A/c	Dr.	₹4000	
	To Furniture A/c		₹4000

- b. Instead of crediting Binil's account, Jacob's account is credited. It can be corrected by debiting Jacob account and crediting Binil's account



Jacob's A/c    Dr.    ₹1000  
    To Binil's A/c            ₹1000

- c. Here, instead of debiting the machine account, the repairs account is debited. To correct this error, the machine account is debited and the repairs account is credited.

Machine A/c    Dr.    ₹600  
    To Repairs A/c            ₹600

- d. Here, Ram's account is already written off. Hence no amount is due from him. Here a wrong credit is given to Ram and it should be rectified by debiting his account and crediting the bad debts recovered account. The rectification entry is

Ram A/c        Dr.    ₹500  
    To Bad debt recovered A/c    ₹500

- e. Here, instead of debiting the furniture account, the purchase account is debited. This can be rectified by debiting the furniture account and crediting the purchase account. The rectification entry is;

Furniture A/c    Dr.    ₹7000  
    To purchase A/c            ₹7000

### Recap

- ◇ Trial Balance: Consolidated list of ledger balances
- ◇ Establish the arithmetical accuracy of recorded transaction.
- ◇ Debit side of Trial Balance, write all the expenses, losses, and assets.
- ◇ Credit side of Trial Balance, write incomes, gains, and liabilities.
- ◇ Accounting Error: mistakes made by an accountant while preparing records.
- ◇ Error of Omission: transaction completely or partially omitted.
- ◇ Error of Commission: transaction is wrongly or incorrectly recorded.
- ◇ Error of Duplication: transaction is recorded more than once.
- ◇ Compensating error: one error is compensated by making another error.
- ◇ Error of principle: violate the accounting rules and principle.
- ◇ Rectification of errors: can be done before and after preparing the Trial Balance.

## Objective Questions

1. What is the major objective of Trial Balance?
2. What does the debit column of the Trial Balance represent?
3. What does the credit column of the Trial Balance represent?
4. What is error of omission?
5. What is error of commission?
6. What is compensating error?
7. What is error of principle?
8. What are the two types of Rectification of errors?

## Answers

1. Establishing arithmetical accuracy.
2. Expenses, losses, and assets
3. Incomes, gains, and liabilities
4. An error occurred when a transaction is wrongly or incorrectly recorded
5. A transaction is wrongly or incorrectly recorded
6. One error is compensated by making another error
7. Violation of the accounting rules and principles
8. Rectification of errors before preparing the Trial Balance and rectification of errors after the preparation of Trial Balance



## Self-Assessment Questions

1. What is Trial Balance and explain the process of preparation of Trial Balance?
2. Explain the need for preparing Trial Balance.
3. Explain compensating errors.
4. What is error of omission?
5. What is error of commission?
6. How can different errors be rectified? Explain with suitable examples.

## Assignments

1. Prepare a Trial Balance for the accounts you keep for your personal transactions. Use imaginary figures and see if you can match debit and credit side of Trial Balance
2. Prepare Trial Balance from the following

Capital A/c	₹40000	Furniture & Fixtures	₹5000
Cash A/c	₹20000	Sundry Creditors	₹45000
Sundry Debtors	₹10000	Purchase returns	₹5000
Opening stock	₹5000	Drawings	₹3000
Wages	₹3000	Depreciation	₹2000
Carriages	₹2000	Patent	₹10000
Sales	₹75000	Goodwill	₹25000
Sales Returns	₹5000	Salary	₹3000
Purchases	₹45000	Printing & Stationary	₹2000
Plant & machinery	₹20000	Advertisement	₹5000

(Ans. TB Total- 165000)

3. Give entries to rectify the following errors
  - ◇ Plant purchased for ₹10000 is debited to purchase account
  - ◇ Cash paid to Ramesh ₹5000 is debited to Rakesh's Account

- ◇ Salary of ₹10000 paid to X is debited to his personal account
- ◇ Cash Purchases for ₹2000 from Anil is debited to his personal account
- ◇ Goods sold for ₹5000 to Arati on credit is wrongly considered as cash sales.

4. The following balances were extracted from the books of a trader. Indicate each of this item appears on which side of the Trial Balance.

Opening stock	5000	Sales	100000
Purchases	75000	Debtors	15000
Creditors	7500	Drawings	7500
Capital	100000	Returns inward	10000
Returns outward	5000	Carriage inward	10000
Carriage outward	5000	Discount allowed	2500
Interest received	10000	Bad debts	2500
Provision for bad debts	5000	Trade expenses	10000
Wages	25000	Goodwill	15000
Investments	25000	Plant and Machinery	25000

### Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
2. Paul, S. K. R. (2011). *Advanced Accounting*. New Central Book Agency (P) Ltd.
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**BLOCK  
02**

**Final Accounts**

# Unit 1

## Final Accounts of Sole Proprietors: Trading Account, Profit and Loss Account

### Learning Outcomes

After the completion of the unit, the learner will be able to:

- ◇ describe the meaning of financial statements
- ◇ introduce the Trading account
- ◇ familiarise the preparation of Trading account
- ◇ acquaint with the Profit and Loss Account
- ◇ explain the preparation of Profit and Loss Account
- ◇ create awareness on the items to be included in Profit and Loss Account

### Prerequisite

Raj, being an aspiring and hardworking individual, decides to start a business of his own. He had decided to go with the idea of Sole Proprietorship and he chooses to start a poultry farm that sells chicken and eggs. As it is a Sole Proprietorship, the farm is owned and operated by Raj himself. As there are no partners, he is the only beneficiary of the profit or the bearer of loss incurred by the operations of the farm.

It has been a year since the advent of Raj's business. He is running a farm and he has incurred a lot of expenses for its proper functioning. He is doing all these to gain a desirable amount of profit from the farm's functioning. So, it is imperative for him to keep a record of all the expenses and revenues from the business and its effect on the farm's resources and debts as well, only then he will be able to ascertain whether his farm is gaining profit or is running at a loss.

In order to compute the profit or loss of the business, he has to document all his business transactions in a systematic manner. This systematic documentation of all business transactions of the farm is called financial statements. In this section, we will look into the components and preparation of the Financial Statement in detail.



## Keywords

Trading Account, Profit and Loss Account, Balance Sheet, Direct Expenses, Direct Income, Indirect Expenses, Indirect Income

## Discussion

Preparation of final accounts is an important stage of accounting process. The final accounts paint a picture of the business's financial status. It demonstrates whether your company generated profit or loss during the accounting period and whether debts can be settled as they become due etc. Before learning about final accounts of sole proprietorship, let us try to understand the term first.

### 2.1.1 Sole Proprietorship

As we know that Sole Proprietorship business is a form of business where an individual invests his own capital and has the right to take decisions by himself and to receive profit or bear loss of the business. As it is owned and operated by a single individual there are certain advantages and disadvantages associated with it. Let us try to understand it with the help of the case of Raj's farm.

Let us first examine the benefits enjoyed by Raj on being the sole owner of the business.

- ◇ Raj was able to start the business with small investment as there is no limit on the minimum initial investment requirement. So, business can commence with limited capital.
- ◇ Raj could commence the operations of the farm straight away as the registration process involved in the establishment of Sole Proprietorship is simple and easy as there are very little fees associated with its registration.
- ◇ Raj has all the freedom in terms of decision making. Decisions regarding the location of the farm, rent to be paid for the land and building, number of employees to be hired, target markets to focus on are easy as it is dependent on the decisions of Raj alone.
- ◇ Raj only faces minimal government regulations in terms of the working of the farm. It usually extends to only filing of the annual taxes. The annual taxes are limited to Raj's income tax alone as in Sole Proprietorship the owner and the business are considered a single legal entity. That means the farm does not need to pay separate corporate tax.
- ◇ Raj's farm is also exempted from disclosing its profit and loss situation to the general public. That means Sole Proprietorship is exempted from public disclosure of its financial statements.

Let us investigate the disadvantages faced by Raj in terms of the farm's operations.

- ◇ Raj will have to face unlimited liability with respect to the operations of the farm, i.e., if the farm had purchased the chickens and the feed required for them on credit from the supplier and if the farm fails to pay the credit amount in time, then Raj is liable to settle the debts of the creditors (suppliers) from his personal assets.
- ◇ Raj will be liable to any legal action taken against his farm, as in Sole Proprietorship. In case someone decides to file a petition against the farm's waste management policies, then Raj will directly be answerable and responsible to the further proceedings of the legal petition.
- ◇ Initially, Raj wanted to include a cattle business along with the poultry farm but lack of capital forced him to be content with poultry business alone. Being a Sole Proprietor, Raj will find it difficult to raise sufficient capital as he will not be able to take funds from the public. So, we can say that in Sole Proprietorship the owner is often faced with the difficulty to raise sufficient capital.

Now that you are familiar with sole proprietorship, its benefits, and limitations, we will try to familiarise the financial statements of the sole proprietors in the next sections.

## 2.1.2 Financial Statements

It has been a year since Raj started his farm and he is happy with the way the farm is functioning. He has got some new ideas regarding expansion of the operations of the farm. For putting these ideas into practice, some additional capital is required. Before further investing in the farm Raj wants to make sure that its functioning, in terms of revenue generation, is satisfactory. From where does he get this information as to the financial performance of the farm? Accurate depiction of the financial performance of business is done in the financial statements. Financial statements contain the information as to the profit and loss and the position of the firm in terms of assets and liabilities.

Financial Statement includes the Trading and Profit and Loss Account and the Balance Sheet. By preparing Trading and Profit and Loss Account, we can find out the profit or loss made by the business. As it represents the net income (Total income after all expenses) of the company, Trading and Profit and Loss Account is also known as Income Statement. Balance Sheet of the business shows the value of assets and liabilities of business. It provides a snapshot of the networth of the business. Networth is the difference between assets and liabilities of a company on a particular date. Balance Sheet is a representation of the financial position of the company so it is also known Position Statement. These financial statements help Raj to make plans, which align with the current financial condition of the farm.

We can conclude that the Financial Statements or Final Accounts are the accounts and statements prepared at the end of every accounting year to find out the profit and loss of the business and to exhibit the financial position of the business. Now let us learn in detail about the financial statements. We can start with the Trading Account.



### 2.1.3 Trading Account

Before going into the concept of Trading Account, let us first try to understand what the term trade means in the context of Raj's farm. Raj purchases good quality chickens from the suppliers and takes good care of these chickens and when they are fully grown, he sells them to customers. We can say that Raj has conducted a trade in terms of the chickens. So, trade can simply be defined as the process of buying and selling of goods and services.

Several transactions related to the purchasing and selling of items are shown in the Trading account. Let us investigate all such major transactions that take place in the buying and selling process of the farm. The main purpose of the farm constitutes meat and egg production. The transactions involved in developing and the sale of the final products are:

- ◇ Purchase good disease resistant chickens for breeding.
- ◇ Cost of good quality feeding material for these chickens.
- ◇ Wages paid for experienced workers.
- ◇ Expenses for water charge, electricity, lighting, and ventilation required by the farm.
- ◇ Revenue earned by the firm from the sale of meat and eggs.

If you look at the nature of the above transactions, you can see that these transactions represent the direct operating expenses (cost of chickens, cost of feeding materials, wages for workers, farm expenses such as electricity, power etc.) incurred by Raj's farm for the purchase and development of the final products (chicken and eggs) of the farm and it also represents the direct operating income (revenue earned from sale of chicken and eggs) obtained by the farm from the sale of its final products (chicken and eggs).

So, in general we can say that **Direct Expenses** are expenses incurred by a business in the overall production of its core products or services and **Direct Income** is the income received by the business from the sale of its core products or services. Now what exactly do you think the trading account of a business communicates as a whole?

Trading account lists all the direct expenses incurred and direct income received by the business from the production and sale. Then, Trading Account gives the difference between these direct operating expenses and direct income of the farm. This estimate is known as the Gross profit or Gross loss of the farm. The Gross profit or Gross loss can be written as:

$$\text{Gross profit or Gross loss} = \text{Net Sales} - \text{Cost of goods sold} \quad \text{-----(1)}$$

Let us look at the Right Hand Side (RHS) of equation (1). The first term Net sales indicate the income earned by the business from the sale of its final goods. You might be wondering why it is represented as Net sales and not just sales. Suppose Raj's farm

makes a sale of 1000 eggs to the customers out of which 100 were slightly broken. So, the customers return the damaged eggs. In this case, the total sale is not 1000 eggs but 900 eggs as 100 were returned to the farm. So, net sales is the difference between total sales and sales returns.

$$\text{Net sales} = \text{Total sales} - \text{Sales return}$$

Now that we are clear with the concept of net sales, we can focus on the second term on the RHS of equation, (1) i.e., cost of goods sold. It is the cost that can be directly associated with the production process. In the case of Raj's farm, the final products are meat and eggs. So, direct cost associated with its production includes:

- ◇ Cost of purchasing the chicks to breed
- ◇ Cost of feeding materials for chicks
- ◇ Transportation cost of bringing the chicks and the feeding materials to the farm
- ◇ Wages paid to laborers for looking after the chick and for collecting the eggs
- ◇ Cost incurred for providing suitable working condition in the farm, such as water charge, electricity, lighting, and ventilation.

The above instances provide you with a basic idea of what cost of goods mean with respect to Raj's farm. Now let us look at the general components of Cost of goods sold that is applicable for every business. Cost of goods sold is represented by the following equation:

$$\text{Cost of Goods Sold} = \text{Opening stock} + \text{Net Purchase} + \text{Direct Expenses} - \text{Closing Stock}$$

As you can see, there are four components which constitute the cost of goods sold, which is depicted on the Right Hand Side (RHS) of the above equation. We can discuss briefly about each of the components.

### 2.1.3.1 Opening Stock

Opening stock is the value of all goods, in any form available with the company at the beginning of the accounting period. Goods in any form means the raw materials for production, work in progress or semi-finished goods and the final goods. The company plans on earning revenue from the sale of these goods in the accounting period. Opening stock can be calculated as:

$$\text{Opening Stock} = \text{Value of raw materials} + \text{Value of Works in Progress} + \text{Value of Final Products}$$

### 2.1.3.2 Net Purchases

Suppose Raj's farm purchases 100 packets of feeding material for the chicks from the



supplier of which 10 packets were slightly damaged. So, the farm returns the damaged packets of feeding material. In this case the total purchase is not 100 packets but 90 packets as 10 were returned to the suppliers. Generally, we can say that out of the total raw materials purchased, some will be returned to the supplier due to lack of quality or damage. The difference between the total purchases and purchase returns is called net purchases.

$$\text{Net Purchase} = \text{Total Purchase} - \text{Purchase Return}$$

### 2.1.3.3 Direct Expenses

Direct Expenses include all those expenses that are incurred by the company in bringing the raw materials to the factory and making it fit for sale. The most common direct expenses incurred by a business are listed below:

*i. Carriage in, Cartage in, Freight in:*

Farm will have to spend some money in transportation of new chickens, feeding materials, etc. from the supplier's premises to the farm premises.

These terms indicate the transportation cost for bringing the raw materials into the factory.

Note that carriage out, cartage out and freight out refer to the cost for distributing the finished goods for selling. It is considered as indirect expense and is charged on Profit and Loss Account and not included on Trading account.

*ii. Wages and Salaries*

Farm will have to pay wages to workers employed with them to take care of the chickens, feed them, provide them with medicine and prepare clean conditions for them to grow and lay eggs. So, wages are payments made to the workers for transforming the raw materials to finished goods. Wages vary depending up on the quantity of output produced. Wages are direct expenses.

The farm also pays monthly remuneration to the office staff that looks after its production and sales affairs, to the security that guards the farm's premises. These people do not directly take part in the production affairs of the farm. So, Salaries are fixed amount of compensation paid to employees who do not take part directly in production but involves in the overall functioning of company. Salaries are indirect expenses. But when wages are clubbed with salaries and the items are mentioned as Wages and salaries in the Trial Balance, they are considered direct expense. If it is given as Salaries and wages in the Trial Balance, then it is considered indirect expense and is charged on the Profit and Loss Account.

*iii. Customs or Import duty, Dock charges*

Suppose Raj's farm imports some disease resistant and high egg yielding variety of

new chicks from Switzerland. Then the farm will have to pay tax to the government it is called customs or import duty. Therefore customs or import duty is the taxes paid to the government when goods are imported from abroad. A dock charge typically refers to a fee or cost associated with the use of a loading dock, which is a platform at a facility, such as warehouse or distribution center, where goods are loaded or unloaded from trucks or other vehicles.

iv. *Octroi*

Raj's farm purchases some high-quality feeding materials from Punjab that produces good growth in chicks without having any side effects. So, the farm will have to pay tax to the state government for this interstate purchase. This tax is Octroi, these are taxes paid to the state government when goods are transferred from one state to another.

v. *Royalty*

Raj's farm is using incubators for artificially hatching eggs. The technology used in the incubator is exclusive patent of another company. So, the farm will have to pay some amount to the owners of this patented incubator technology. These payments are called Royalties. These are payments made to owners for using their patent or copyrighted works.

Note: Royalties are considered direct expenses and is entered in the trading account but when it is mentioned that royalties are based on sales, then it is taken as indirect expenses and is entered in the Profit and Loss Account.

vi. Factory expenses for making the product ready for sale.

The farm will incur some expenses for creating an environment that is favourable for the growth and development of the chicks. These expenses include factory rent, lighting, gas, fuel, electricity, power, etc. and are considered direct expenses.

### 2.1.3.4 Closing Stock

Raj's farm might be having some newly purchased chicks, some half-grown chicks, some fully grown chickens, eggs, etc. that are unsold at the end of the accounting period. The value of these semi-finished and finished products available with the farm at the end of the accounting period is called closing stock of the farm. It is the amount of goods that remain unsold at the end of the accounting year. Similar to opening stock, closing stock also consists of raw materials for production, work in progress or semi-finished goods and the final goods. The closing stock for a particular accounting year becomes the opening stock for the next accounting year.

Now that you have got a clear view of all the factors that needs to be considered to determine the gross profit or gross loss of a company. We can next focus on the preparation of trading account.



## 2.1.4 Preparation of Trading Account

Trading Account helps to ascertain the gross profit or gross loss of a business. Gross profit or Gross loss can be represented as:

$$\text{Gross Profit or Gross Loss} = \text{Net Sales} - \text{Cost of goods sold}$$

We have learned in detail about the components of net sales and cost of goods sold that constitute the Right Hand Side of the above equation. All these components should be included in the trading account. Now let us see how these components can be arranged or written in the Trading Account.

All expense and losses associated with a business are entered on the debit side of the respective account and all incomes and gains of the business are entered on the credit side of the respective account. Trading Account is a nominal account, so the above rule is applied in entering items to its debit and credit side.

### 2.1.4.1 Items written on the debit side of Trading account

As per the rule of nominal account, all expenses and losses will be entered on the debit side of trading account. Given below is the list of items written on the debit side of trading account:

1. Opening Stock
2. Net Purchases (Purchases – Purchase return)
3. Direct Expenses

### 2.1.4.2 Items to be written on the credit side of trading account

All income and gain will be entered on the credit side of the Trading account. It includes:

1. Net Sales (Sales – Sales return)
2. Closing Stock

After entering the respective items on the debit side and credit side, the Trading Account is balanced by inserting the difference amount (difference of debit side and credit side) on the side (debit side or credit side) where amount is less in order to make the total on both sides equal. This difference amount added for balancing the debit side and credit side represents either gross profit or gross loss of the firm.

If credit side total amount is greater than debit side, then it means the company is making a gross profit as revenue from sales is greater than the expenses. If debit side total amount is greater than credit side amount, then it means company's expenses are greater than revenue, so the company suffers gross loss. As you are familiar with the preparation of trading account, we can now look into a general format of the Trading account.

Table 2.1.1 Format of Trading Account

Dr		Cr	
Particulars	Amount	Particulars	Amount
Opening stock	xxx	Sales	xxx
Purchases	xxx	Less: Sales returns__xx	xxx
Less: Purchase returns	xx	Closing stock	xxx
Direct expenses			
Carriage/Cartage/Freight in inwards	xxx		
Wages/Wages and Salaries	xxx		
Customs/Dock/Octroi	xxx		
Royalty	xxx		
Gas/Electricity/Water/Fuel/Power/ Factory rent	xxx		
To Gross profit c/d	xxx	By Gross loss c/d	xxx
Total	xxxx	Total	xxxx

Now, we will prepare a Trading Account to make the concept clearer.

### Illustration 2.1.1

From the following information on Raj's farm, prepare Trading account for the year ended 31 December 2020.

Particulars	Amount	Particulars	Amount
Sales	25000	Factory Expenses	200
Purchase	4000	Repairs	190
Capital	6200	Stock (01-01-2020)	1600
Salary	750	Rent	250
Machinery	15000	Drawings	1700
Furniture	3600	Advertisement	300
Sundry creditors	4600	Carriage in	300
Wages	100	Cash at bank	2600
Sundry Debtors	8560	Bills Payable	3350

The closing stock was ₹250.



## Solution

### Trading Account for the year ended 31 December 2020

Particulars	Amount	Particulars	Amount
Opening stock	1600	Sales	25000
Purchases	4000	Closing stock	250
Direct expenses			
Carriage inwards	300		
Wages	100		
Factory expenses	200		
To Gross profit c/d	19050		
	25,250		25,250

### Illustration 2.1.2

Prepare Trading Account from the following.

Stock as on 01/04/2015	10000
Purchases	200000
Freight	15000
Wages	50000
Carriage	10000
Sales	320000
Return Inward	10000
Return outward	20000
Stock as on 31/03/2018	20000

## Solution

### Trading Account

Particulars	Amount	Particulars	Amount
Opening stock	10000	Sales	320000
Purchases	200000	(-)Returns	10000
(-) Return	20000	Closing stock	20000
Direct expenses			
Carriage	10000		
Wages	50000		
Frieght	15000		
To Gross profit c/d	65000		
	330000		330000

### 2.1.5 Profit and Loss Account

Every business would like to know the result of the business operations conducted by them during a particular period. What do you mean by this result? Result means the amount of final profit or loss that the business generates for its owner from its operations. For instance, Raj can determine the result of buying and selling activities of his farm during the previous year, i.e., gross profit or gross loss from Trading Account. So, do you think Raj should be content with this information as to the final profit and loss situation of the farm?

The answer is no, because Trading account only discusses the performance of the company with regard to the direct expenses and direct income. There are some other factors like indirect expenses and indirect income that need to be addressed along with their direct counterparts, while determining the final profit or loss position of the company. This final profit or loss obtained is called the net profit or net loss of the company which the owner must bear. This information as to the net profit and net loss is provided by the Profit and Loss Account.

Let us take the case of Raj's is poultry farm. Its core business is egg and meat production and sales. Conduct of this business results in direct expenses and direct income. Apart from that Raj will have to suffer some other expenses like insuring chickens against diseases and farm against natural disasters and accidents, telephone charges for farm's purpose, salaries paid for the farm's security guard, advertisement and promotional expenses of the farm and expenses for transportation of eggs to various shops for selling. These complimentary expenses are considered indirect expenses. These indirect expenses can be generally characterised as:

- a. Office and administrative expenses, such as telephone, postage, office rent, salaries of office staff, legal charges, audit fees and insurance.



- b. Selling and distribution expenses, such as advertisement, commission, carriage outwards (transportation cost for distributing the final products to customers) and packing charges.
- c. Miscellaneous expenses like repairs, depreciation, interest on loan, bad debts and provision for bad debt.

The farm also receives revenue from certain other sources as well. For your understanding let us consider following instances.

- ◇ A portion of the farm's building is given on rent to Raj's friend for running a shop. In this case the farm will receive revenue in the form of rent.
- ◇ Raj had purchased the feeding material on credit. Now when Raj went to pay this amount, the supplier provides him some discount. In some cases, discounts are allowed by the creditors while settling the account. This discount is also revenue for the farm.
- ◇ Using the revenue generated from the farm's operations, Raj made certain small investments in banks and other companies. Interest and dividend received from these investments are also revenue for the farm.

These incomes are not obtained from the main business of the farm but it also contributes to the profit of the farm. These incomes can be considered Indirect Income. Indirect Income is the income received by the company from activities other than sales of its final goods and services. Since it is generated from activities other than the operating activities of the company, it is also known as Non-operating Income. Some common specimens of indirect income are commission received, rent received, discount received, dividend received, etc..

Profit and Loss Account is prepared to include these factors as well and determine the net profit or net loss of the company. Profit and Loss Account is a nominal account that is prepared by incorporating the indirect expenses incurred and indirect income earned by a business, along with its gross profit or gross loss in order to ascertain the net profit or net loss of the business.

## 2.1.6 Preparation of Profit and Loss Account

Profit and Loss Account is prepared as a continuation of Trading Account. Since Profit and Loss Account is a nominal account the accounting rule of debit and credit is applicable here.

“Debit all expenses and losses

Credit all income and gains”

This means all indirect expenses and losses will be written on the debit side and all indirect income and gains will be written on the credit side of the Profit and Loss Account.

Items to be written on the debit side of Profit and Loss Account.

- ◇ Gross Loss – If Trading Account discloses gross loss for the business, then it should be brought down to the debit side of Profit and Loss Account.
- ◇ Office and Administrative expenses
- ◇ Selling and Distribution expenses
- ◇ Miscellaneous expenses

Items to be written on the credit side of Profit and Loss Account:

- ◇ Gross Profit – If the company earns gross profit as per Trading Account, then it will be brought down to the credit side of Profit and Loss Account.
- ◇ Indirect Income and Gains.

Now, on balancing the Profit and Loss Account, if total credit side value exceeds the total debit side value, then the balance amount will be written on the debit side and it is termed as net profit. If the total debit side value exceeds the total credit side value, then the balance amount will be written on the credit side and it is called net loss. The net profit and net loss are the results of a business's operations for a particular period of time. So, the net profit will be added to the capital of the owner and if it is net loss then it will be reduced from the owner's capital

Table 2.1.2 Format of Profit and Loss Account

Particulars	Amount	particulars	Amount
To Gross loss b/d (if any)	xxx	By Gross profit b/d (if any)	xxx
Salaries	xxx	Interest Received	xxx
Printing And Stationeries	xxx	Dividend Received	xxx
Rent, Rate and Taxes	xxx	Rent Received	xxx
Audit Fees	xxx	Commission Received	xxx
Postage And Telegram	xxx	Discount Received	xxx
Legal Charges	xxx	Any other income	xxx
Audit Fees	xxx		
Insurance	xxx		
Telephone	xxx		
Bank charges	xxx		
Advertisement	xxx		
Commission Paid	xxx		
Depreciation	xxx		
Charity	xxx		
Carriage outwards	xxx		
Travelling Expenses	xxx		



Discount Allowed	xxx		
Bad Debts	xxx		
Provision for Doubtful Debts	xxx		
Any other expense	xxx		
Net Profit (if any)	xxx	Net Loss (if any)	xxx
Total	xxxx	Total	xxxx

**Note:**

- ◇ Net profit /Net loss must be transferred to Capital account.
- ◇ Personal expenses of the owner like income tax, domestic and household expenses will not be written in the Profit and Loss Account.
- ◇ From the Trial Balance given in the question, only indirect expenses and indirect incomes are entered in Profit and Loss Account.
- ◇ Apprentice Premium is an indirect income received by the company for training someone.

Now let us solve a simple problem that involves the preparation of Trading and Profit and Loss Account.

**Illustration 2.1.3**

From the following information on Raj's farm, prepare Trading and Profit and Loss Account for the year ended on 31 December 2020.

Particulars	Amount	Particulars	Amount
Sales	25000	Factory Expenses	200
Purchase	4000	Repairs	190
Capital	6200	Stock (01-01-2020)	1600
Salary	750	Rent	250
Machinery	15000	Drawings	1700
Furniture	3600	Advertisement	300
Sundry creditors	4600	Carriage in	300
Wages	100	Cash at bank	2600
Sundry Debtors	8560	Bills Payable	3350

The closing stock was ₹250.

## Solution

### Trading and Profit and Loss Account for the year ended 31 December 2020

Particulars	Amount	Particulars	Amount
Opening stock	1600	Sales	25000
Purchases	4000	Closing stock	250
Direct expenses			
Carriage inwards	300		
Wages	100		
Factory expenses	200		
To gross profit c/d	19050		
	25,250		25,250
		By gross profit b/d	19050
Salary	750		
Repairs	190		
Rent	250		
Advertisement	300		
Net profit transferred to capital account	17560		
	19050		19050

### Illustration 2.1.4

Prepare Trading and Profit and Loss Account for Sree. Ltd from the following details.

Purchases	150900	Opening stock	60100
Depreciation	33100	Closing stock	55200
Carriage inward	4100	Wages	65000
Sales	360000	Factory Salaries	26000
Office Salaries	18000	General Expense	23100
Repair	10000		



## Solution

### Trading and Profit and Loss Account

Particulars	Amount	Particulars	Amount
Opening stock	60100	Sales	360000
Purchases	150900	Closing stock	55200
Direct expenses			
Carriage inwards	4100		
Wages	65000		
Factory Salaries	26000		
To Gross profit c/d	109100		
	415200		415200
Office Salaries	18,000	By gross profit b/d	109100
General Expense	23100		
Repair	10000		
Depreciation	33100		
Net profit transferred to capital account	24900		
	109100		109100

### Recap

- ◇ Financial Statement includes Trading and Profit and Loss Account and Balance Sheet.
- ◇ Financial statements are prepared at the end of accounting year.
- ◇ Profit and loss are represented by Trading and Profit and Loss Account.
- ◇ Values of assets and liabilities are shown in the Balance Sheet.
- ◇ Trading Account depicts transactions of buying and selling of goods.
- ◇ Trading account gives gross profit or gross loss.
- ◇ Expenses from core operating activities are direct operating expenses.
- ◇ Income from sale of final products is direct income.

- ◇ Opening Stock is goods available at the beginning of accounting period.
- ◇ Direct expenses are incurred in bringing raw materials and making it fit for sale.
- ◇ Closing Stock is the goods remaining unsold at the end of accounting year.
- ◇ Profit and Loss Account gives net profit or net loss.
- ◇ It incorporates indirect expenses and income with gross profit or gross loss.
- ◇ Indirect Expenses are complimentary expenses in production.
- ◇ Indirect Income is received from activities other than the sale of goods.

### Objective Questions

1. Who receives profit or bear loss in Sole Proprietorship?
2. When are final accounts prepared?
3. What information do you get from a trading account?
4. What term represents the cost incurred by the firm in production of goods?
5. What are the constituents of opening stock?
6. What type of account is Trading Account?
7. What are the common factory expenses?
8. What kind of expense is transportation cost?
9. What happens when credit side is greater than debit side in Trading account?
10. What type of account is Profit and Loss Account?
11. What happens when debit side is greater than credit side in Profit and Loss Account?
12. What type of expense is carriage outwards?
13. Where will the net profit or net loss be transferred to?



## Answers

1. Owner
2. End of accounting year
3. Gross profit or Gross loss
4. Cost of goods sold
5. Raw materials, semi-finished goods and finished goods.
6. Nominal Account
7. Gas, Power, Electricity, Fuel, Water, lighting.
8. Indirect Expense
9. Business earns Gross Profit
10. Nominal Account
11. Net loss for business.
12. Indirect Expense
13. Capital Account of owner.

## Self-Assessment Questions

1. Explain sole proprietorship.
2. Write down a short note on advantages and disadvantages of sole proprietorship.
3. What are financial statements?
4. Explain Trading Account and its significance.
5. Explain the items included in Profit and Loss Account with suitable examples.
6. How Profit and Loss Account helps sole traders?

## Assignments

1. Visit a small business venture in your locality and enquire about the direct expenses incurred and direct income earned by it and prepare a trading account to determine the gross profit or gross loss of the business.
2. Prepare trading account and find out the gross profit from the following details.

Purchases	10000	Opening stock	4000
Purchase Return	2000	Closing stock	6000
Carriage inward	2000	Sales Return	5000
Sales	20000	Wages	4000

(Hint: Gross Profit – 3000)

3. Prepare Trading and Profit and Loss Account from the following particulars.

Purchases	20000	Opening stock	2000
Purchase Return	1000	Closing stock	5000
Carriage inward	1000	Sales Return	2000
Sales	30000	Salaries	2000
Cartage	1000	Rent	1000
Interest	2000	General Expense	1000
Discount Received	500	Insurance	500
Discount Allowed	1000		

(Hint: Gross Profit- 10000, Net Profit – 3000)

4. Since you have got a general understanding of the relationship between gross profit and net profit, try to represent their relationship in the form of an equation.

**(Hint: Try to include Non-operating expenses and Non-operating income to form the relationship)**

## Suggested Readings

1. Maheswari, S. N. (2018). *Advanced Accounting*. Vikas Publishing House.
2. Paul, S. K. R. (2011). *Advanced Accounting*. New Central Book Agency (P) Ltd.
3. Gupta, R. L., Radhaswamy M.: *Advanced Accountancy*, Sultan Chand & Sons, New Delhi.



4. Maheswari, S. N., *Management Accounting and Financial Control*, Sultan Chand & Sons, New Delhi.
5. Miller-Nobles, Tracie L. Mattison, Brenda L., and Matsumura, Ella Mae (2016). *Horngran's Financial and Managerial Accounting: The Financial Chapters*.

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# Unit 2

## Indemnity

### Learning Outcomes

After the completion of the unit, the learner will be able to:

- ◇ describe assets and liabilities.
- ◇ acquaint with the Balance Sheet.
- ◇ familiarise with the preparation of the Balance Sheet.

### Prerequisite

From the preparation of Trading and Profit and Loss Account of the farm, Raj finds that he is earning net profit and he is very happy with the way the poultry farm is functioning. Since the farm is a profit-making concern, he wishes to expand it with cattle rearing business. What is the basic requirement for expanding the business?

The fundamental requirement is, need for additional capital. So, what can Raj do to increase the capital? Some of his friends would like to invest in his farm but they would prefer to know the financial position of the farm. So, he tells his friends, who are potential investors, that his farm is running at a profit and they will get a return by being part of the farm. As a proof to substantiate his claim about the profit situation, he presents them with the firm's Trading and Profit and Loss Account. But will the investors be ready to make an investment in a company just based on Trading and Profit and Loss Account?

The answer is no, because Trading and Profit and Loss Account shows only the profit earning capacity of the business. Financial position of the firm is represented by its asset, liabilities, and capital. Knowledge about the assets and liabilities helps to ascertain the solvency position of the firm, i.e., the ability of the firm to pay back its debts when they become due. This information relating to the financial position of the company is provided by a statement known as Balance Sheet.



## Keywords

Capital, Accounting Equation, Current Assets, Fixed Assets, Intangible Assets, Current Liabilities, Long Term Liabilities, Grouping and Marshalling.

## Discussion

Before going into the concept of Balance Sheet and its preparation, we need to have a brief understanding about the constituents that forms the Balance Sheet, i.e., Assets, Liabilities and Capital.

### 2.2.1 Assets

Raj has acquired certain resources during the course of the farm's functioning which help in the daily operations of the farm. Some of these resources are:

- ◇ Cash available with the farm.
- ◇ Land where the farm is situated and the buildings where the activities of farm take place.
- ◇ Machineries like incubators, egg collecting and storing equipment, chicken dressing equipment for assisting the operations of the farm.
- ◇ Unsold stock available with the farm in the form of new chicks, half grown chicks, fully grown chicken, and eggs.

All these items are resources that are owned by the farm and which can be expressed in monetary terms. These resources are called Assets. It is with these Assets the business performs its daily operations. Some of the common assets of business are Cash, Land and Building, Machinery, Investments, Stock in hand, etc.. Different types of assets are discussed in detail in the later stages of this unit.

### 2.2.2 Liabilities

Raj had purchased 10 new incubators with a view to increasing the number of new chickens. But since he was short of sufficient fund, he took a loan from the bank for making the purchase of incubators. This loan is a debt the farm owes to the bank and it should be paid back when it is due. This debt of the farm is known as Liability. So, Liabilities are obligations or debts that the business has to pay back at some time in the future. Some of the general liabilities are Loans taken, Bill payable, Debentures issued etc.. Different types of liabilities are discussed in detail in the later stages of this unit.

### 2.2.3 Capital

Raj has made some investment for starting the farm. This investment made by Raj

is the Capital of the farm. From the farm's point of view this capital is a liability that has to be paid back to Raj at the time of winding up of farm's operations. Since Raj is the owner of the farm the net profit generated from the farm's operations will be added to the capital to be paid back to Raj and the net loss incurred by the farm will have to be borne by Raj as it will be reduced from the capital. So, we can define Capital as the amount invested by the owner in the business. It increases with net profit and decreases with net loss. Now, Raj might withdraw some money once in a while from the farm to carry out his personal needs such as filling petrol for his car or for paying his daughters tuition fees. Since these withdrawals are from the capital amount invested by Raj in the farm, it will result in reduction of capital. The farm keeps a record of all these withdrawals made by Raj for personal needs from time to time and places it together under a common heading as Drawings. So, Drawings can be defined as cash or assets withdrawn from the business by the owner for personal use. Any type of drawings will result in reduction of the business's capital.

## 2.2.4 Accounting Equation

As you have got a basic understanding of Assets, Liabilities and Capital, now let us see how they are related to each other. Since Assets are important resources for the functioning of the business, how do you think the business obtained these assets? The answer to this question can be explained by looking at two scenarios where Raj had acquired different assets for his farm.

- ◇ Raj had the initial investment with which he purchased the land for the farm.
- ◇ But Raj does not have sufficient money of his own to purchase 10 incubators. So, he will have to take a loan from the bank for making that purchase.

Similarly, business concern purchases its assets using the owner's capital or by borrowing it from outside sources. As we know assets are obtained from liabilities and capital, we can represent their relationship as

$$\text{Asset} = \text{Liabilities} + \text{Capital}$$

This equation is known as the accounting equation and it always balances, which means the Left Hand Side (LHS) and Right Hand Side (RHS) of the equation always remain equal. So, Accounting Equation is the concept that a business's assets must be equal to the sum of its liabilities and owner's capital. Now you might think why this equation remains balanced every time. This can be answered using the double-entry concept of accounting which says that in every transaction two accounts will be involved and when an account is debited, subsequently another account will be credited. Let us try to understand this with the following simple transactions:

- i. Suppose Raj has invested ₹100 in the farm, the transaction results in increasing the cash (Asset) of the farm by ₹100 and at the same time the Capital is also increased by ₹100.
- ii. Similarly, if the farm purchases furniture worth ₹1000 on credit (without paying cash) from supplier, then the farm's furniture (Assets) increases by ₹1000, at the



same time the amount it owes to the supplier (Liability) also increase by ₹1000.

Now if you assign these transactions to the accounting equation, you can see the LHS and RHS remain balanced and this happens with every transaction.

- i. 100 (Assets increased by cash) = 100 (Capital is increased)
- ii. 1000(Assets increased by furniture) = 1000 (Liability is increased)

The Accounting Equation forms the foundation of the Balance Sheet.

## 2.2.5 Balance Sheet

We have already discussed the scenario where a potential investor wants to know about the assets and liabilities of Raj's farm. Only then one would be able to assess the solvency of a business i.e., the ability of the business to pay back its debts on time. For that purpose, the firm need to prepare a Balance Sheet at the end of the accounting year to show the farm's true financial strength.

Balance Sheet always depicts the financial position of the business. The financial strength of a business depends on the means by which its assets are purchased, i.e., what per cent of liabilities and capital are used for purchasing assets. Imparting of information about financial strength of the company is essential for the existing and potential shareholders.

The information as to the position of the company in terms of assets, liabilities and capital is provided by the Balance Sheet. Since it reveals the financial position of the company, it is also known as **Position Statement**. The Balance Sheet is the detailed representation of the accounting equation. It gives a detailed statement of the impact of all transactions on the assets, liabilities and capital of the company at a particular point of time. The company's financial position keeps on changing and the Balance Sheet reveals the financial position of the company with respect to the time of its preparation. So, it is a static statement as well.

Transactions of any business can be associated to three basic types of accounts, namely nominal account, real account, and personal account. The Real and Personal Accounts in the Trial Balance, after the preparation of the Trading and Profit and Loss Account, will be grouped as assets and liabilities in the Balance Sheet. One needs to be familiar with the way in which assets and liabilities are classified for preparation and understanding of the Balance Sheet. Let us examine the classification of assets and liabilities.

### 2.2.5.1 Items to be entered in the Balance Sheet

#### A. Assets

We have discussed in detail the assets with illustration of Raj's farm in the beginning of this chapter. Now we will classify the Assets in a way to be written in a Balance Sheet:

## ◆ Fixed Assets

The farm acquires certain resources like land, building, machinery, furniture etc. to assist it in its operations and to be used for a long time. The farm does not intend to sell these items any time soon. These resources owned by the farm are called fixed assets of the farm. Fixed assets are acquired by the business for long term use and it is not meant for immediate resale. Some of the common fixed assets associated with any business are Land, Building, Furniture, Plant, Machinery, etc.

## ◆ Current Assets

The farm will have certain resources available that can be easily converted to cash within one year. These resources are called current assets of the farm. Current assets are assets that are in the form of cash or that can be easily converted to cash within short period. Current Assets include:

- a. Cash in hand – Cash available with the farm at a particular date. This cash might be obtained from various sources, such as Raj's capital, loan taken from bank, income from sale of chicken eggs etc. Cash in hand is the total amount of accessible cash available with the business at their disposal.
- b. Cash at bank – It is the amount of money held at the bank by the farm in the form of current account (cash can be withdrawn anytime) or other deposit accounts (gets interest for the deposited cash and cash can be withdrawn easily). The farm will be able to withdraw this money use it for their requirements as and when required. So, cash at bank is the amount of money kept at the bank by a business which is available at their disposal.
- c. Bills receivable – One hotel has purchased large quantities of chicken and eggs from the farm without making immediate cash payments. The farm needs some kind proof for this transaction. Raj for the safety of the farm, prepares a bill stating the amount and the time by which the hotel should pay back the specified cash to the farm. This bill should be accepted by the hotel for the purchase to take place. This bill is known as bills receivable. Normally, the payment period stated in the bills receivable is less than a year thereby making it a current asset. So, bills receivable is a legal agreement stating that a customer agrees to make a full payment of what they owe to a company at a future date.
- d. Sundry debtors – Some individuals residing near the farm used to purchase eggs and meat from the farm on credit. They used to pay the money to the farm usually during the first week of every month when they get their salaries. The farm does not raise the bills receivable on their account as the amount to be paid back is less and because of the faith the farm has over them. But the farm keeps a record of these individuals and the amount they owe to the farm. The farm groups all these individuals under the common heading as Sundry debtors. Sundry debtors in general are persons who receive goods from a business on credit and are liable to pay back the amount in the immediate future.
- e. Short term investments – From the profit the farm generates, Raj decided to



make some investments in treasury bills issued by the government. For the money invested the government will provide Treasury bill as proof to Raj. The Treasury bill also specifies the interest rate, the government agrees to pay to Raj's farm for the invested money. Usually, the maturity period of Treasury bills is less than a year, which means Raj will get back the originally invested amount within this period. This Treasury bill is a form of short-term investment. Short term investments in general are temporary investments that can be converted to cash within one year period.

- f. Closing Stock – Raj's farm might be having some newly purchased chickens, some half grown chickens, some fully grown chickens, eggs, etc. that are unsold at the end of the accounting period. The value of these semi-finished and finished products available with the farm at the end of the accounting period is called closing stock of the farm.
- g. Prepaid Expense – Prepaid expenses mean paying in advance for things you will need later. For Raj's farm, they may pay in advance for things like chicken feed or medicine. The farm should record these payments as current assets on their books and slowly use them up over time. It helps the farm plan and make sure they have what they need.
- h. Outstanding or Accrued Income – When the farm receives revenue from renting out its outhouse, but the tenant requests extra time to make payment, this is known as outstanding or accumulated income. Rent that was meant to be paid this month is now paid the next month. The farm has earned the money, but it still has not been received.

#### ◆ Intangible Assets

Raj's farm has earned a great reputation in the community. People trust the farm because it always delivers products on time and replaces any faulty eggs. This positive word-of-mouth has attracted more customers, increasing the farm's profits. This trust and reputation are called goodwill, which is an intangible asset. Intangible assets, like goodwill, do not have physical form but bring long-term value to a business.

## B. Liabilities

We have discussed in detail about liabilities with illustration of Raj's farm in the beginning of this chapter. Now we will classify the Liabilities in a way to be written in a Balance Sheet:

#### ◆ Fixed Liabilities or Long-Term Liabilities

Suppose Raj's farm took a bank loan to buy incubators for hatching eggs. This loan is a liability for the farm, which they do not have to repay it right away. It has a maturity period of up to 10 years. Such debts that need to be repaid after one year or more are called long-term liabilities. Examples include long-term loans, debentures, and public deposits.

## ◆ Current Liabilities

The farm will have certain other obligations like making payment to suppliers of chicks in cases where the chicks were purchased on credit. The farm is liable to settle these obligations as soon as possible. These debts can be called as current liabilities of the farm. Current liabilities in general are debts to be repaid by the business within one year. Current Liabilities include:

### a. Bank Overdraft

When Raj's farm needed more money for a purchase, their bank account balance was zero. Thankfully, SBI, the bank they have a good relationship with, allowed them to continue using the account even with no money. This extra amount drawn from the bank with permission is called a bank overdraft. The farm has to pay back this amount to the bank soon, making it a current liability. Overdraft lets businesses withdraw money even with a zero balance.

### b. Bills Payable

The farm bought feeding material on credit from the supplier. To guarantee the transaction, the supplier prepares a bill stating the amount and when the farm should make the payment. This bill, which makes the farm responsible for paying the supplier, is called bills payable. Usually, the repayment period mentioned in the bill is less than a year, making it a current liability. Bills payable is a legal agreement for the farm to pay the owed amount in the future.

### c. Sundry Creditors

Raj had purchased a new variant of feeding material from a supplier who is his friend. The purchase was made on credit. Raj promised to pay the amount back after a few months and since the supplier was Raj's friend no bill drawn as guarantee. For the farm this is a liability that needs to be settled immediately. The farm keeps a record of this obligation and the amount they owe to the supplier. Similar kind of liabilities of the farm will be grouped together and placed under the common heading as Sundry Creditors. Sundry Creditors can be defined as persons to whom a company owes money when goods or services are purchased on credit.

### d. Outstanding Expenses

The workers at Raj's farm, who are from other states, asked to receive their wages in bulk to save for their visits to home. As a result, their wages are not paid monthly though it is due every month. These unpaid wages are called outstanding expenses. They are expenses that are due but not yet paid and are considered current liabilities. Common outstanding expenses include unpaid salary, wages, and rent.

## C. Capital/Owner's Equity

Balance Sheet is a detailed depiction of the Accounting Equation, so apart from Assets and Liabilities Balance Sheet also contains information about Owner's Equity



or Capital. We have discussed the term Capital with an illustration of Raj's farm in the beginning of this chapter.

## 2.2.6 Preparation of Balance Sheet

Now with the concepts you have learned so far in this chapter, we look at the general steps to be followed in the preparation of Balance Sheet.

- ◇ Real Accounts and Personal accounts which are not entered in the Trading and Profit and Loss Account are entered in the Balance Sheet.
- ◇ Balance Sheet is not an account but it is a statement and as a result it does not have debit side and credit side.
- ◇ Balance Sheet has two sides: Asset side and Liability side.
- ◇ Assets are written on the right side of the Balance Sheet and Liabilities and Capital are written on the left side of the Balance Sheet.
- ◇ Balance Sheet is a detailed depiction of the Accounting Equation. So, as per the accounting equation, the Asset side and Liability side of the Balance Sheet must be equal.
- ◇ Assets and Liabilities are arranged in the Balance Sheet according to the principle of Grouping and Marshalling.

### 2.2.6.1 Grouping or Marshalling of Assets and Liabilities

According to the Companies Act 2013, Balance Sheets must be prepared in a standard format using the method of grouping or marshalling. In Raj's farm's Balance Sheet, individuals who owe money for purchases are presented together under "Sundry Debtors" instead of listing them individually which is an example of grouping. Marshalling is the arrangement of assets and liabilities in a specific order. For the farm, current assets are listed first, followed by fixed assets and intangible assets. On the liability side, current liabilities come first, followed by fixed liabilities and capital. This order is known as the order of liquidity, reflecting the farm's ability to convert assets to cash and settle debts promptly. Sole proprietorships and partnerships commonly follow this practice in Balance Sheet preparation. Assets and liabilities can be marshalled in order of permanence also. Order of permanence arranges assets and liabilities based on their permanency within the business. Intangible assets are listed first, followed by fixed assets and current assets. On the liability side, owner's capital comes first, followed by long term liabilities and current liabilities. Corporate businesses typically follow the order of permanence in their Balance Sheets.

The Final Accounts, we are dealing here are that of Sole Proprietors, so we will be preparing the Balance Sheet according to the order of liquidity. As we have learned in detail about the preparation of Balance Sheet, we will look into the general format of Balance Sheet as per the order of liquidity and order of permanence separately.

Table 2.2.1 Balance Sheet in the order of liquidity

Liabilities	Amount	Asset	Amount
Bank Overdraft	Xxx	Cash In Hand	xxx
Sundry Creditors	xxx	Cash At Bank	xxx
Bills Payable	xxx	Short term investments	xxx
Outstanding Expenses	xxx	Bills Receivable	xxx
Loans	xxx	Sundry Debtors	xxx
Capital: xxx		Closing Stock	xxx
Add: Net profit xxx		Prepaid Expenses	xxx
Add: Interest on Capital <u>xxx</u>		Furniture	xxx
	xxx	Machinery	xxx
Less: Drawings <u>xxx</u>		Land and building	xxx
	xxx	Goodwill	xxx
	Xxxx		Xxxx

Table 2.2.2 Balance Sheet in the order of permanence.

Liabilities	Amount	Asset	Amount
Capital : xxx		Goodwill	xxx
Add: Net profit xxx		Land And Building	xxx
Add: Interest on Capital xxx	xxx	Plant And Machinery	xxx
	xxx	Furniture And Fittings	xxx
Less: drawings <u>xxx</u>		Prepaid Expenses	xxx
	xxx	Closing Stock	xxx
Loans	xxx	Bills Receivable	xxx
Bills Payable	xxx	Sundry Debtors	xxx
Outstanding Expenses	xxx	Short term investments	xxx
Sundry Creditors	xxx	Cash At Bank	xxx
Bank Overdraft	xxx	Cash In Hand	xxxx
	xxxx		xxxx

Since the concept behind the preparation of Final Accounts is discussed, we can solve a simple problem involving the preparation of Final Accounts.



### Illustration 2.2.1

From the following information on Raj's Farm, prepare Trading and Profit and Loss account for the year ended 31 December 2020 and a Balance Sheet as on that date.

Particulars	Amount (₹)	Particulars	Amount (₹)
Sales	25000	Factory Expenses	200
Purchase	4000	Repairs	190
Capital	6200	Stock (01-01-2020)	1600
Salary	750	Rent	250
Machinery	15000	Drawings	1700
Furniture	3600	Advertisement	300
Sundry creditors	4600	Carriage inwards	300
Wages	100	Cash at bank	2600
Sundry Debtors	8560	Bills Payable	3350

The closing stock was ₹250.

### Solution

#### Trading and Profit and Loss Account for the year ended 31 December 2020

Particulars	Amount	Particulars	Amount
Opening stock	1600	Sales	25000
Purchases	4000	Closing stock	250
Direct expenses			
Carriage inwards	300		
Wages	100		
Factory expenses	200		
To gross profit c/d	19050		
Total	25250	Total	25250
Salary	750	By gross profit b/d	19050
Repairs	190		
Rent	250		

Advertisement	300		
Net profit transferred to capital account	17560		
Total	19050	Total	19050

### Balance Sheet as on 31 December 2022

Liabilities	Amount	Asset	Amount
Bills Payable	3350	Cash at bank	2600
Sundry Creditors	4600	Closing Stock	250
		Sundry debtors	8560
Capital	6200	Furniture	3600
Add: Net profit	17560	Machinery	15000
	23760		
Less: Drawings	1700		
	22060		
	30010		30010

### Illustration 2.2.2

From the following Trial Balance, prepare Trading and Profit and Loss Account for the year ended 31 December 2020.

Trial Balance as on 31 December 2020

Particulars	Debit Balance	Credit Balance
Capital		1500000
Drawings	130000	
Machinery	300000	
Land and building	1100000	
Furniture	120000	
Sundry debtors	200000	
Sundry creditors		220000



Bills receivable and payable	220000	60000
Bank overdraft		520000
Closing stock	400000	
Investment	80000	
Cash in Hand	50000	
Net profit		300000
	2600000	2600000

## Solution

### Balance Sheet as on 31 December 2020

Liabilities	Amount	Asset	Amount
Bank overdraft	520000	Cash in Hand	50000
Bills payable	60000	Bills receivable	220000
Sundry creditors	220000	Investment	80000
Capital 1500000		Sundry debtors	200000
Add: Net profit 300000		Closing stock	400000
Less: Drawings (130000)		Furniture	120000
	1670000	Machinery	300000
		Land and building	1100000
	2470000		2470000

## Recap

- ◇ Assets are resources of a company expressed in monetary terms.
- ◇ Liabilities are obligations that have to be paid in future.
- ◇ Capital is the amount invested by the owner.
- ◇ Drawings are withdrawals from the business by the owner for personal use.
- ◇ Accounting Equation is:  $\text{Assets} = \text{Liabilities} + \text{Capital}$
- ◇ Balance Sheet gives a list of assets, liabilities and capital.
- ◇ Current assets are cash or that can be easily converted to cash within one year.
- ◇ Fixed assets are for long term use and not for immediate resale.
- ◇ Intangible Assets don't have any physical presence but they add value to firms.
- ◇ Current Liabilities are debts to be repaid within one year.
- ◇ Long term Liabilities are debts to be repaid after one year or more.
- ◇ Grouping is putting items of similar nature under common heading in the Balance Sheet.
- ◇ Marshalling is the order in which assets and liabilities are written in the Balance Sheet.

## Objective Questions

1. What are resources of value possessed by a business?
2. What are withdrawals made by the owner from the business for personal needs?
3. What are the two sources for financing the Assets?
4. How can Capital be obtained when Assets and Liabilities are given?
5. What is the detailed depiction of accounting equation?
6. What kind of liability is Bank Overdraft?



7. What kind of asset is Goodwill?
8. How are individuals who owe money to the firm represented in the Balance Sheet?
9. What comes last in the Asset side and Liability side of the Balance Sheet in the order of liquidity?
10. How are assets and liabilities marshalled in sole proprietorship business?

### Answers

1. Assets
2. Drawings
3. Liabilities and Capital
4.  $\text{Capital} = \text{Assets} - \text{Liabilities}$
5. Balance Sheet
6. Current Liability
7. Intangible asset
8. Sundry Debtors
9. Intangible Assets on asset side, Capital on liability side
10. Order of Liquidity.

## Self-Assessment Questions

1. Explain assets and liabilities with suitable examples.
2. Write a short note on the Balance Sheet with illustration.
3. Explain the process of preparation of the Balance Sheet with illustration.

## Assignments

1. The basic concepts of Balance Sheet including its foundation, constituents, importance and preparation are all familiar to you by now. Try to collect the Trial Balance details of a business and prepare a Trading and Profit and Loss Account and Balance Sheet to determine the financial position of the business.
2. Make a Balance Sheet for Mr. Dev as of March 31, 2021, using the information below.

- ◇ Capital ₹550000
- ◇ Personal Drawings ₹10000
- ◇ Accounts Receivable ₹100000
- ◇ Accounts Payable ₹80000
- ◇ Long term Loan ₹20000
- ◇ Profit and Loss Account ₹160000
- ◇ Closing Stock ₹50000
- ◇ Production Plant ₹150000
- ◇ Office Building ₹120000
- ◇ Land ₹300000
- ◇ Goodwill ₹50000
- ◇ Furniture and Fixtures ₹30000

(Hint: Balance Sheet Total – 800000)



3. Using the information below, create Mr. Nivedh's Balance Sheet as of March 31, 2021.

- ◇ Capital ₹44000
- ◇ Investment ₹20000
- ◇ Drawings ₹8400
- ◇ Debtors ₹6400
- ◇ Creditors ₹4200
- ◇ Loan From Niranjana ₹20000
- ◇ Cash in hand ₹360
- ◇ Cash at bank ₹7200
- ◇ Furniture ₹3700
- ◇ Plant ₹10000
- ◇ Net profit ₹1660
- ◇ General reserve ₹1000
- ◇ Closing stock ₹14800

(Hint: Total of Balance Sheet ₹62460)

4. You know that a Balance Sheet is also known as a Position Statement because it gives the financial position of a firm in terms of Assets, Liabilities and Capital at a particular period of time. Now try to think about the possible reasons for the Statement of Assets, Liabilities and Capital being called a Balance Sheet. Simply put, where does the Balance Sheet get its name from.

**Hint:** The name has got something to do with the remaining accounts after preparation of the Trading and Profit and Loss Account being transferred to the statement and also the statement being a detailed description of Accounting Equation.

### Suggested Reading

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# Unit 3

## Final Accounts with Adjustments

### Learning Outcomes

Upon the completion of this Unit, the learner will be able to:

- ◇ prepare Final Accounts
- ◇ explain the adjustments in the preparation of final account
- ◇ be acquainted with the accounting treatment of various adjustments

### Prerequisite

Raj's Balance Sheet may not be accurate because he solely relied on the Trial Balance information for preparing the Final Accounts. The Trial Balance only included transactions recorded in the books until its preparation date, excluding pending transactions. For instance, Raj had to pay a total salary of ₹50000, but only ₹40000 was actually paid and recorded in the Trial Balance. The outstanding salary of ₹10000 remained unrecorded. Similarly, Chicken Feed Ltd. owed Raj's farm a commission of ₹10000 for increasing their sales. Since the commission had not been received by the Trial Balance date, it was omitted from the Trial Balance. These adjustments, representing pending transactions, must be considered to accurately determine the farm's true profit and financial position. This chapter will cover various adjustments and how they should be entered in the final accounts.

### Keywords

Closing Stock, Outstanding Expense, Prepaid Expense, Accrued Income, Income received in advance, Depreciation, Bad Debt, Provision for doubtful debt, Interest on Capital, Interest on Drawings, General Reserve.



- a. Outstanding expenses being added to the concerned expenses on the debit side of Trading Account or Profit and Loss Account depending on the nature of expense (Direct or Indirect).
- b. Outstanding expense is a personal account representing the person to whom the expense has to be paid. So, it is shown as a current liability in Balance Sheet.

### 2.3.3 Prepaid Expenses

Prepaid Expense is paid in the current accounting year but its benefit will be accrued only in the subsequent years. So, at the time of preparation of Trial Balance, prepaid expense will not be recognised as an actual expense. But according to GAAP, the expenses must be recorded as they are incurred, so prepaid expenses need to be recognised as actual expense for balancing the book of accounts and for that they are introduced as adjusting entry in the transactions of a business. The corresponding adjustment entry is:

Prepaid Expenses A/c	Dr
To Expenses A/c	

Effect of this entry is

- a. Prepaid expenses being deducted from the concerned expenses on the debit side of the Trading or Profit and Loss Account depending on the nature of expense (Direct or Indirect).
- b. Prepaid expense should be shown as current asset in the Balance Sheet.

### 2.3.4 Outstanding or Accrued Income

Outstanding or Accrued Income represents the income earned by the business but not yet received. It is not recorded in the Trial Balance as this income is not received at the time of its preparation. But according to GAAP the revenue of a business should be recognised when they are earned and not when they are received. So, in order to balance the book of accounts of business the outstanding or accrued income should be recognised as actual revenue. It is done by introducing the outstanding or accrued income as an adjusting entry. Its treatment is similar to that of prepaid expenses. The adjustment entry is:

Accrued income A/c	Dr
To income A/c	

This entry will result in:

- a. Addition of Accrued Income to the corresponding income received on the credit side of Trading or Profit and Loss Account depending upon the nature of income (Direct or Indirect)





Interest on capital A/c      Dr

To Capital A/c

When such an interest on capital is recorded in the Profit and Loss Account the adjustment entry is;

Profit and Loss Account      Dr

To Interest on capital A/c

Effect of the entry:

- a. This interest is considered an indirect expense and is written on the debit side of the Profit and Loss Account.
- b. This interest is added to the capital as it is an income for the owner and written on the liability side of Balance Sheet.

### 2.3.10 Interest on Drawings

Drawings are cash or assets withdrawn from the business by the owner for personal use. In continuation with the above illustration on the interest on capital, we can say the farm is treating the capital amount as loan it had acquired and Raj is considering the capital amount as an investment he had made. So, when Raj withdraws some amount of money for his personal use from the farm's capital, it is similar to the case where the farm is lending some money to Raj out of the capital the farm had acquired. So, for this amount lent to the farm an interest will be charged from Raj. This interest paid by Raj to the farm against the drawings made by him is called Interest on drawings. This amount is an indirect income for the farm. And similar to the drawings, this interest on drawings will also be deducted from the owner's capital. The adjustment entry is:

Drawings A/c      Dr

To Interest on drawings A/c

For transferring interest on drawings to Profit and Loss Account the adjusting entry is:

Interest on drawings A/c      Dr

To Profit and Loss A/c

Effect of the entry:

- a. This interest is considered an indirect income and is written on the credit side of the Profit and Loss Account.
- b. This interest is deducted from the capital and written on the liability side of Balance Sheet.

### 2.3.11 Transfer to General Reserve

Raj has a big dream about the future growth and development of the farm. Raj, even during the inception of his poultry business, wanted to expand it to cattle rearing as



well. And he knows for making this dream a reality he needs an increased capital. For that Raj had made a decision regarding the utilisation of the net profit of the farm. He decided that all the net profit obtained from the farm's operations will not be added to his capital rather a portion of it will be transferred to the farm's reserve. This transferred amount after accumulation can be utilised for expanding the operations of the farm. This amount transferred to the reserve out of the net profit of a business is called Transfer to general reserve. It is shown on the debit side of Profit and Loss Account and also on the liability side of the Balance Sheet as it is taken out of the net profit which belongs to the owner.

### 2.3.12 Important steps for the preparation of Final Accounts

Now that you have learned about all the concepts related to preparation of the final accounts of a business. Let us try to do a recollection of all the steps right from the beginning of the first chapter to the final chapter which helps you in preparing the final accounts.

- ◇ Prepare the Trial Balance from the ledger accounts
- ◇ All items appearing in the Trail Balance are entered only once (either in Trading Account, Profit and Loss Account or in Balance Sheet)
- ◇ Items, which appear outside the Trial Balance, are adjustments and need to be entered at two places. (Either in Trading Account, Profit and Loss Account or in Balance Sheet)
- ◇ The items shown on the credit side of Trial Balance are either shown on the credit side of Trading or Profit and Loss Account or on the Liability side of the Balance Sheet.
- ◇ The items shown on the debit side of Trial Balance are either shown on the debit side of Trading or Profit and Loss Account or on the Asset side of the Balance Sheet.
- ◇ Trading account contains Purchases, Purchase returns, Sales and Sales returns. It also contains all direct expenses related to purchase or manufacture of goods is on the debit side.
- ◇ All indirect expenses and indirect income are shown respectively on the debit side and credit side of the Profit and Loss Account.
- ◇ If expenses such as rent, lighting are specifically given as incurred with respect to factory, then they are considered direct expenses and entered on the debit side of Trading Account. If it is not specified and simply given as rent, lighting then it will be considered indirect expenses and will be allotted to the debit side of Profit and Loss Account.
- ◇ The remaining Real and Personal Accounts in the Trial Balance after preparation of Trading or Profit and Loss Accounts are shown in the Balance Sheet.

- ◇ Remember to include the information in the adjustments in the financial statements.
- ◇ The Asset side and Liability side of the Balance Sheet must be equal for the Final Accounts to be correct.

### Illustration 2.3.1

From the following information on a company, prepare Trading and Profit and Loss Account for the year ended 31 December 2020 and a Balance Sheet as on that date.

Particulars	Amount	Particulars	Amount
Sales	25000	Factory Expenses	200
Purchase	4000	Repairs	190
Capital	6200	Stock (01-01-2020)	1600
Salary	750	Rent	250
Machinery	15000	Drawings	1700
Furniture	3600	Advertisement	300
Sundry creditors	4600	Carriage inwards	300
Wages	100	Cash at bank	2600
Sundry Debtors	8560	Bills Payable	3350

The closing stock was ₹250. Depreciate Machinery and Furniture by 5%.

### Solution

#### Trading and Profit and Loss Account as on 31 December 2020

Particulars	Amount (₹)	Particulars	Amount(₹)
Opening stock	1600	Sales	25000
Purchases	4000	Closing stock	250
Direct expenses			
Carriage inwards	300		
Wages	100		
Factory expenses	200		



To Gross profit c/d	19050		
	25,250		25,250
		By Gross profit b/d	19050
Salary	750		
Repairs	190		
Rent	250		
Advertisement	300		
Depreciation of machinery	750		
Depreciation on furniture	180		
Net profit transferred to capital account	16630		
	19050		19050

### Balance Sheet as on 31 December 2020

Liabilities	Amount	Asset	Amount
Bills Payable	3350	Cash at bank	2600
Sundry Creditors	4600	Closing Stock	250
		Sundry debtors	8560
Capital	6200	Furniture	3600
Add: Net profit	16630	Less: Depreciation	180
	22830		3420
Less: Drawings	1700	Machinery	15000
	21130	Less: Depreciation	750
			14250
	29080		29080

#### Working Notes

- ◇ Closing stock given in the adjustment is shown on the credit side of trading account and asset side of Balance Sheet.
- ◇ Depreciation given in the adjustment is taken as indirect expense and is debited to Profit and Loss Account and is deducted from the respective assets on the asset side of the Balance Sheet.

Calculation of depreciation

Depreciation is 5% of Machinery =  $15000 \times 5/100 = 750$   
 Depreciation is 5% of Furniture =  $3600 \times 5/100 = 180$

### Illustration 2.3.2

From the following Trial Balance, prepare Trading and Profit and Loss Account for the year ended 30 June 2020 and a Balance Sheet as on that date.

Particulars	Dr.	Cr.
Capital		12000
Purchases	22000	
Wages	3000	
Sales		32000
Factory Expenses	1000	
Commission received		4800
Salaries	1000	
Carriage outwards	500	
Rent received		1500
Cash in hand	1000	
Cash at bank	1500	
Repairs	500	
Building	18000	
Return inwards	500	
Return outwards		1100
Debtors	4500	
Creditors		4000
Bills receivable	600	
Bills Payable		800
Telephone Charges	100	
Stock as on 1/7/2019	2000	
Total	56200	56200

#### Adjustments

1. Commission accrued but not received amount ₹800



2. Rent received in advance ₹300
3. Wages outstanding ₹400
4. Salary Prepaid ₹200
5. Closing Stock ₹4200

## Solution

### Trading and Profit and Loss Account for the year ended 30 June 2020

Particulars	Amount	Particulars	Amount
Opening stock	2000	Sales	32000
Purchases	22000	Less: Return	500
Less: Return Outwards	1100	Closing stock	4200
Direct expenses			
Wages	3000		
Add: Wages outstanding	400		
Factory expenses	1000		
To Gross profit c/d	8400		
	35700		35700
Salary	1000	By Gross profit b/d	8400
Less: Prepaid	200	Commission received	4800
Carriage outwards	500	Add: Accrued	800
Repairs	500	Rent received	1500
Telephone charges	100	Less: Advance	300
Net profit transferred	13300		
Total	15200	Total	15200

### Balance Sheet as on 30 June 2020

Liabilities	Amount	Assets	Amount
Outstanding wages	400	Cash in hand	1000
Income received in advance	300	Cash at bank	1500
Sundry Creditors	4000	Closing stock	4200
Bills Payable	800	Prepaid Salary	200
Capital	12000	Accrued Income	800

Add: Net Profit	13300	25300	Sundry Debtors	4500
			Bills Receivable	600
			Building	18000
Total		30800	Total	30800

### Working Notes

- ◇ Closing stock given in the adjustment is shown on the credit side of Trading account and asset side of Balance Sheet.
- ◇ Accrued income is added to the respective income (Commission received) on the credit side of Profit and Loss Account and it is entered as current asset in asset side of Balance Sheet.
- ◇ Income received in advance is deducted from the respective income (Rent received) on the credit side of Profit and Loss Account and it is entered as current liability in the liability side of the Balance Sheet.
- ◇ Outstanding expense is added to the respective expense (Wages) on the debit side of Trading Account and it is entered as current liability in the liability side of the Balance Sheet.
- ◇ Prepaid expense is deducted from the respective expense (Salary) on the debit side of the Profit and Loss Account and it is entered as current asset in asset side of Balance Sheet.

### Illustration 2.3.3

From the following Trial Balance, prepare Trading and Profit and Loss account for the year ended on 31 December 2019 and a Balance Sheet as on that date.

#### Trial Balance

Particulars	Dr.	Cr.
Capital		93000
Sales		282000
Purchases	170000	
Goodwill	15000	
Cash in hand	4000	
Opening stock	40000	



Investment	10000	
Machinery	30000	
Bad debt	6000	
Salaries	32000	
Factory expenses	17000	
Sundry debtors	90000	
Sundry Creditors		50000
Advertisement	6000	
Drawings	5000	
Total	425000	425000

Adjustments:

1. Closing Stock is valued at ₹ 47000.
2. Bad debts written off ₹1000.
3. Provide 5% of debtors for doubtful debts.
4. Provide interest on capital at 10%.
5. Charge interest on drawings at 5%.
6. Transfer 10% of net profit to reserve.

### Solution

#### Trading and Profit and Loss Account for the year ended 31 December 2019

Particulars	Amount	Particulars	Amount
Opening stock	40000	Sales	282000
Purchases	170000	Closing Stock	47000
Direct Expenses			
Factory Expenses	17000		
To Gross profit c/d	102000		
	329000		329000
Salaries	32000	By Gross profit b/d	102000
Advertisement	6000	Interest on drawings	250

Bad debt	6000		
Add: Bad debt written of	1000		
Add: 5% Provision	<u>4450</u>	11450	
Interest on capital		9300	
Transferred to reserve (10% of profit)		4350	
Net Profit transferred to capital Account		39150	
Total		102250	Total 102250

### Balance Sheet as on 31 December 2019

Liabilities	Amount	Assets	Amount
Sundry Creditors	50000	Cash in hand	4000
Capital	93000	Closing Stock	47000
Add: Interest	9300	Sundry Debtors	90000
Add: Net Profit	<u>39150</u>	Less: Bad debt W.O	1000
	141450	Less: 5% Provision	<u>4450</u>
Less: Drawings	<u>5000</u>	Machinery	30000
	136450	Investment	10000
Less: Interest	<u>250</u>	Goodwill	15000
Reserve	4350		
Total	190550	Total	190550

#### Working Notes

- ◇ Closing stock given in the adjustment is shown on the credit side of trading account and asset side of the Balance Sheet.
- ◇ Bad debt is given in Trial Balance as ₹6000, and additional bad debt is given in adjustment as ₹1000. This additional bad debt (₹1000) will be added to the initial bad debt (₹6000) and entered on the debit side of Profit and Loss Account. Later this additional bad debt (₹1000) will be deducted from the sundry debtors on the asset side of Balance Sheet
- ◇ Provision for doubtful debt is given as 5% of sundry debtors (sunday debter is 9000 bad debt written off)=  $90000 \times (5/100) = 4450$ . These ₹ 4450 will be added to the initial bad debt (₹6000) and entered on the debit side of Profit and Loss Account. Later this provision for doubtful debt (₹4450) will be deducted from the sundry debtors on the asset side of Balance Sheet.



- ◇ 10% interest on capital =  $93000 \times (10/100) = 9300$ . These ₹9300 is considered indirect expense and is entered on the debit side of Profit and Loss Account. Later this ₹9300 will be added to the capital on the liability side of the Balance Sheet.
- ◇ 5% interest on drawings =  $5000 \times (5/100) = 250$ . This ₹250 is considered gain and is entered on the credit side of the Profit and Loss Account. Later this ₹250 is deducted from capital on the liability side of the Balance Sheet.
- ◇ 10% of net profit =  $43500 \times (10/100) = 4350$ . This ₹4350 (transfer to reserve) is considered an expense to the company and will be entered on the debit side of the Profit and Loss Account. Remember that the net profit will not be entered as ₹43500 but will be entered as ₹39150 which is the difference of the original net profit and transfer to reserve. ( $43500 - 4350 = 39150$ ). Later this ₹4350 which is the reserve, will be entered on the liability side of the Balance Sheet.

### Recap

- ◇ Adjustments are pending transactions that are not recorded in Trial Balance.
- ◇ Closing Stock are goods unsold at the end of accounting year.
- ◇ Outstanding Expenses are expenses due but not yet paid.
- ◇ Prepaid expenses are expenses paid in advance.
- ◇ Outstanding or Accrued Income is income earned but not yet received.
- ◇ Income received in advance is income received from next year.
- ◇ Depreciation is decrease in value of asset over time due to wear and tear.
- ◇ Bad Debt is irrecoverable portion of debt that is due from sundry debtors.
- ◇ Provision for doubtful debts deal with loss due to nonpayment of debt in future.
- ◇ Interest on Capital is interest paid by business on owner's capital.
- ◇ Interest on drawings is interest charged by business on drawings of owner.
- ◇ Transfer to general reserve is amount kept for business growth from net profit.

## Objective Questions

1. What are the pending transactions known as?
2. What are salaries due?
3. Where in financial statements will outstanding expenses be entered?
4. What is insurance premium paid in advance?
5. Where will accrued income be written in the Balance Sheet?
6. What kind of expense is depreciation?
7. Why is bad debt entered on debit side of Profit and Loss Account?
8. How can business represent true value of sundry debtors in Balance Sheet?
9. Why transfer to general reserve is a liability?

## Answers

1. Adjustments
2. Outstanding Expenses
3. Debit side of Trading or Profit and Loss Account and on liability side of Balance Sheet.
4. Prepaid Expense
5. Asset side
6. Indirect Expense
7. Bad Debt is taken as loss.
8. By providing Provision for further Baddebts and doubtful debts.
9. Transfer to general reserve is taken out of net profit which belongs to the owner.



### Self-Assessment Questions

1. Discuss the limitations of final accounts without adjustments?
2. Explain the main adjustments in the final accounts with illustration?
3. Explain Accrued Income.
4. Explain the concept of bad debts with an example.
5. What is the need for provision for doubtful debts?
6. Explain the term prepaid expense with an example.
7. How will you treat an expense paid in advance in the accounting process?
8. What is the treatment of bad debt appearing in adjustments in accounting?

### Assignments

1. Consider the following adjustments and indicate necessary entries for the same. Describe the accounting treatment for each item.
  - i. Officers' salary to be paid were ₹65000.
  - ii. Depreciate Production Plant at 10%. (Plant Value - ₹ 500000)
  - iii. Payment of Wages pending were ₹10000.
  - iv. Rent paid in advance ₹12000.
  - v. Provide for interest on capital 5% per annum. (Capital 10 Lakhs)
  - vi. Closing value of Stock ₹100000.
2. Prepare final Accounts of Richu Pvt. Ltd for the year ended 31/3/2018

Particulars	Amount	Particulars	Amount
Capital	100000	Factory Wages	50000
Creditors	12000	Bank	10000
Purchase Returns	5000	Repairs	500
Sales	164000	Opening Stock	20000
Accounts Payables	5000	Rent	4000
Production Plant	40000	Factory Expenses	8000

Debtors	24000	Office Expenses	7000
Drawing	10000	Bad Debts	2000
Purchases	10500	Carriage	1500
Sales Returns	3000	Fuel and Power	1000

Adjustments:

- ◇ Closing Stock is valued at ₹14500.
- ◇ Bad debts written off ₹5000.
- ◇ Provide 5% of debtors for Doubtful debts.
- ◇ Depreciate Production Plant by ₹4000
- ◇ Repairs due is ₹400

(Hint: Gross Loss- 5000, Net Loss – 28850, BS Total – 78550)

3. So now you know that Adjustments are pending transactions of the company, which should be considered while preparing the final accounts in order to get accurate information regarding the profit or loss situation and the financial position of the company in terms of assets, liabilities and capital. Try to think about the concept that results in the need for the recognition of these pending transactions in the final accounts of the company.

(Hint: It is one of the concepts in GAAP.)

### Suggested Reading

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**BLOCK  
03**

# **Cash Flow and Fund Flow Statements**

# Unit 1

## Fund Flow Statement

### Learning Outcomes

This unit aims at:

- ◇ introducing the concept of fund
- ◇ explaining the concept fund flow transaction
- ◇ familiarising the fund flow statement
- ◇ describing the essential requirements for the preparation of fund flow statement.
- ◇ elaborating the preparation of fund flow statement

### Prerequisite

Catamount Ltd. an imaginary car manufacturing company experienced significant growth in the past year. They expanded their production capacity, invested in new technology, and launched innovative marketing campaigns. To finance these initiatives, Catamount raised capital through issuing shares and taking long-term loans. Simultaneously, they received funds from the sale of their vehicles and generated cash through their operational activities. These inflows of funds were then utilised to acquire new machinery, upgrade their production facilities, and cover research and development costs. Catamount can gain a comprehensive understanding of how their funds were obtained and used, which will aid in strategic decision-making and ensuring a healthy financial position. A financial statement called fund flow statement gives information about the inflow and outflow of funds within a business over a given time period, usually a year. This unit will throw light into that.

### Keywords

Fund, Fund flow, Working capital, Fund flow statement.



## Discussion

When you hear the term fund what is the first impression that comes to your mind. You are most probably ready with the answer that it is cash. It may be right to a certain extent. Funds and cash are often used interchangeably. However, the scope and utility of the two vary significantly in terms of accounting.

### 3.1.1 Fund

In business, fund is considered cash in a narrow sense. Businesses such as Catamount maintain an accurate record of all their business transactions in the form of cash. This will help them to formulate sound financial plans for the future. If cash and fund are equivalent in accounting, then cash should only be used in business contexts. But businesses use both these terms. So, there is some difference between fund and cash. Let us try to understand what exactly that is.

The following are the list of some of the transactions made by Catamount.

- ◇ They have purchased a new factory and some machinery for cash. Catamount made this investment for the purpose of expanding their business.
- ◇ They have repaid some of their debts in the form of debentures with cash. Debentures, were issued by Catamount when they were in need of money. The creditors gave money to Catamount by purchasing these debentures in return for a fixed interest. Now as their financial position improved Catamount redeemed these debentures.
- ◇ Issuing shares for cash in order to raise capital. As an expansion strategy Catamount has provided opportunity for interested people to become their owners. For this they have issued shares and people who wish to be associated with Catamount as shareholders will invest in the company by purchasing these shares.

If you look at the above transactions, you can see that all of these are cash transactions, as cash is involved in every one of them. Looking at the above transactions one might be tempted to generalise that, all transactions of a business might be associated with cash. But that is not the case and you will understand it from the following transactions.

- ◇ Catamount has factories at different localities in the country and they have decided to stop their operations in certain locations due to the lack of availability of skilled labour and enhanced transportation cost. The company has some debts with creditors in the locality as well. Since they are closing their factory, they have decided to settle these debts by providing this factory to the creditors. The creditors have accepted this offer and the debts are settled.
- ◇ Catamount had purchased some machinery and furniture on credit. So, these purchases were made without paying cash.

These are all business transactions without the involvement of cash. Yet these transactions also need to be recorded in the books of account. So, if you go by the idea that cash and fund are same, then many important financial transactions tend to be neglected. This opens the scope for the term fund in business.

You can see from the above transaction that Catamount was able to settle their debts, but these debts were not paid with cash but settled with a fixed asset in the form of factory. So, fund involves cash but it is not limited to cash. Fund means all the resources of monetary value that are used by the business in the form of cash, material, machinery, etc.

In general, the definition used for working capital is ‘resources available with the company to meet its current and short-term obligations.’ So, from the above cited discussion we can conclude that the term fund in a popular sense means the working capital.

### 3.1.2 Flow of Fund

What is meant by flow of fund? It simply means the transfer of funds. Since we have already concluded that fund in business means working capital, flow of fund means transfer or change in working capital of the business. From now on the terms fund flow and change in working capital will be used interchangeably for further discussions. So, fund flow simply means increase or decrease in the working capital of business. Working capital is the difference between current assets and current liabilities. So, we can draw some important concepts regarding the flow of fund from the increase and decrease of working capital.

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

From the equation you can draw the following conclusions about working capital with respect to changes in current assets and current liabilities. These concepts are the logic behind the preparation of schedule of changes in working capital, which forms the initial phase of the fund flow statement.

#### **Working capital changes with changes in Current assets and Current liabilities**

- i. When Current Assets **increase**, Working Capital **increases**. In the Right-Hand Side (RHS) of the above equation when the term current asset increases and the term current liabilities remain constant, then naturally it will result in increase in working capital. As working capital and fund are same, increase in working capital for a company means inflow of fund to the company.
- ii. When Current Assets **decrease**, Working Capital **decreases**. In the RHS of the above equation when current asset which has a positive sign, decreases and the current liability, which has a negative sign, remains constant, then it will result in decrease of working capital. Decrease in working capital for a company means outflow of fund from the company.
- iii. When Current Liabilities **increase** Working Capital **decreases**. When current liabilities with the negative sign in the RHS of the above equation increase and



current assets with positive sign remain constant, then it will result in decrease of working capital which means outflow of fund from the company.

- iv. When Current liabilities **decrease** Working Capital **increases**. When current liabilities decrease and current assets remain constant in the RHS of the above equation, it will result in increase of working capital which means inflow of fund to the company.

### 3.1.3 Fund flow Statement

Flow of fund has a very significant impact on the operation and life of a company. Suppose you are a shareholder who wants to know the causes for the change in the values of assets and liabilities of Catamount during a particular period. This change is caused by fund flow that happened in Catamount during that period. In order to get a clear picture regarding the impact of this fund flow on assets and liabilities, you will need to classify the fund flow of Catamount as sources from which they get fund (fund inflow) and different applications of such fund (outflow of fund). This vital information regarding the sources and application of fund of a company during a particular period is provided by fund flow statement.

Fund flow statement represents the flow of fund in a systematic and detailed manner. Because of its ability to classify the fund flow as source and applications, fund flow statement is also known as 'Where Got-Where Gone Statement' or 'Statement of Changes in Financial Position'.

### 3.1.4 Preparation of Fund flow Statement

Now you have basic idea of what fund flow statement is and what it represents. Since the fund flow statement mainly represents the changes in the values of assets and liabilities during a particular period, what do you think is the information necessary to prepare a fund flow statement? For understanding the change in values of assets and liabilities during a period, you need the Balance Sheet at the beginning and at the end of the period and from this information a comparative Balance Sheet is prepared. In this comparative Balance Sheet, the change in values of assets, liabilities and capital can be observed. This comparative Balance Sheet is the vital information needed for the preparation of fund flow statement.

Now we will move onto the preparation of fund flow statement. It is a combination of two statements. They are:

- a. Schedule of changes in working capital
- b. Statement of source and application of fund

We will examine in detail the preparation of both these statements.

#### 3.1.4.1 Schedule of changes in working capital

Merely checking whether there is fund flow associated with Catamount's transaction

using the working capital equation will not be adequate to understand the changes in working capital. For that you need to record the fund flow associated with all the transactions of Catamount in a systematic manner. These recordings prepared in the form of a table with current assets and current liabilities, shows the change in the working capital over a period of time. This table is called schedule of changes in the working capital. The following are the points to be noted in the preparation of schedule of changes in the working capital.

- ◇ Always keep in mind that current assets and current liabilities are only considered for the preparation of schedule of changes in the working capital.
- ◇ We have already discussed in detail regarding current assets and current liabilities with illustrations in Block 2. But still for making it easier for you, a list of current assets and current liabilities are given below. This is provided so that you do not find any difficulty in identifying them from the comparative Balance Sheet provided in the question.

Common Current Assets are:

- a. Cash in hand
- b. Cash at bank
- c. Bills receivable
- d. Sundry debtors
- e. Stock in trade
- f. Prepaid expenses
- g. Accrued income
- h. Short term investments

Common Current liabilities are:

- a. Bank overdraft
- b. Cash credit
- c. Sundry creditors
- d. Bills payable
- e. Outstanding expenses
- f. Income received in advance
- g. Short term loan

- ◇ List down all the current assets.
- ◇ Now compare the value of current assets of the previous year with the current asset of the present year as given in comparative Balance Sheet.
- ◇ List down all the current liabilities.



- ◇ Similarly compare the values of current liabilities of the previous year with the current liabilities of the present year in the comparative Balance Sheet.
- ◇ The difference between two years is observed individually for each current assets and current liabilities.
- ◇ The difference in value of each item is to be recorded as increase or decrease in two adjacent columns.
- ◇ The increase column and decrease column are finally balanced by inserting the difference amount on the side where amount is less in order to make the total on both sides equal.
- ◇ This difference amount added for balancing the two columns represents either a net increase or net decrease in working capital.
- ◇ Apart from this you need to keep in mind the working capital equation and the effect of changes in current assets and current liabilities have on the working capital. These effects are already presented to you as four concepts in the previous section.

As we have gone through all the important steps in preparation of Schedule of Changes in Working Capital, let us now see the format of Schedule of Changes in Working Capital.

Table 3.1.1 Schedule of Changes in Working Capital

Particulars	Previous Year (₹)	Current year (₹)	Working capital changes	
			Increase (₹)	Decrease (₹)
A. Current assets				
Cash at bank	XX	XX	X	---
Cash in hand	XX	XX	X	---
Sundry debtors	XX	XX	X	---
Bills receivable	XX	XX	---	X
Closing stock	XX	XX	X	---
Outstanding income	XX	XX	---	X
Prepaid expenses	XX	XX	---	X
	XX	XX		
B. Current liabilities				
Bills payable	XX	XX	X	---
Sundry creditors	XX	XX	---	X
Bank overdraft	XX	XX	---	X
Prepaid income	XX	XX	---	X

Short term loans	XX	XX	X	---
Outstanding expenses	XX	XX	X	
	XX	XX	X	X
C. Working capital(A-B)	XX	XX		
D. Net increase or decrease in working capital	X	---	---	X
Total			XX	XX

Now to apply what you have learned we will prepare a simple schedule of changes in the working capital from the given comparative statement.

### Illustration 3.1.1

From the following Balance Sheets of Catamount for the year ending 31 March 2019 and 31 March 2020. prepare the Schedule of changes in working capital.

#### Balance Sheet

Liabilities	2019(₹)	2020(₹)	Asset	2019(₹)	2020(₹)
Capital	500000	600000	Stock	100000	150000
Creditors	200000	150000	Plant and machinery	250000	275000
Profit and Loss Account	25000	35000	Debtors	200000	175000
			Cash	175000	185000
Total	725000	785000	Total	725000	785000

### Solution

#### Schedule of Changes in Working Capital

Particulars	2019(₹)	2020(₹)	Working capital changes	
			Increase(₹)	Decrease(₹)
A. Current assets				
Stock	100000	150000	50000	
Debtors	200000	175000		25000



Cash	175000	185000	10000	
	475000	510000		
B. Current liabilities				
Creditors	200000	150000	50000	
	200000	150000		
C. Working capital(A-B)	275000	360000	110000	25000
D.Net increase in working capital	85000			85000
Total	360000	360000	110000	110000

### 3.1.5 Statement of Sources and Application of Fund

Now from the statement of schedule of changes in working capital, you have obtained the changes in working capital of Catamount for a particular period. From the above illustration you can see that there is an increase in working capital, which means there is inflow of fund to Catamount. But will you be satisfied with this information? You as a shareholder need to know in detail about the various sources from which Catamount had obtained the funds and how these funds were employed. This information is not available in the schedule of changes in the working capital.

This important information as to the source and application of fund is provided by the Statement of Source and Application of Fund which is also known as the Fund Flow Statement. Now before going to the steps involved in the preparation of fund flow statement, we need to understand the transactions of the company that come under sources of fund and the transactions that come under applications of fund. In the following discussion an explanation of the components of sources and applications of funds are given.

#### 3.1.5.1 Sources of Fund

All those activities that result in the inflow of fund to the company are considered sources of fund. All the sources of fund associated with a company are listed below and each of them will be explained in terms of Catamount's operations.

##### a. Fund from operations

Catamount earns income from selling cars, which is known as Operating income. However, they also earn additional income from non-operating sources, such as interest earned on investments. This is called non-operating income. The total income of Catamount is the sum of Operating income and non-operating income.

On the expense side, Catamount incurs both Operating expenses related to car manufacturing and Non-operating expenses, like depreciation of machinery. The total expenses consist of Operating expenses and Non-operating expenses. Net profit is calculated by subtracting total expenses from total income.

To determine the Fund from Operations (FFO), we need to connect net profit to gross profit.

Fund from operations (FFO) = Operating income – Operating expense

Net Profit = Total income – Total expense

Total Income = Operating income + Non-operating income ----- (1)

Total expenses = Operating expenses + Non-operating expenses -----(2)

By combining the equation 1 and 2 we can derive at equation 3

Net profit = (Operating income – Operating expense) +

Non-operating income – Non-operating expense ----- (3)

In the above equation the portion in the parenthesis can be replaced with Fund from Operations and can be rearranged to arrive at an equation to calculate fund from operations as below;

***Fund from Operations = Net Profit + Non-operating Expenses – Non-operating income***

This is the equation which helps us to calculate fund from operations from the comparative Balance Sheet. Fund from Operations need to be separately calculated as it contains many elements. Given below is a format of statement showing the preparation of Fund from Operations.

Table 3.1.2 Statement showing calculation of fund from operation

Particulars	₹	₹
Profit and Loss Account closing balance	xx	
Less: Profit and Loss Account opening balance	(xx)	
Net profit for current year as per Profit & Loss Account		xx
Add. i Depreciation and provision for depreciation	xx	
ii. Amortisation of fictitious assets and intangible assets	xx	
iii. Transfer to reserve	xx	
iv. Loss on sale of fixed assets	xx	
v. Any other non-cash expenditure	xx	xx
		xx
Less: i. Profit on sale of fixed assets	(xx)	
ii. Interest received, commission received, dividend received	(xx)	
iii. Appreciation in the value of fixed assets	(xx)	
iv. Refund of income tax	(xx)	xx
v. Fund from operations		xx



## Elements of the fund from operation.

### i. Net profit

We know that net profit is the actual profit earned by Catamount. Now in the comparative Balance Sheet the value of net profit as such would not be given. But net profit can be found by taking the difference between closing balance and opening balance of the Profit and Loss Account given in the comparative Balance Sheet.

List of Non-operating expenses of Catamount that needs to be added to net profit.

#### a. Depreciation and provision for depreciation

Depreciation is the reduction in the value of the fixed asset over time. It is a Non-operating expense that needs to be added to net profit to find Fund from Operations.

#### b. Amortisation of fictitious and intangible assets

Prior to becoming a firm, Catamount incurred expenses. These costs consist of professional compensation and registration fees. Since the account of these expenses have debit balance, businesses must show this in the asset side of their Balance Sheet. They are regarded as fictitious assets because preliminary costs are actual financial outlays rather than genuine assets. They are eventually written off over a certain time period decided by the company. Catamount also has important intangible assets like goodwill and patents. The process of gradually deducting the initial cost of such items is called amortisation. For instance, if Catamount decides to write off ₹1,00,000 in preliminary expenses over the course of five years, ₹20,000 will be charged each year, and this amount will be subtracted from the Balance Sheet's total of fictitious assets. In order to determine the Fund from Operations, the amortisation expense is added as a Non-operating item to the net profit.

#### c. Transfer to reserve

Transfer to reserve with respect to Catamount simply means moving a portion of its profit to its retained earnings for the purpose of further expansion and growth of Catamount. This necessarily means that the portion of profit moved is not available to be distributed as profit to owners of Catamount. So, it is considered a Non-operating expense and is added to the net profit for calculating the Fund from Operations.

#### d. Loss on sale of fixed asset

Catamount had disposed off one of its production plants as its operation was a costly affair mainly due to the high cost of transporting raw materials. The plant needs to be disposed off quickly because Catamount was in need of money in setting up a new factory in a favourable locality. As the sale of the plant was made in a hurry, Catamount had suffered a loss from the transaction. This loss incurred by Catamount from the sale of the plant is treated as an expense, but it is not incurred directly from its operations so it is taken as a Non-operating expense. This is added to net profit for calculating the Fund from Operations.

List of Non-operating income of Catamount, that needs to be deducted from net profit.

a. Profit on sale of fixed asset

Suppose Catamount had sold some land it possessed near the highway at a very high price. From this transaction Catamount had received a considerable amount of profit. As this amount gained is not directly from the sale of cars, it will be considered a Non-operating income. So, it needs to be deducted from net profit for calculating Fund from operations.

b. Dividend, interest and commission received

Catamount had made some investments in the form of deposit in bank and in shares of another company. They will receive interest and dividend respectively as return from the above investments. Catamount being a car manufacturer made some promotions for a tyre company which has close association with them. For these promotions the tyre company had given some commission to Catamount. This interest, dividend and commission received by Catamount add up as income for them. Since, this income is received from sources other than sale of cars, it is taken as Non-operating income. So, it needs to be deducted from net profit for calculating Fund from Operations.

c. Appreciation in the value of fixed asset

When the present value of a production plant of Catamount was assessed, it is much higher than the price for which it was initially purchased. So, we can say there is an appreciation in the value of this plant over time. This increase in value is source of Non-operating income for Catamount. So, it should be deducted from net profit for calculating the Fund from Operations.

d. Refund of income tax

The owners of Catamount had paid a certain amount as income tax on the basis of the revenue they received from the company. They had contributed some amount to Prime Minister's relief fund, on account of this contribution they received some relaxation in the income tax to be paid. As a result, a portion of income tax already paid by them was refunded. This refunded tax is treated as a Non-operating income for Catamount and it needs to be reduced from net profit for calculating the Fund from Operations.

So, these are the elements that need to be added with or deducted from net profit in order to obtain fund from operations.

Now, let us learn the other sources of fund.

## ii. Issue of shares

Catamount's capital is divided into equal parts known as shares. The holders of the shares are entitled to a proportion of Catamount's profit in the form of dividend. So, when Catamount issues shares, interested individuals buy these shares by investing



money in Catamount in the form of capital. As a result, fund will flow into Catamount in the form of capital through the issue of shares.

### **iii. Issue of debentures and long-term loans**

Debentures are long term securities issued by Catamount for raising funds. The holder of the debenture will get a fixed interest from Catamount in return. Similarly, when in need of funds Catamount also takes long term loans from banks and in return, they will pay interest. So, Catamount generates fund as debt through the issue of debentures and long-term loans taken.

### **iv. Sale of fixed assets and investments**

We have discussed in the above illustrations the profit and loss scenarios experienced by Catamount as a result of the sale of the plant. But irrespective of the profit and loss scenario, we can say for sure that Catamount will receive a major amount of money just through the sale of the plant. So, we can say that fund will flow into Catamount from the sale of fixed assets and investments.

### **v. Income from long term investments**

Catamount had made some long-term investments in the form of deposit in bank and as shares in a tyre company. Catamount will receive interest and dividend respectively as returns from these investments. These returns will result in the inflow of fund into Catamount. So, these are a source of fund.

## **3.1.5.2 Applications of fund**

We have gone through the list of all the major source of fund. So, you know from where Catamount made its funds. As a shareholder you need to know how these funds were utilised by Catamount. So let us check out the main applications of fund.

### **i. Redemption of preference shares**

We have already discussed preference shares in detail in the previous chapter. Preference shares are shares issued by the company for raising capital and in return fixed dividend will be paid. As the name suggests preference shareholders will always get a preference in terms of dividend distribution over equity shareholders. Now when this preference shares are matured Catamount has decided to redeem it i.e., repay the money to the preference shareholders. Since there is outflow of fund from the company, it is an application of fund.

### **ii. Redemption of debentures and repayment of loans**

Catamount has taken loans for raising money for future expansions. These debts are in the form of debentures and long-term loans from the bank. At the time of their maturity Catamount had repaid these debts to the concerned institutions or people. Through this process the company is reducing its fixed liabilities by paying back the

money they have borrowed. Since the payment is made with company's fund, it is an application of fund.

### **iii. Payment of dividend and tax**

All payments made by the company in the form of dividend or tax will result in an outflow of fund. So, it comes under the applications of fund. But keep in mind that proposed dividend and provision for tax are not application of fund as payment is not made in the same year.

### **iv. Purchase of fixed assets and investments**

When Catamount has a requirement for purchasing some machinery and they have sufficient money available with them, they will purchase this machinery using own fund. Therefore, an outflow of fund occurs in this transaction. As a result, it is an application of fund. So, we can say purchase of fixed assets and investments made by the firm comes under application of fund.

### **v. Operating losses**

Catamount has suffered some losses from its operations i.e., from the production and sale of cars. These losses suffered by the company will result in reduction of the company's fund so it is considered an application of funds.

The following points are to be considered during the preparation of fund flow statement:

- ◇ It is to be noted that in the preparation of fund flow statement, current assets and current liabilities are not considered.
- ◇ Fund flow statement is prepared based on changes in fixed assets, fixed liabilities, and capital.
- ◇ Fund flow statement will have two sections, one representing the sources of fund and the other showing applications of fund.
- ◇ All the sources and application of fund along with their values will be listed one by one in their respective columns.
- ◇ Finally, both the columns are balanced by inserting the difference on the side where amount is less in order to make the total on both sides equal.
- ◇ This difference added for balancing the two columns represents either a net increase or net decrease of working capital. This difference will be the same as the net increase or decrease in the working capital obtained from the Statement of Schedule of Changes in the Working Capital.

This is the general procedure in which the fund flow statement is prepared. Let us examine the format of the Fund Flow Statement.



Table 3.1.3 Funds Flow Statement

Sources	₹	Applications	₹
Issue of shares	xx	Redemption of preference shares	xx
Issue of debentures	xx	Redemption of debentures	xx
Sale of fixed assets	xx	Payment of tax	xx
Long term borrowings	xx	Repayment of loans	xx
Sale of investments	xx	Purchase of fixed assets	xx
Fund from operations	xx	Payment of dividend	xx
Income from long term investment	xx	Purchase of investments	xx
Net decrease in working capital	xx	Operating loss	xx
		Net increase in working capital	xx
Total	xx	Total	xx

Through few illustrations, we can clearly understand the concept of fund flow statement and its preparation.

### Illustration 3.1.2

From the following particulars of Catamount Ltd. prepare:

- ◇ Schedule of changes in working capital.
- ◇ A statement showing source and applications of fund Next time Balance Sheet

Liabilities	2019(₹)	2020(₹)	Asset	2019(₹)	2020(₹)
Capital	500000	600000	Stock	100000	150000
Creditors	200000	150000	Plant and Machinery	250000	275000
Profit and Loss Account	25000	35000	Debtors	200000	175000
			Cash	175000	185000
Total	725000	785000	Total	725000	785000

## Solution

Schedule of Changes in Working Capital				
Particulars	2019(₹)	2020(₹)	Effect on working capital	
A. Current assets			Increase(₹)	Decrease(₹)
Stock	100000	150000	50000	
Debtors	200000	175000		25000
Cash	175000	185000	10000	
	475000	510000		
B. Current liabilities				
Creditors	200000	150000	50000	
	200000	150000		
C. Working capital(A-B)	275000	360000		
D. Net increase in working capital	85000			85000
Total	360000	360000	110000	110000

### Fund Flow Statement for the year ending 31<sup>st</sup> March 2020

Sources	Amount (₹)	Applications	Amount (₹)
Issue of shares	100000	Purchase of Plant and Machinery	25000
Fund from Operations	10000	Net increase in working capital	85000
Total	110000	Total	110000

### Working Notes

#### Share capital account

Particulars	Amount (₹)	Particulars	Amount (₹)
		By Balance b/d	500000
To Balance c/d	600000	By Cash	100000
Total	600000	Total	600000

Share Capital account is a liability account, since all liability accounts have credit balance ₹500000 is b/d to the credit side. When balancing the account, you can see cash of ₹100000 is credited from the capital account. So, it means a share of ₹100000 is issued for cash.



Corresponding Journal entry is:

Cash a/c           Dr.    100000  
                           To Capital a/c       100000

**Table 3.1.10 Plant and Machinery Account**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	250000		
To Cash (Purchase)	25000	By Balance c/d	275000
Total	275000	Total	275000

Plant and Machinery account is an asset, since all asset accounts have debit balance ₹250000 is b/d to the debit side. When balancing the account, you can see the plant and machinery account is debited with cash of ₹25000. So, it means purchase of plant and machinery is done with cash of ₹25000.

Corresponding Journal entry is:

Plant and Machinery a/c   Dr.    25000  
                                   To Cash a/c               25000

**Calculation of fund from operations**

Profit and Loss Account closing balance	35000
Less. Profit and Loss Account opening balance	25000
Current year's profit as per Profit & Loss Account	10000

**Illustration 3.1.3**

From the following Balance Sheet prepare schedule of changes in working capital and fund flow statement

Liabilities	2019(₹)	2020(₹)	Asset	2019(₹)	2020(₹)
Capital	30000	40000	Land and Building	151000	158000
Profit and Loss Account	175000	200000	Stock	60000	40000
Debentures	120000	100000	Debtors	70000	65000
Creditors	5000	3000	Cash	49000	80000
Total	330000	343000	Total	330000	343000

## Solution

### Schedule of Changes in Working Capital

Particulars	2019(₹)	2020(₹)	Effect on working capital	
			Increase (₹)	Decrease (₹)
<b>A. Current assets</b>				
Stock	60000	40000		20000
Debtors	70000	65000		5000
Cash	49000	80000	31000	
	179000	185000		
<b>B. Current liabilities</b>				
Creditors	5000	3000	2000	
	5000	3000		
<b>C. Working capital(A-B)</b>	174000	182000		
<b>D. Net increase in working capital</b>	8000			8000
<b>Total</b>	182000	182000	33000	33000

### Fund Flow Statement

Sources	Amount (₹)	Applications	Amount (₹)
Issue of shares	10000	Redemption of debentures	20000
Fund from operations	25000	Purchase of land	7000
		Net increase in working capital	8000
<b>Total</b>	35000	<b>Total</b>	35000

### Share capital account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance c/d	40000	By balance b/d	30000
		By cash	10000
<b>Total</b>	40000	<b>Total</b>	40000

Share Capital account is a liability account, since all liability accounts have credit balance; ₹30000 is b/d to the credit side. When balancing the account, you can see cash of ₹10000 is credited from the capital account. So, it means a share of ₹10000 is issued for cash.





Profit and Loss Account	56000	68000	Stock	75000	74000
Mortgage loan		150000	Debtors	49000	97000
Creditors	200000	170000	Cash	100000	150000
General reserve	70000	75000	Plant and machinery	50000	100000
Bills payable	10000	20000			
Total	374000	521000	Total	374000	521000

## Solution

### Schedule of Changes in Working Capital

Particulars	2020(₹)	2021(₹)	Effect on working capital	
			Increase(₹)	Decrease(₹)
<b>A. Current assets</b>				
Stock	75000	74000		1000
Debtors	49000	97000	48000	
Cash at bank	100000	150000	50000	
	224000	321000		
<b>B. Current liabilities</b>				
Creditors	200000	170000	30000	
Bills payable	10000	20000		10000
	210000	190000		
<b>C. Working capital(A-B)</b>	14000	131000		
<b>D. Net increase in working capital</b>	117000			117000
<b>Total</b>	131000	131000	128000	128000

### Funds Flow Statement

Sources	Amount (₹)	Applications	Amount (₹)
Fund from operations	17000	Purchase of plant	50000
Loan	150000	Net increase in working capital	117000
Total	167000	Total	167000

Working notes:



### Plant and machinery Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	50000	By Balance c/d	100000
To Cash (Purchases)	50000		
<b>Total</b>	<b>100000</b>	<b>Total</b>	<b>100000</b>

Plant and Machinery account is an asset, since all asset accounts have debit balance ₹50000 is b/d to the debit side. When balancing the account, you can see the plant and machinery account is debited with cash of ₹50000. So, it means purchase of plant and machinery is done with cash of ₹50000.

Corresponding Journal entry is

Plant and machinery a/c	Dr.	50000
To Cash a/c		50000

### Calculation of Fund from Operation

Profit and Loss Account closing balance	68000
Less. Profit and Loss Account opening balance	56000
Current year's profit as per Profit and Loss Account	12000
Add general reserve (75000-70000)	5000
<b>Fund From Operation</b>	<b>17000</b>

### Recap

- ◇ Working capital is resources available to meet short term obligations.
- ◇ Fund means working capital.
- ◇ Fund flow means the movement of funds
- ◇ Fund flow statement represents flow of fund in systematic manner.
- ◇ Fund flow gives source and applications of fund so known as 'Where Got-Where Gone Statement.'
- ◇ Fund flow is prepared from comparative Balance Sheet.

- ◇ Schedule of changes in the working capital gives working capital changes over a period.
- ◇ Fund flow statement lists source and application of funds.
- ◇ Activities results in the inflow of fund to the company are sources of fund.
- ◇ Fund from Operations (FFO) is cash generated from business operations.
- ◇ Activities resulting in outflow of fund are applications of fund.

### Objective Questions

1. What does fund mean in Accounting?
2. How are funds affected when current liability decreases?
3. What will happen to fund when current asset decreases?
4. Will all transactions result in flow of fund?
5. What will be the change in fund when cash is received from sundry debtors?
6. What will happen to funds when debentures are issued for generating cash?
7. How will you get information regarding change in fund flow?
8. Why is fund flow statement known as 'Where Got Where Gone' Statement?
9. What information is used in preparation of fund flow statement?
10. What can be obtained from schedule of changes in working capital?
11. Which statement gives information about sources and applications of fund?



## Self-Assessment Questions

1. Write a short note on fund through an illustration.
2. Explain fund flow transaction with examples.
3. Explain fund flow statement.
4. Explain the elements of the fund from operation with suitable examples.
5. Write a short note on different sources and applications of fund.

## Assignments

1. Compute fund from operations from the following

Profit and Loss Account

Particulars	Amount	Particulars	Amount
Salaries	5000	Gross Profit	1000
Rent	2000	Rent received	5000
Depreciation	1000	Interest income	4000
Preliminary Expense	2000	Net loss	5000
Loss on sale of land	5000		
	15000		15000

(Hint: FFO: 3000)

2. Prepare fund flow statement from the following data

Particulars	2013	2014
Inventory	3,100	3,200
Cash	2,000	2,500
Bills Receivable	2,400	2,700
Other Asset	800	700
Fixed Asset	5,000	5,800

Accumulated Depreciation	2,100	2,500
Creditors	2,000	2,100
L.Term Debt	1,400	1,300
Equity Capital	5,000	5,300
Retained Earnings	2,800	3,700

- a. Fixed assets costing ₹ 1,200 were purchased for cash.
- b. Fixed assets (original cost ₹400, accumulated depreciation ₹150) were sold for ₹200.
- c. Depreciation for the year 2014 amounted to ₹550 and duly debited to Profit and Loss Account.
- d. Dividends paid amounted to ₹300 in 2014.
- e. Reported income for 2014 was ₹300 amount is inflated

(Hint: Increase in Working Capital - 700, Sources and applications - 2300)

3. Financial statements of companies are public documents, so it will be readily available in the internet. Try to collect the comparative Balance Sheet and perform an analysis to determine the source and application of funds of companies of your choice.
4. You might be familiar with the fact that Sachin Tendulkar was having a major share in the football team, Kerala Blasters. Recently it was revealed in the news that he sold his shares and it was purchased by the existing shareholders of the company. So, a transfer of shares has taken place.
  - a. Using the concept, we have so far learned, do you think that transaction resulted in fund flow for the company?
  - b. Also look into various transactions that come up in the news and try to infer whether they are fund transactions or not.



### Suggested Reading

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SGOU



# Unit 2

## Cash Flow Statement

### Learning Outcomes

This unit aims at:

- ◇ familiarising the learners with the Cash Flow Statement
- ◇ explaining the significance of Cash Flow Statement
- ◇ describing the difference between Fund Flow and Cash Flow Statement

### Prerequisite

Have you ever been to a Reliance store? If someone asks you this question, you are most certain to ask back, which type of Reliance stores are you talking about? Because Reliance has its operations extended to very diverse fields. In your locality you have Reliance Fresh – neighbourhood store, Reliance Digital – an electronic specialty store, Jio Digital Life – specialty store for mobility and communication, Ajio – online fashion store, Reliance Trends – apparel store and so on. So how do you think Reliance is able to do this?

A simple answer will be it is owned by Mukesh Ambani, the richest man in India. The answer is correct but how can you explain it in accounting terms. Reliance is able to flourish in every field because they have adequate cash balance from their operations. Having sufficient cash balance gives freedom to the management of the firm to make daring decisions and exploit all the opportunities available in the market. In this section we are going to learn about cash, its flow, and the preparation of cash flow statement.

### Keywords

Cash, Cash flow statement, Cash from operation

## Discussion

The lifeblood of any company is a solid cash flow. If the inflows and outflows are balanced properly, it should prosper. If you make a mistake, your company could suffer. Understanding the state of your cash can help you determine whether or not your company is headed in the right direction.

### 3.2.1 Cash

At a stationery store, you exchange money to buy a notepad. The physical medium used to trade commodities is money, which comes in the form of coins and banknotes. It stands in for currency, which is extensively used and trusted for making payments. Like how blood is necessary for the human body, money is critical for businesses. It significantly affects how a business runs its operations.

Although cash is a component of the overall fund, a separate cash flow statement is created to reveal the company's cash position. This is due to the fact that adjustments to working capital, like a reduction in current liabilities as a result of settlements, can increase the company's working capital while decreasing its available cash. Shareholders and investors can determine the cash balance of a company accurately by examining the cash flow statement. Companies like Catamount can plan for growth, obtain funding, and capture new market opportunities by being aware of their cash status. Because the fund flow statement does not accurately reflect a company's cash flow status, creating a cash flow statement is crucial.

### 3.2.2 Cash Flow Statement

Cash flow associated with Catamount are not limited to a single activity. Cash inflow and outflow will be there in production and sale of cars, cash will be involved in generating capital and repaying of debts, cash will also be involved when a plant is sold or purchased by Catamount. So, these cash flows should be systematically considered and recorded if true cash position of Catamount is to be known. Cash flow statement is a statement prepared for reporting the accurate reasons for changes in cash during a period of time. It also depicts the inflow and outflow of cash in various activities of business in a detailed manner. It summarises the changes in cash position of a firm between two Balance Sheet dates and enumerates the net effect of various business transactions on cash.

It was said that cash was involved in certain activities of Catamount. So, what are these various activities? Catamount requires cash specifically for activities like operations, financing and investing. Let us briefly discuss the cash inflow and outflow associated with these activities

#### a. Cash flow from operations

The core activities of a business are known as its operational activities. Cash will be associated with the operational activities, as cash in the form of income from sales and



cash in the form of expenses in production will be experienced by Catamount. Here, the total cash flow of Catamount from operational activities will be the difference between cash revenue from car sales and cash expense incurred in car production.

Following are the two methods to find out Cash from Operations.

- i. **Direct Method:** In this method, the total of all receipts or payments falling under the category of operational activities is considered for calculation. For instance, the operating activities section would list items like cash received from customers, cash paid to suppliers, cash paid for interest, cash paid for wages, cash paid for R&D, cash paid for selling, general, and administrative costs, and any other important sum related to the actual operations of the business.
- ii. **Indirect Method:** Indirect method is the most common method used for calculating cash flow from operations. Under this method the cash flow from operational activities can be found with the aid of Fund from Operations (FFO). Along with Fund from Operations we need to incorporate changes in working capital to arrive at cash from operations.

Now how does the change in working capital influence cash flow in operations? From the following scenarios we can draw four important conclusions regarding the effect of working capital changes (due to increase or decrease in current assets and current liabilities other than cash) on cash flow.

- i. Increase in current asset other than cash in hand and at bank will result in decrease of cash balance.

When Catamount paid for insurance in advance using cash, it increased its current asset called prepaid expense. However, this also means that the company had to use up some of its cash. So, when a current asset other than cash increases, the company's cash balance decreases as a result.

- ii. Decrease in current asset other than cash in hand and at bank will result in an increase in cash balance

When Catamount sells cars to customers on credit, the customers become sundry debtors, which are considered current assets. If one day these sundry debtors pay the amount they owe in cash to Catamount, it will result in an increase in cash for the company. At the same time, the value of sundry debtors, which is a current asset, will decrease. Therefore, we can say that a decrease in a current asset other than cash leads to an increase in the company's cash balance.

- iii. Increase in current liability will result in an increase of cash balance.

When Catamount purchases raw materials from a supplier on credit, it creates a current liability because it owes money to the supplier. Here, Catamount did not use cash to pay for the raw materials. When the need is fulfilled without spending cash, it means that their cash balance has increased. However, this also leads to an increase in the amount of money owed to sundry creditors or an increase in current liability. Therefore, an increase in current liability results in an increase in

the cash balance for Catamount.

- iv. Decrease in current liability will result in a decrease of cash balance.

When Catamount pays back the cash to sundry creditors, it reduces the amount of money it owes them, leading to a decrease in current liability. However, this transaction also causes Catamount's cash balance to decrease. Therefore, a decrease in current liability results in a decrease in Catamount's cash balance.

The above points are presented in a tabular form below. This is the format for calculating cash flow from operation under indirect method.

**Table 3.2.1 Statement showing calculation of cash from operations (Indirect Method)**

	Amount (₹)	Amount (₹)
Fund From Operations (FFO)		XX
Add. Increase in current liability	XX	
Decrease in current asset	XX	XX
Less: Increase in current asset	(XX)	XX
Decrease in current liability	(XX)	(XX)
Cash from operations		XX
Or		Or
Cash outflow on account of operations		(-XX)

We have already discussed in detail the calculation of Fund from Operations (FFO) in the previous chapter, that is why the steps for its determination are not provided here. You need to first find Fund from Operations the same way as you did in the previous chapter. Please keep in mind that if the final value is positive, it means the company is obtaining that much amount of cash from operations. And if the final value is negative, it means the company is losing that much amount of cash in operations.

### **b. Cash flow from financing activities.**

Catamount needs money to expand its operations. How do they finance this requirement? Catamount has two options; they can either generate the required cash as debt or as capital. This can be done respectively by issuing debentures or shares. Such activities to generate cash is called financing activities. Financing activities include all those activities that are concerned with generation of cash in the form of capital and debts and involve their repayment. Cash flow in financing activities result in the increase or decrease of capital and borrowings of the company.

### c. Cash flow from investing activities.

Catamount wants its operations to be taken to a new location, so they purchased a new plant with cash at the same time disposing of the existing plant. So, we can say that Catamount had sold a fixed asset and acquired another and in both these transactions cash has involved. These activities performed by Catamount are called investing activities. And cash flow in investing activities is concerned with the purchase and sale of fixed assets.

### 3.2.3 Preparation of cash flow statement

Like the fund flow statement, the cash flow statement is also prepared from the comparative Balance Sheet provided in the question. Given below are the steps to be followed for the preparation of cash flow:

- i. Finding the initial balance of cash and cash equivalents at the start of the reporting period is the first step of preparing a cash flow statement.
- ii. Calculate the cash flow from operating activities. This process is essential since it shows how much money a business made from its operations.
- iii. Determine the cash flows from your investment activities. The cash flows associated with purchasing and selling long-term assets like real estate, buildings, and equipment are described in this portion of the cash flow statement. Remember that only free cash investments are covered in this section.
- iv. The sum of the cash flows from operating, investing, and financing activities is the change in net cash for the time period. This figure represents the overall cash flow a business made or lost during the reporting period. A company with a positive net cash flow had more money coming in than going out, whereas one with a negative net cash flow had more money going out than coming in.
- v. You can compute the closing amount of cash and cash equivalents at the end of the reporting period by adding the sum calculated at step 4 to the opening balance of cash.

These are the steps to be followed for the preparation of the Cash Flow Statement. Given below is the format of the Cash Flow Statement as per the discussion.

**Table 3.2.2 Cash Flow Statement (Direct Method)**

Particulars	Amount	Total
<i>Cash flow from operating activities:</i>		
Receipts from sale of goods and services, royalties, etc.	XXXX	
Less: Payment to employees, taxes, suppliers, etc.	(XXXX)	

Net cash from operating activities (A)	XXXX	
<i>Cash flow from investing activities:</i>		
Sale of investments, vehicles, property, etc.	XXXX	
Less: Purchase of machinery, plant, equipment, etc.	(XXXX)	
Net cash from investing activities (B)	(XXXX)	
<i>Cash flow from financing activities:</i>		
Proceeds from issuing shares, borrowings from banks, etc.	XXXXX	
Less: Repayment of loan	(XXXX)	
Payment of dividends to shareholders	(XXX)	
Net cash from financing activities (C)	XXXX	
Add: Net cash flow during the year (A + B + C)		XXXX
<b>Opening Cash Balance</b>		XXXX
<b>Ending Cash Balance</b>		XXXXX

**Table 3.2.3 Cash Flow Statement (Indirect Method)**

Particulars	Amount	Total
<i>Cash flow from operating activities:</i>		
Fund Flow from Operations	XXXX	
Add/Less: Changes in Working Capital	(XXXX)	
Cash from operating activities (A)	XXXX	
<i>Cash flow from investing activities:</i>		
Sale of investments, vehicles, property, etc.	XXXX	
Less: Purchase of machinery, plant, equipment, etc.	(XXXX)	
Net cash from investing activities (B)	(XXXX)	
<i>Cash flow from financing activities:</i>		
Proceeds from issuing shares, borrowings from banks, etc.	XXXXX	



Less: Repayment of loan	(XXXX)	
Payment of dividends to shareholders	(XXX)	
Net cash from financing activities (C)	XXXX	
Add: Net cash flow during the year (A + B + C)		XXXX
<b>Opening Cash Balance</b>		XXXX
<b>Ending Cash Balance</b>		XXXXX

The total cash balance as per the cash statement will be equal to the total closing cash balance given in comparative balance statement. We will now try to solve some simple problems with the concepts learned.

Now let us look at some illustrations to understand the method of preparation of cash flow statement.

### Illustration 3.2.1

Balance Sheet of Catamount as on 31-03-2020 and 31-03-2021 were as follows

Liabilities	31-03-2020	31-03-2021	Asset	31-03-2020	31-03-2021
Share capital	45000	52000	Cash	21000	25000
Profit and Loss Account	1200	2500	Stock	15000	10000
creditors	15000	17000	Debtors	12000	14000
Debentures	10000	8000	Land	23200	30500
Total	71200	79500	Total	71200	79500

### Solution

#### Cash Flow Statement

Particulars	Amount(₹)	Amount(₹)
Cash from Operations (Operating activities) (A)		6300
Cash from Financing Activity		
Issue of shares	7000	

Redemption of debentures	(2000)	
Net Cash flow from financing (B)		5000
Cash from Investing Activity		
Purchase of land	-7300	
Cash from Investing (C)		-7300
Net Cash flow during the year (A+B+C)		4000
Opening Cash balance		21000
<b>Closing cash balance</b>		<b>25000</b>

### Working Notes

#### Calculation of fund from operation

Profit and Loss Account closing balance on 31/03/2021	2500
Less. Profit and Loss Account opening balance 31/03/2020	(1200)
Fund from Operations (FFO)	1300

Note: The difference in Profit and Loss Account is taken as fund from operations because, there is no Non-operating expenses and incomes present in the illustration given. Otherwise, you need to adjust such items also for arriving at fund flow from operations (revisit the illustrations from previous unit for clarity).

#### Statement showing calculation of cash from operations

	Amount (₹)	Amount (₹)
Fund From Operations (FFO)		1300
Add. 1. Increase in creditors	2000	
2. Decrease in stock	5000	7000
		8300
Less: 1. Increase in debtors	(2000)	(2000)
Cash from operations		6300

#### Land Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	23200	By Balance c/d	30500
To Cash (Purchase)	7300		
Total	30500	Total	30500

Land account is an asset, since all asset accounts have debit balance, ₹23200 is b/d to



the debit side. When balancing the account, you can see that the land account is debited with cash of ₹7300. So, it means purchase of land is done with cash of ₹7300.

Corresponding Journal entry is;

Land a/c           Dr.       7300  
                     To Cash a/c                       7300

#### Share Capital Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance c/d	52000	By Balance b/d	45000
		By Cash	7000
Total	52000	Total	52000

Capital account is a liability, since all liability accounts have credit balance, ₹45000 is b/d to the credit side. When balancing the account, you can see that the capital account is credited with ₹7000. So, it means shares of ₹7000 are issued for cash.

Corresponding Journal entry is:

Cash a/c           Dr.       7000  
                     To Capital a/c                       7000

#### Debentures Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Cash	2000	By Balance b/d	10000
To Balance c/d	8000		
Total	10000	Total	10000

Debentures account is a liability, since all liability accounts have credit balance, ₹10000 is b/d to the credit side. When balancing the account, you can see the debenture account is debited with ₹2000. So, it means repayment of debentures for ₹2000 with cash.

Corresponding Journal entry is

Debentures a/c       Dr.       2000  
                     To Cash a/c                       2000

### Illustration 3.2.2

**Balance Sheet of a firm as on 31-03-2020 and 31-03-2021 were as follows.**

Liabilities	31-03-2020	31-03-2021	Asset	31-03-2020	31-03-2021
Share capital	75000	125000	Cash	38000	45000
P & L account	4500	7000	Stock	57500	60000
Loan from bank	25000	40000	Debtors	25000	80000
Bills payable	30000	35000	Machinery	14000	22000
Total	134500	207000	Total	134500	207000

You are required to prepare cash flow statement

### Solution

#### Cash Flow Statement

Particulars	Amount (₹)	Amount(₹)
Cash flow from operation (A)		-50000
Cash flow from Investing		
Cash paid to purchase machinery	8000	
Net Cash flow from Investing (B)		-8000
Cash flow from financing		
Cash from loan	15000	
Cash from issue of shares	50000	
Net Cash flow from Investing (C)		65000
Net Cash flow during the year (A+B+C)		7000
Opening Cash balance		38000
Closing cash balance		45000

#### Working Notes



### Calculation of fund from operation

Profit and Loss Account closing balance on 31/03/2021	7000
Less. Profit and Loss Account opening balance 31/03/2020	4500
Fund from Operations (FFO)	2500

### Statement showing calculation of cash from operations

	Amount (₹)	Amount (₹)
Fund From Operations (FFO)		2500
Add. 1. Increase in bills payable	5000	5000
		7500
Less: 1. Increase in debtors	(55000)	
Less: 2. Increase in stock	(2500)	(57500)
Cash outflow on account of operations		-50000

### Machinery Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	14000	By Balance c/d	22000
To Cash (Purchase)	8000		
Total	22000	Total	22000

Machinery account is an asset, since all asset accounts have debit balance, ₹14000 is b/d to the debit side. When balancing the account, you can see the machinery account is debited with ₹8000. So, it means purchase of machinery is done with ₹8000.

Corresponding Journal entry is

Machinery a/c	Dr.	8000
To Cash a/c		8000

### Share Capital Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance c/d	125000	By Balance b/d	75000
		By Cash	50000
Total	125000	Total	125000

Capital account is a liability, since all liability accounts have credit balance, ₹75000 is b/d to the credit side. When balancing the account, you can see that the capital account is credited with ₹50000. So, it means shares of ₹50000 are issued for cash.



Payables	16,000	20,800
Debentures		20,000
Share capital	80,000	56,000
Retained earnings	10,800	8,400
	<b>1,06,800</b>	<b>1,05,200</b>

#### Profit and Loss Account details

Net Credit sales ₹95,000

Cost of goods sold ₹44,000

Gross profit ₹51,000

Operating expenses (including depreciation) ₹28,600

Net profit ₹22,400

Dividend declared and paid ₹20,000

#### Additional information

During the year furniture costing ₹10,000 on which ₹8,000 depreciation was provided, sold for ₹1,500. The loss on disposal is included in selling and administrative expenses.

### Solution

#### Cash Flow Statement

Particulars	₹	₹
Cash Flow from Operating Activities		
Cash received from customers	99400	
Cash paid to suppliers & employees	-56700	
Net cash flow from operating activities		42700
Cash Flow from Investing Activities		
Purchase of furniture	-30000	
Sale of furniture	1500	
Net cash used in investing activities		(28500)
Cash Flow from Financing Activities		
Dividend paid	-20000	
Redemption of debentures	-20000	
Proceed from issuance of shares	24000	
Net cash used in financing activities		(16000)
Net decrease in cash & cash equivalents during the year		-1800

Cash & cash equivalents at the beginning of the year		9700
Cash & cash equivalents at the end of the year		7900

Working Notes:

1. Calculation of cash received from customers

#### Receivables

Particulars	Amount	Particulars	Amount
To Balance b/d	12700	By Cash received from Customers (Balancing Figure)	99400
To Net Credit Sales	95000	By Balance c/d	8300
Total	107700	Total	107700

2. Calculation of cash payment to suppliers and employees

#### Payments

Particulars	Amount	Particulars	Amount
To Cash (Balancing Figure)	56700	By Balance b/d	20800
To Balance c/d	16000	By Operating Expense *	11900
		By Purchases*	40000
Total	107700	Total	107700

\*Operating Expense = Operating Expense (excluding Depreciation) – (Increase in Accumulated Depreciation + Allowance for Doubtful Debt + Loss on Sale) this equation is used since we have to find out the operating expenses after adjusting the non-cash and non-operating expenses.

$$= (28600 - 8000) - (8050 + 150 + 500)$$

$$= 20600 - 8700 = 11900$$

\*Purchases = Cost of Sales – Decrease in Inventory

$$= 44000 - (40000 - 36000)$$

$$= 40000$$

We can examine the significance and limitations of cash flow statement as well as the differences it shares with fund flow statement.



### 3.2.4 Significance of Cash Flow Statement

Let us try to understand the significance of cash flow statement through series of connected questions with respect to Catamount.

- i. What information does cash flow statement convey?

Cash flow statement gives information related to the inflow and outflow of cash from operating, investing and financing activities of Catamount. Simply put, Catamount will be able to know its cash balance from the cash flow statement.

- ii. What can Catamount analyse from this information?

From the cash balance Catamount will be able to get a detailed view of its position. That is Catamount will be able to know the amount of cash available with it in the form of coins and currencies (liquidity)

- iii. What significance does liquidity position have on Catamount?

With information on liquidity, Catamount will be able to assess their ability to pay the debts as and when they become due (solvency). Liquidity is an indication of repayment capacity. So, lenders depend on cash flow statement for providing loans to the company.

- iv. Does cash flow statement in any way influence the present working of Catamount?

Cash flow statement helps Catamount in identifying the transactions that increase cash outflow. These transactions will result in a reduction of Catamount's cash balance. So, the company analyses these transactions and take necessary measures to control cash outflow.

- v. How is this information utilised by Catamount with respect to future business?

It helps Catamount in assessing various future business opportunities on the basis of the cash available with them. Based on this assessment adequate financial policies are formulated. It is highly useful for short term financial planning.

### 3.2.5 Limitations of Cash Flow Statement

Limitations of cash flow statement can be understood with respect to Catamount through a series of questions.

- i. Will cash flow statement give any information about the net income of Catamount?

It does not give information about the net income of Catamount. Net income is the difference between total revenue and total expense. Items such as depreciation, amortization, etc. also form part of Catamount's total expense and revenue. These are non-cash items. As a result, these will not be considered in the preparation of cash flow statement. So, cash flow statement will not be able to give the information on net income of Catamount.

ii. Can Catamount use cash flow statement as a substitute for fund flow statement?

Fund flow statement gives information about the working capital of Catamount. And we know that cash forms a part of this working capital. So, working capital has a wider scope as compared to cash. As cash flow statement is limited to information on cash alone, it cannot act as a substitute to fund flow statement.

iii. Can Catamount use cash flow statement to substitute the income statement?

Income statement or trading and profit and loss statement gives the net profit or net loss associated with Catamount by taking into consideration all the direct and indirect expenses and income associated with it. Cash flow statement will not be able to emulate that as the income statement includes direct and indirect expense and income of Catamount including non-cash transactions. So, cash flow statement cannot be used as a substitute for income statement as both of them have a separate function to perform.

### 3.2.6 Difference between Fund Flow Statement and Cash Flow Statement

Major difference between fund flow and cash flow statements can be understood through a series of questions.

**Table 3.2.4 Comparison of Fund flow Statement and Cash Flow Statement**

Basis of Comparison	Fund Flow Statement	Cash Flow Statement
What does it represent?	It shows the changes in funds and its reasons between two Balance Sheet dates	It shows the changes in cash and its reasons between two Balance Sheet dates
What can be deduced from it?	Net Working Capital Position	Liquidity Position
What does the company do with this deduction?	Use it for long term financing	Use it for short term financing
Is there any connection between the two?	Good working capital position does not indicate good cash balance.	Cash is a part of working capital. So better cash position will lead to improved working capital.
Do they have any prescribed format?	No prescribed format	Prescribed form as per Ind AS-7



## Recap

- ◇ Cash flow statement gives the cash balance of company.
- ◇ It depicts the inflow and outflow of cash.
- ◇ Company uses cash for operations, financing and investing activities.
- ◇ Operating activities are transactions related to core functions of business.
- ◇ Financing activities are transactions used to fund the business.
- ◇ Investing activities are transactions related to the growth of business
- ◇ Fund from operations and changes in the working capital gives cash from operations.
- ◇ If cash from operations is positive, it is source of cash.
- ◇ If cash from operations is negative, it is application of cash.

## Objective Questions

1. What is the simplest form in which cash is available?
2. What does cash flow statement convey?
3. What implication will you get if cash from operations is negative?
4. What do you call the transactions used to fund business?
5. What impact does decrease in current asset other than cash has on cash balance?
6. What relationship does the change in current liability and cash balance share?
7. What cash flow is associated with redemption of debentures?

## Answers

1. Coins and banknotes
2. Cash balance
3. Outflow of cash from company
4. Financing activities.
5. Cash balance increases
6. Direct relationship
7. Cash outflow from financing activities (outflow)

## Self-Assessment Questions

1. Explain the cash flow statement with suitable examples
2. What is the significance of Cash Flow Statement in an organisation?
3. What is the difference between fund flow and cash flow statement?

## Assignments

1. Find out Cash from Operations from the following extract from cash book

Particulars	₹	Particulars	₹
To Balance B/d	150000	By Repayment of Loan	450000
To Sale of Machinery	1350000	By Purchase of Machinery	1200000
To Receipts from Debtors	9000000	By Payment to Creditors	7800000
To Issue of Shares	3000000	By Dividends	300000
		By Wages and Salaries	600000
		By Rent, Rates, and Tax	300000
		By Income Tax	150000



		By Balance C/d	2700000
Total	13500000	Total	13500000

(Hint: Cash from Operation – 15,00,000)

2. Compute cash from operations from the following P&L Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Salaries	5000	By Gross Profit b/d	25000
To Rent	1000	By Profit on Sale - land	5000
To Depreciation	2000	By Income tax refund	3000
To Goodwill W/o	4000		
To Proposed Dividend	5000		
To Provision for Tax	5000		
To Loss on sale of Plant	1000		
To Net Profit	10000		
Total	33000	Total	33000

(Hint: Cash from Operation – 19000)

3. Balance Sheet of a firm as on 31-03-2020 and 31-03-2021 were as follows.

Liabilities	31-03-20	31-03-21	Asset	31-03-20	31-03-21
Share capital	20000	25000	Cash	20000	25000
P & L account	5000	8000	Stock	13000	31000
Loan from bank	75000	80000	Debtors	35000	28000
Creditors	10000	20000	Building	42000	49000
Total	110000	133000	Total	110000	133000

You are required to prepare cash flow statement

(Hint: Net increase in Cash 5000)

4. Consider a company of your choice and closely look into its fund flow transactions and cash flow transactions. Try to identify the nature of the transactions that are different in fund flow statement and cash flow statement. Make a list of differences you have observed between the fund flow and cash flow statements.

### Suggested Reading

1. Jain, S. P. & Narang, K. L., (2017) *Advanced Cost Accounting*, Kalyani publishers, New Delhi.
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4. Atrill, Peter and McLaney, Eddie (2013). *Financial Accounting for Decision Makers* (seventh edition). Pearson.



**BLOCK  
04**

**Ratio Analysis**

# Unit 1

## Ratio Analysis

### Learning Outcomes

This unit aims at:

- ◇ familiarising the classification ratios
- ◇ introducing the concept of financial ratios
- ◇ describing the objectives of ratio analysis
- ◇ narrating the benefits and shortcomings of ratio analysis

### Prerequisite

In our daily life, we are going through numbers and measurements very often, knowingly, or unknowingly. Using measurements in our kitchen activities, calculating the bus fare and, even when we are simply crossing the road we come across numbers. Sometimes these numbers are large and sometimes these numbers are small.

In the case of large numbers, the calculation and comparison are difficult. Ancient mathematicians have found an idea to compare these large numbers in a simple way, that is ratios. Ratios show the link or relation between different numbers. It can be expressed as pure ratio (for example 2:1), percentage (for example 40%), and rate (for example 2 times, 3 times), etc. We can find many examples where we use ratios in our daily routine. For instance, while making coffee, there is a ratio between coffee powder and water. Let us learn more about how businesses use ratios for their analysis in this unit.

### Keywords

Financial ratios, Liquidity ratios, Profitability ratios, Solvency ratios, Turnover ratios



## Discussion

Financial ratios are essential tools for analysing financial statements because they help businesses quantify many different aspects of their operations. The relative magnitude of two chosen numerical values taken from the financial accounts of an organisation constitutes a financial ratio or accounting ratio.

### 4.1.1 Ratio Analysis

Is there a need for ratios in business?

A person who does not know anything about financial statements can see only some numbers in the financial statement and cannot understand what these numbers represent. So, ratios are important in the business. The major aim of financial ratios is to measure the efficiency of the firm by presenting the financial data simply and understandably. In a company, there are many issues related to profit, growth, sales, etc. We cannot fix problems until the problems are identified. Financial ratio analysis helps to identify the nature of financial problems. “The ratio that expresses the relation between two accounting numbers derived from the financial statement is called accounting ratio.” “The process of identifying the organisational strength and weakness with the help of accounting ratios is called ratio analysis.”

### 4.1.2 Objectives of Ratio Analysis

Do you remember the percentage of marks you got in school?

A student gets a clear picture of his overall academic performance from the percentage of marks. In the same way, a company can analyse its financial performance through financial ratios. Firms can evaluate their business growth, strengths and weaknesses, etc. through financial ratios. It helps to present the financial data of the firm in a simple manner.

Other major objectives of financial ratios are:

- ◇ To compare their efficiency with the previous year activities.
- ◇ To measure the profitability.
- ◇ To present the result of business to interested parties like government, creditors, shareholders, etc.
- ◇ To identify the steps needed to improve their performance.
- ◇ To analyse key problems of the organisation.

### 4.1.3 Advantages of Ratio Analysis

The accounting ratio is an important and useful technique for evaluating the efficiency, trend, progress, and weakness of an enterprise. Investors use accounting ratios for

evaluating investment decisions. The main advantages of analysis of accounting ratios are:

- i. It helps to analyse the strength, weaknesses, opportunities, and threats of the organisation.
- ii. It is useful for simplifying the complex data into presentable information.
- iii. It assists in the managerial decision making process.
- iv. Ratio analysis helps to maintain a systematic record of comparison.
- v. Ratios help to compare and communicate the financial data between two dates.

#### 4.1.4 Disadvantages of Ratio Analysis

Financial ratios have some limitations also. The major limitations of ratios are:

- i. Calculation of ratios are based on accounting data, if accounting data involves any error, it affects the ratio.
- ii. Ratios are comparisons and they show only a general picture of problems, not an in-depth view.
- iii. Ratios highlight the problem but do not offer any solution.
- iv. Ratios are helpful in quantitative analysis but not applicable in qualitative analysis.
- v. Ratio calculations are based on historical data, so it has some limitations while preparing future financial plans.

#### 4.1.5 Classification of Ratios

Based on nature, financial ratios can be classified into the following.

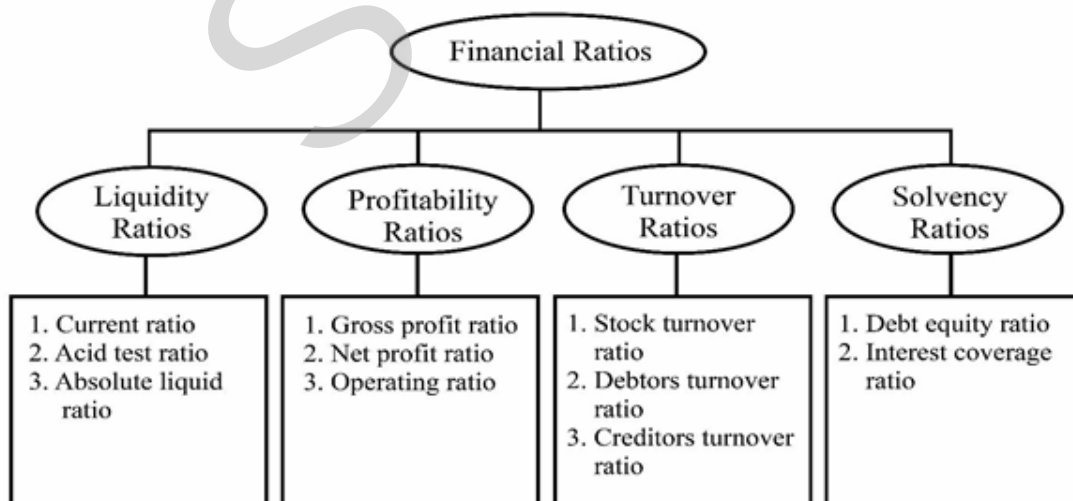


Figure 4.1.1: Classification of ratios

- ◇ Liquidity ratios: Liquidity ratios discuss the liquidity of the firm i.e, the firm's ability to repay its short term obligations.
- ◇ Profitability ratio: The profitability ratio helps to measure the profitability of the firm.
- ◇ Turnover ratio/ Activity ratio: This measures the efficiency of utilisation of resources. The turnover ratio measures the speed of asset conversion into sales.
- ◇ Solvency ratio: The solvency ratio discusses the solvency of the firm i.e, the capacity of the firm to repay its long term obligations.

### Recap

- ◇ Ratio: numerical expressions that define the relationship between two numbers
- ◇ Financial ratios: connection or relation between two accounting numbers
- ◇ Ratio analysis: process of identifying the organisational strength and weakness with the help of accounting ratios

### Objective Questions

1. What is a ratio?
2. What are financial ratios?
3. What does the solvency ratio represent?

### Answers

1. Numerical expressions that define the relationship between two numbers
2. It shows the connection or relation between two accounting numbers
3. It represents the solvency of the firm.

### Self-Assessment Questions

1. Explain ratio analysis
2. Why is ratio analysis needed for businesses?
3. Write a short note on advantages of ratio analysis

### Assignments

1. Identify the business areas where the ratios are applicable for decision-making.
2. Find out different life scenarios where you can apply ratios and explain the significance of ratios on that regard.

### Suggested Reading

1. Atrill, Peter and Mclaney, Eddie (2013). *Financial Accounting for Decision-makers*.
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4. Gupta, R.L., Radhaswamy M: *Advanced Accountancy*, Sultan Chand & Sons, New Delhi.



# Unit 2

## Liquidity Ratios

### Learning Outcomes

This unit enables the learner to:

- ◇ grasp the meaning of liquidity ratios
- ◇ analyse different types of liquidity ratios
- ◇ be acquainted with the calculation and significance of various liquidity ratios

### Prerequisite

Mr. Ram owns land worth ₹12 lakhs. But one day he met with an emergency and required ₹10 Lakhs for settling the issue. But he is not able to settle the issue, even though he owns land worth ₹12 Lakhs. Here, the land is not a liquid asset so it cannot be converted into cash for urgent needs. If the investments are in the form of a liquid asset, they can be used in the case of emergencies. Liquid assets mean those assets that can be converted into cash within one year.

We can relate the same with a business scenario. If an organisation does not have adequate liquid assets, it will face difficulty in meeting the routine expenses. Liquidity in an organisation measures the company's capability to pay short-term debts. In this unit, we will examine how businesses study their liquidity position with the help of ratios.

### Keywords

Liquidity, Current ratio, Quick ratio, Absolute liquidity ratio

## Discussion

Generally, the liquidity position of any organisation is assessed using liquidity ratios. There are several ratios coming in the category of liquidity ratio. Let us examine these in detail.

### 4.2.1 Liquidity Ratios

MCP Pvt. Ltd. is a big manufacturing firm, now they decided to expand their business. So, they seek the support of creditors and lenders. MCP Pvt. Ltd. conducted a meeting with some creditors and lenders. At that meeting, creditors put forward a condition that they want to analyse the ability of the firm to meet their current liabilities through cash payment. It means the liquidity of the firm. which, they can analyse through three ratios: current ratio, acid test ratio, and absolute liquidity ratio.

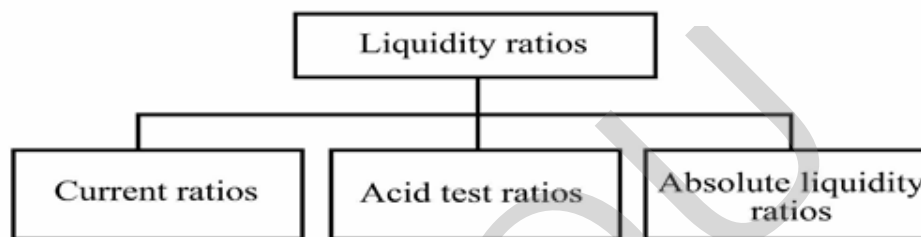


Figure 4.2.1: Classification of liquidity ratios

Liquidity ratio can be classified into three: current ratio, acid-test ratio, and absolute liquidity ratio. The major raw data for calculating liquidity ratios are current assets and current liabilities.

#### 4.2.1.1 Current Ratio

First, the MCP Pvt. Ltd. tries to identify their current ratio. The current ratio has significant importance while analysing the working capital, credit requirements, and short-term liquidity of the firm. It reflects the connection between current assets and current liability. The current ratio can be computed as current assets divided by current liability.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

**Current assets:** Current Assets are the assets that are expected to be used immediately or turned into cash within one year. Current assets involve bills receivable, cash in hand, cash at the bank, sundry debtors, stock, prepaid expenses, etc.

**Current liabilities:** Current liabilities are liabilities that are expected to be paid within one year. It includes bills payable, bank overdraft, cash credit, outstanding expenses, creditors, etc.

## Significance of Current Ratio

The current ratio is a crucial metric for determining a company's capacity to settle its creditors' short-term liabilities. It will aid the companies in determining their liquidity, but investors should not base their analysis of an organisation's financial standing only on this single number.

After calculating the current ratio, it gives some answers like 2:1, 1.5:1, etc. It indicates the liquidity position of the organisation, that is the ability of the company to pay off the current liability.

There are some standards developed for each ratio that helps to compare and analyse the liquidity position of the firm.

The general rule for the current ratios is that the ratio is typically greater than or equal to 2(2:1). It is considered a sign of the financial health of an organisation. When a current asset is twice of current liability, it is interpreted as satisfactory.

### 4.2.1.2 Quick Ratio or Acid Test Ratio

MCP Pvt. Ltd. provides their current ratio details to the creditors. But the creditors say that they want to know more about the liquidity, so the firm goes for quick ratio. The quick ratio is also known as the acid test ratio.

The name acid test came into ratios based on the ancient use of acid to test the purity of metals like gold. If the metal gets passed in the acid test process, it is considered pure and if metal fails in the test, it is considered impure. Likewise, a quick ratio helps to purify the liquidity of the firm by deducting some elements from current assets and current liability.

It describes the relationship between quick asset or liquid asset to quick liability.

$$\begin{aligned}\text{Quick Ratio} &= \frac{\text{Quick Assets or Liquid Assets}}{\text{Quick Liabilities}} \\ &= \frac{\text{Current assets} - (\text{Stock} + \text{Prepaid expense})}{\text{Current liabilities} - (\text{Bank overdraft} + \text{Cash Credit})}\end{aligned}$$

Quick asset or liquid asset means, assets that can quickly be converted into cash. It involves current assets except stock and prepaid expenses.

Why stock and prepaid expenses are excluded from the current asset in the case of quick ratio?

Here, stock or inventories sometimes take a long period to be converted into cash. Prepaid expenses are expenses paid in advance or expenses paid during the accounting period but not due. So, they cannot be used to meet current liabilities. That is why these two items are excluded from the quick asset.

Here, quick liability means current liability excluding bank overdraft and cash credit because these two are considered a continuing short term advance arrangement with banks.

### Significance of Acid Test Ratio

The acid test ratio is a reliable way to determine if a corporation has enough liquid assets on hand to pay its short term obligations. The acid test ratio, also referred to as the quick ratio, is a liquidity ratio that assess a company's capacity to settle its immediate or current liabilities with its available cash.

In the acid test ratio, 1:1 is considered the satisfactory level of liquidity. Here, the value of the current asset is equal to the value of the current liability. So, it implies that the firm can meet its immediate obligations. Company exactly has adequate current assets for immediate liquidity to pay off its current liabilities. If the ratio is less than 1:1, then the position of the firm is not up to the mark. If the ratio is above 1:1, the firm is considered sound.

#### 4.2.1.3 Absolute liquidity Ratio or Cash position Ratio

After calculating the current ratio and quick ratio, now MCP Pvt. Ltd. needs to identify their potential to cover short term liabilities using cash and cash equivalence. The absolute liquidity ratio or the cash position ratio helps to do this. Here, the firm is considering only cash and short term marketable securities as current assets because these are the most liquid resources of the company. Compared to other ratios, absolute liquidity ratio or cash position ratio is more conservative, because it is strictly based on the most liquid assets of the firm that are cash and cash equivalent assets.

Absolute liquidity ratios can be calculated by dividing cash and marketable securities by quick liabilities.

$$\text{Absolute liquidity ratio} = \frac{\text{Cash} + \text{Market Securities}}{\text{Quick Liabilities}}$$

### Significance of Absolute Liquidity Ratio

A company's ability to pay off obligations entirely with its liquid assets (cash and cash equivalents such as marketable securities) is determined by its cash position ratio, which measures the ultimate liquidity of the business. Creditors use it to assess how quickly a business can pay off short-term obligations. In this case, 0.75:1 is considered an adequate level.

#### Illustration 4.2.1

From the given Balance Sheet calculate the current ratio, quick ratio, absolute liquidity ratio



### Balance Sheet

Liabilities	Amount	Asset	Amount
Capital	20000	Fixed asset	5000
Current liabilities	15000	Stock	5000
		Cash in hand	10000
		Bills receivable	15000
	35000		35000

◆ Calculation of the current ratio

$$\begin{aligned} \text{Current asset} &= \text{Stock} + \text{Cash} + \text{Bills receivable} \\ &= 5000 + 10000 + 15000 \\ &= 30000 \end{aligned}$$

$$\text{Current liabilities} = 15000$$

$$\begin{aligned} \text{Current ratio} &= \frac{\text{Current Asset}}{\text{Current Liabilities}} \\ &= \frac{30000}{15000} \\ &= 2:1 \end{aligned}$$

◆ Calculation of acid test ratio

$$\begin{aligned} \text{Quick asset} &= \text{Current asset} - \text{Stock and Prepaid expenses} \\ &= 30000 - 5000 \\ &= 25000 \end{aligned}$$

$$\begin{aligned} \text{Quick ratio} &= \frac{25000}{15000} \\ &= 1.6:1 \end{aligned}$$

$$\begin{aligned} \text{Absolute liquidity ratio} &= \frac{10000}{15000} \\ &= 0.6:1 \end{aligned}$$

(Here, no bank overdraft is given so current liability is considered quick liability)

**Interpretation:**

Here, the current ratio is 2:1. So, it is considered satisfactory.

The quick ratio is 1.6:1, which is good.

But absolute liquidity ratio is 0.6:1. So, it is not up to the mark.

Analysing these three ratios we can say that the firm can fulfill its short term obligations well. However, the cash in hand alone may not be sufficient for this purpose.

**Illustration 4.2.2**

From the Balance Sheet calculate the current ratio and quick ratio.

**Balance Sheet**

Liabilities	Amount	Asset	Amount
Capital	100000	Fixed asset	50000
Creditors	50000	Stock	20000
Bank OD	25000	Debtors	10000
Bills payable	25000	Prepaid expenses	20000
Outstanding expenses	10000	Cash in hand	100000
Provision for tax	40000	Cash at bank	50000
	250000		250000

**Solution**

- ◆ Calculation of the current ratio

$$\begin{aligned}
 \text{Current Ratio} &= \frac{\text{Current Assets}}{\text{Current Liabilities}} \\
 &= \frac{\text{Stock} + \text{debtors} + \text{cash in hand} + \text{cash at bank} + \text{prepaid expenses}}{\text{Creditors} + \text{Bank OD} + \text{Bills payable} + \text{outstanding expenses} + \text{Provision for tax}}
 \end{aligned}$$



$$\begin{aligned}
 &= \frac{200000}{150000} = 1.3:1 \\
 \text{Quick ratio} &= \frac{\text{Quick assets or liquid assets}}{\text{Quick liability}} \\
 &= \frac{\text{Current asset} - (\text{Stock} + \text{prepaid expenses})}{\text{Current liability} - \text{Bank OD}} \\
 &= \frac{200000 - 40000}{150000 - 25000} \\
 &= \frac{160000}{125000} = 1.28:1
 \end{aligned}$$

### Interpretation:

Here, the current ratio is 1.3:1. It is below the accepted standard of current ratio. So, in this case, the current ratio is not up to the mark. But the quick ratio, in this case, is 1.28:1, that is good.

### Illustration 4.2.3

Calculate current asset from the given data.

Acid test ratio = 1.8, Current liabilities = 100000, Stock = 30000

### Solution

$$1.8 = \frac{\text{Current asset} - (\text{Stock} + \text{prepaid expenses})}{\text{Current liability} - (\text{Bank OD} + \text{Cash credit})}$$

In this case,

$$1.8 = \frac{\text{Current asset} - 30000}{\text{Current liability}}$$

$$\text{Current Asset} - 30000 = \text{Current Liabilities} \times 1.8$$

$$\text{Current Asset} = 180000 + 30000$$

$$\text{Current Asset} = 210000$$

### Illustration 4.2.4

Given current liability = 1000000, current ratio = 2, acid test ratio = 1.5, find current asset, quick asset, stock.

### Solution

◆ Calculation of current asset

$$\text{Current ratio} = 2:1 \text{ or } 2/1$$

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{2}{1}$$

$$\text{Current liability} = 1000000$$

$$\text{Current asset} = 1000000 \times \frac{2}{1} = 2000000$$

◆ Calculation of Quick asset

$$\text{Liquid ratio} = 1.5:1$$

$$\text{Liquid ratio} = \frac{\text{Quick assets or liquid assets}}{\text{Current liability}}$$

$$1.5 = \frac{\text{Liquid asset}}{1000000}$$

$$\text{Liquid Asset} = 1500000$$

◆ Calculation of Stock

$$\text{Liquid asset} = \text{current asset} - \text{stock}$$

$$1500000 = 2000000 - \text{stock}$$

$$\text{Stock} = 2000000 - 1500000$$

$$= 500000$$



### Illustration 4.2.5

Calculate absolute liquidity ratio and quick ratio. Given data: stock=5000, cash=20000, short term marketable securities=30000, current liabilities= 20000

### Solution

- ◆ Calculation of absolute liquidity ratio

$$\begin{aligned}\text{Absolute liquidity ratio} &= \frac{\text{Cash} + \text{Marketable securities}}{\text{Quick liabilities}} \\ &= \frac{20000 + 30000}{20000} \\ &= 2.5:1\end{aligned}$$

- ◆ Calculation of quick ratio

$$\begin{aligned}\text{Quick ratio} &= \frac{\text{Quick assets or liquid assets}}{\text{Quick liabilities}} \\ &= \frac{\text{Current asset} - \text{stock}}{\text{Quick liabilities}}\end{aligned}$$

Current asset = cash+ short term marketable securities

$$= 20000+30000$$

$$= 50000$$

$$\text{Quick ratio} = \frac{50000 - 5000}{20000}$$

$$= \frac{45000}{20000}$$

$$= 2.25:1$$

## Recap

- ◇ Liquidity Ratio: analyses company's capability to pay short term debts
- ◇ Current ratio; connection between current asset and current liability
- ◇ Acid test ratio; relation between quick asset and quick liability
- ◇ Absolute liquidity ratio; relation between cash and marketable securities and quick liabilities

## Objective Questions

1. Which is the ideal ratio for the current ratio?
2. What are liquid assets?
3. What is the equation for calculating the absolute liquidity ratio?
4. What is the ideal ratio for quick ratio?
5. What is the acid test ratio?

## Answers

1. 2:1
2. Current assets excluding stock and prepaid expenses like; cash, bills receivables, etc.
3. 
$$\frac{\text{cash} + \text{Marketable securities}}{\text{Quick liabilities}}$$
4. 1:1
5. Connection between quick asset and quick liability



## Self-Assessment Questions

1. Explain liquidity ratio with suitable examples?
2. Write a short note on the current ratio?
3. Explain the significance of quick ratio.
4. Why is the current ratio important?
5. Differentiate quick ratio and absolute liquidity ratio.

## Assignments

1. Try to find more reasons behind the importance of liquidity ratios in a firm.
2. From the Balance Sheet below, find out liquidity ratios for the organisation and discuss your inferences.

Liabilities	Amount	Asset	Amount
Bills Payable	3350	Cash at bank	2600
Sundry Creditors	4600	Closing Stock	250
		Sundry debtors	8560
		Furniture	3600
Capital	6200	Machinery	15000
Add: Net profit	<u>17560</u>		
	23760		
Less: Drawings	<u>1700</u>		
	22060		
	<u>30010</u>		<u>30010</u>

(Hint: CR-1.435:1, QR-1.4:1, ALR-0.32:1)

3. Determine the various liquidity ratios using the information below.

Particulars	Amount
Stock	1,50,000
Cash in hand	50,000
Trade Debtors	3,00,000
Creditors	3,50,000

Bills Receivable	30,000
Bank Overdraft	30,000

(Hint: CR-1.2:1, QR-1:1, ALR-0.13:1)

4. Find out Quick Ratio from the below details

Current Liabilities	65,000
Current Assets	85,000
Stock	20,000
Advance Tax	5,000
Prepaid Expense	10,000

(Hint: QR – 0.77:1)

### Suggested Reading

1. Atrill, Peter and Mclaney, Eddie (2013). *Financial Accounting for Decision-makers*.
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# Unit 3

## Profitability Ratios

### Learning Outcomes

This unit enables the learners to:

- ◇ get accustomed to profitability ratios
- ◇ examine different types of profitability ratio
- ◇ familiarise the calculation and significance of different profitability ratios

### Prerequisite

We all heard about the term profit and we know the meaning of the word profit. But do you know about profitability? What does it indicate?

We can consider the case of Mr. Jane to comprehend this concept better. Mr. Jane purchased a bag at ₹400 and sold it at ₹450. Here, we find a difference between the selling price and cost price, that is, profit ₹50 ( $₹450 - ₹400$ ). Profit is only a monetary value. This doesn't provide any insight into how effective the sale was. For that purpose we rely on profitability. A company's profitability is determined by how much money it makes compared to how much it spends. In general, the ability of an organisation to make this profit over some time is called profitability and it indicates the success or failure of the business.

### Keywords

Gross profit ratio, Net profit ratio, Operating ratio

## Discussion

The profitability of any organisation can be evaluated with the help of profitability ratios. There are several ratios coming in this category. Let us examine these in detail.

### 4.3.1 Profitability Ratios

We learned about the expansion of MCP Pvt. Ltd. After the successful meeting with creditors, they decided to expand their business. Now they want to know about the success or failure of their business in future.

Do you know which types of ratios are helpful for analysing the profitability of the firm?

The profitability ratios are the type of ratios based on their nature and they help to measure the profitability and efficiency of the business. Profitability is the sign of organisational efficiency based on the operational activities of the firm. Poor operational activities of the firm lead to reduction in sales and profit. So, identifying the profitability of a firm helps in decision making regarding the company's efficiency.

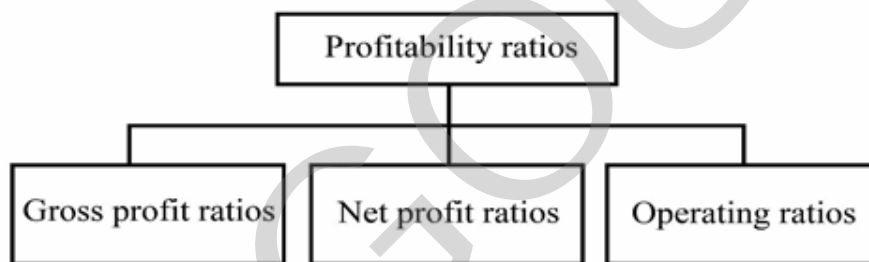


Figure 4.3.1: Classification of profitability ratios

#### 4.3.1.1 Gross Profit Ratio

The gross profit ratio has a significant role in managerial decision making. In the case of MCP Pvt. Ltd., they collected their trading account details and sales details for calculating the gross profit ratio. This ratio helps in decision making related to pricing policy, and for the effective utilisation of available resources.

The gross profit ratio indicates the relationship between gross profit and net sales.

$$\text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Net sales}} \times 100$$

Or

$$\text{Gross profit ratio} = \frac{\text{Sales} - \text{Cost of goods sold}}{\text{Net sales}} \times 100$$



Gross profit means the profit of a company after deducting costs related to making products. It will appear in the income statement (Trading account) of the organisation or will be calculated by deducting the cost of goods sold.

### Significance of Gross Profit Ratio

The gross profit ratio is used to determine how much profit is on hand to cover the company's operating costs. An increase in the gross profit percentage reflects to a rise in the profit margin. To determine growth, the gross profit ratio may be contrasted to the firm's ratio from the prior year or to ratios from comparable businesses. This ratio is a crucial indicator of how effectively a business uses labour and resources when producing products or providing services to customers. In a nutshell, it plays a significant role in determining the company's financial success and profitability. A higher ratio shows higher efficiency and a low gross profit ratio shows low efficiency of the firm.

#### 4.3.1.2 Net Profit Ratio

After analysing the gross profit ratio of MCP Pvt. Ltd., we need to analyse the net profit ratio. So, we collect information about net sales and net profit. The net profit ratio describes the connection between net profit and net sales. It is calculated by dividing the net income after tax by net sales.

$$\text{Net profit ratio} = \frac{\text{Net profit}}{\text{Net sales}} \times 100$$

Net Profit: It is the total earnings of the organisation after subtracting all the expenses. It will appear in the income statement (Profit and Loss Account) of the organisation.

### Significance of Net Profit Ratio

Investors can determine whether the leadership of a business is making enough money from sales and whether running costs and overhead expenses are in check using the net profit ratio. One of the most crucial measures of a company's total financial health is its net profit ratio. A higher ratio shows higher efficiency and a low net profit ratio shows low efficiency.

#### 4.3.1.3 Operating Ratio

In profitability analysis, MCP Pvt. Ltd. understood that they want to analyse the effective control over operating cost and net sales. So, the firm should calculate the operating ratio. The operating ratio helps to compare the relation between operating cost and net sales. Operating costs are ongoing expenses in the day-to-day activities of the business.

$$\text{Operating ratio} = \frac{\text{Operating cost}}{\text{Net sales}} \times 100$$

Operating cost = Cost of goods sold + Operating expenses

## Significance of Operating Ratio

The operating ratio measures how much a business spends overall in relation to its revenue or net sales. In a variety of sectors, the operating ratio is used to analyse companies and gauge their operational effectiveness. An increasing operating ratio is regarded as a bad sign because it means that operating costs are rising compared to sales or revenue. In contrast, if the operating ratio is dropping, either revenue or expenditures are rising, or a combination of the two. Here, lower operating ratios indicate more profitability because they refer to an effective control over operating cost. If a company's operating ratio rises over time, it may be necessary to adopt cost controls for profit upgrades.

Now let us try to find out solutions for some illustrations with different profitability ratios in the coming section.

### Illustration 4.3.1

Calculate gross profit ratio:

Gross profit=15000,

Net sales= 150000

### Solution

#### ◆ Calculation of gross profit ratio

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

$$= \frac{15000}{150000} \times 100$$

$$= 10 \%$$

### Illustration 4.3.2

Calculate gross profit ratio from the trading account.



### Trading account

Particulars	Amount (₹)	Particulars	Amount (₹)
To opening stock	7000	By sales	125000
To purchases	100000	By closing stock	25000
To carriage inwards	8000		
To gross profit C/d	35000		
Total	150000	Total	150000

### Solution

$$\begin{aligned} \text{Gross Profit Ratio} &= \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 \\ &= \frac{35000}{125000} \times 100 \\ &= 28\% \end{aligned}$$

### Illustration 4.3.3

Calculate Gross profit ratio.

a) Sales= 130000

Gross profit is 30% of the cost

### Solution

Let cost price be 100

Sales price= 100+30=130

If the sales price is 130, Gross profit= 30

$$\text{If the sales price is 1 gross profit} = \frac{30}{130}$$

$$\text{If sales price is 130000 gross profit} = \frac{30}{130} \times 130000 = 30000$$

$$\text{Gross profit ratio} = \frac{30000}{130000} \times 100 = 23.07\%$$

#### Illustration 4.3.4

Calculate Gross profit ratio.

a) Sales= 130000

Gross profit 30% on sales

#### Solution

Gross profit= 30% on sales

$$\begin{aligned} &= 130000 \times \frac{30}{100} \\ &= 39000 \end{aligned}$$

$$\text{Gross profit ratio} = \frac{\text{gross profit}}{\text{net sales}} \times 100$$

$$= \frac{39000}{130000} \times 100$$

$$= 30\%$$

#### Illustration 4.3.5

Calculate Gross profit ratio.

a. Sales=250000,



b. cost of goods sold=200000

### Solution

$$\begin{aligned}\text{Gross profit} &= \text{Sales} - \text{Cost of goods sold} \\ &= 250000 - 200000 \\ &= 50000\end{aligned}$$

$$\text{Gross profit ratio} = \frac{50000}{250000} \times 100 = 20\%$$

### Illustration 4.3.6

Calculate Gross profit ratio.

Net profit	₹50000
Selling and distribution	₹8000
Income received	₹4000
Sales	₹1000000
Sales tax@10%	

### Solution

Gross profit=Net profit + Selling and distribution expenses-Income received

$$\begin{aligned}&= 50000 + 8000 - 4000 \\ &= 54000\end{aligned}$$

Net sales=Sales-Sales tax

$$= 1000000 - \left( \frac{10}{100} \times 1000000 \right)$$

$$= 1000000 - 100000$$

$$= 900000$$

$$\text{Gross profit ratio} = \frac{50000}{900000} \times 100 = 6\%$$

### Illustration 4.3.7

Calculate net profit ratio

Net profit=48000

Net sales= 400000

### Solution

$$\begin{aligned}\text{Calculate Net profit ratio} &= \frac{\text{Net profit}}{\text{Net sales}} \times 100 \\ &= \frac{48000}{400000} \times 100 \\ &= 12\%\end{aligned}$$

Calculate net profit ratio from the given data

Sales	₹500000
Administration expenses	₹75000
Selling expense	₹30000
Cost of goods sold	₹195000

### Illustration 4.3.8

Net profit = Sales-Cost of goods sold-Administration expense

$$= 500000 - 195000 - 75000$$

$$= 230000$$

$$= \frac{230,000}{5,00,000} \times 100$$

$$= 46\%$$



### Illustration 4.3.9

From the following data calculate net profit ratio

Sales	₹800000
Gross profit	₹400000
Loss on sale of machinery	₹30000
Operating expenses	₹20000
Provision for tax	₹50000

#### Profit and Loss Account

Dr

Cr

Particulars	Amount (₹)	Particulars	Amount (₹)
To Operating expenses	20000	By Gross profit b/d	400000
To Loss on sale of machinery	30000		
To Provision for tax	50000		
To Net profit	300000		
Total	400000	Total	400000

### Solution

$$\text{Net profit ratio} = \frac{\text{Net profit}}{\text{Net sales}} \times 100$$

$$= \frac{300000}{800000} \times 100$$

$$= 37.5\%$$

### Illustration 4.3.10

Calculate operating ratio.

Sales	₹300000
Operating expenses	₹30000
Cost of goods sold	₹90000

### Solution

$$\text{Operating ratio} = \frac{\text{Operating cost}}{\text{Net sales}} \times 100$$

Operating cost = Cost of goods sold + Operating expenses

$$= 120000$$

$$\text{Operating ratio} = \frac{\text{Operating cost}}{\text{Net sales}} \times 100$$

$$= \frac{120000}{300000} \times 100$$

$$= 40\%$$

### Recap

- ◇ Profitability Ratio: analysing the profitability of the firm
- ◇ Gross profit ratio: relation between gross profit and net sales
- ◇ Net profit ratio: comparison between net profit and net sales
- ◇ Operating ratio: connection between operating cost and net sales



### Objective Questions

1. What is gross profit ratio?
2. What is net profit ratio?
3. What is the major aim of profitability ratios?
4. How to calculate operating cost?
5. How to calculate gross profit from sales and cost of goods sold?

### Answers

1. What is gross profit ratio?
2. What is net profit ratio?
3. What is the major aim of profitability ratios?
4. How to calculate operating cost?
5. How to calculate gross profit from sales and cost of goods sold?

### Self-Assessment Questions

1. What are profitability ratios?
2. Explain different types of profitability ratios.
3. How the Net profit ratio is used to analyse a company?
4. How Operating ratio helps in company analysis?
5. Differentiate gross profit ratio and net profit ratio.

## Assignments

1. Calculate Gross Profit Ratio from the following

- a. Sales – ₹150000
- b. Cost of goods sold - ₹80000

(Ans. 46.67%)

2. The Gross Profit Ratio for a company is 20%. A total of 20% of the revenue is from cash sales, with credit sales totaling ₹100,000. Company incurred indirect costs of ₹1,50,000. Please find the company's net profit ratio. (Ans. 8%)

3. Calculate Operating Ratio

Cost of Sales – ₹350000

Operating Expenses – ₹30000

Sales Revenue – ₹500000

Return Inward – ₹30000

(Ans. 80.85%)

4. Analyse why sales are more important in all profitability ratios?

## Suggested Reading

1. Atrill, Peter and Mclaney, Eddie (2013). *Financial Accounting for Decision-makers*.
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# Unit 4

## Turnover Ratios

### Learning Outcomes

After the completion of this Unit the Learner will be able to:

- ◇ explore turnover ratio
- ◇ explain different types of turnover ratios
- ◇ perceive the significance and calculation of different turnover ratios

### Prerequisite

We know that MCP Pvt. Ltd. produces bags. Bag manufacturing starts from transforming raw materials like leather, zip, etc. into finished goods in the form of bags. These finished goods (bags) are to be sold and thereby cash is received. So, there is a time gap between production and sale. During this period bags are kept as stocks. The sale of these bags consists of cash sales and credit sales. For credit sales, a reasonable time may be granted to the debtors to remit the amount. So, there is a need to analyse the period taken for converting these stocks into sales and receivable into cash. Turnover ratios helps companies to study this and we will look into the details in this unit.

### Keywords

Stock Turnover Ratios, Debtors Turnover Ratios, Creditors Turnover Ratios

## Discussion

The ability of an organisation in utilising its resources effectively can be assessed using Turnover ratios. Let us discuss the concept, relevance, and types of Turnover ratios in this unit.

### 4.4.1 Turnover Ratios

The turnover ratios are also known as activity ratios. They measure the speed of asset conversion into sales.

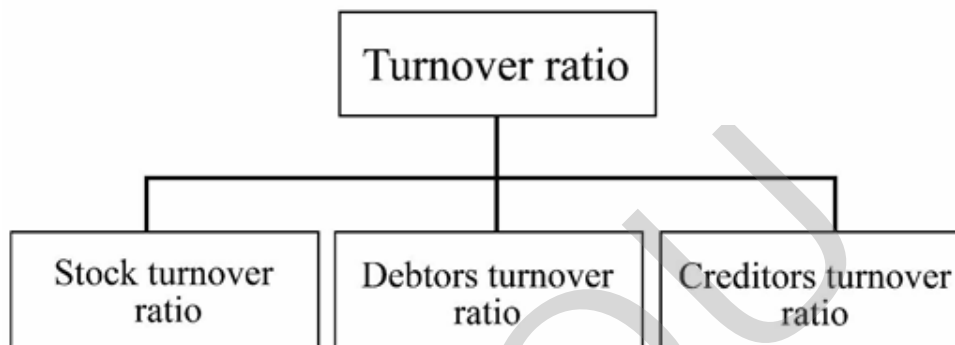


Figure 4.4.1: Classification of turnover ratio

#### 4.4.1.1 Stock Turnover Ratio

The stock turnover ratio is also known as the inventory turnover ratio or stock velocity. Stock velocity helps to analyse whether the investment in inventories is within the proper limit or not. It shows the link between the cost of goods sold and the average stock.

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

Cost of Goods Sold= Sales- Gross Profit

Or

Cost of Goods Sold= (Opening Stock + Purchases + Direct Expenses)-  
Closing Stock

$$\text{Average stock} = \frac{\text{Opening stock} + \text{Closing stock}}{2}$$

If there is no opening stock, the closing stock is considered average stock.

## Significance of Stock Turnover Ratio

Stock turnover ratio shows a great deal about an organisation's forecasting abilities, inventory control, and marketing and promotional know-how. A large ratio suggests either strong sales or a lack of inventory to sustain those rates of sales. A low ratio, on the other hand, denotes sluggish sales, poor market demand, or an excess of inventory. Simply the high ratio shows rapid sales and low inventory turnover ratio indicates blocking of funds in the stock.

### 4.4.1.2 Debtors Turnover Ratio

Debtors turnover ratio is also known as Debtor's velocity and it tells about the credit collection power and policies of the firm. A company's efficiency in recovering receivables from its customers is measured by the financial metric debtors turnover ratio.

$$\text{Debtors Turnover Ratio} = \frac{\text{Net credit sales}}{\text{Average accounts receivable}}$$

Here account receivable includes bills receivables and debtors.

### Significance of Debtors Turnover Ratio

The Debtors turnover ratio provides information about how effectively a business handles collections. This is significant because it has a direct bearing on both the amount of cash that a business could have on hand and the amount of cash that it might anticipate receiving in the near future. A business may not receive funds or be ineffectively managing its cash flow if it does not monitor or handle its collection procedure. Debtors turnover ratio shows the efficiency of employees committed with the collection of book debts. High ratio shows that debts are collected on time.

### 4.4.1.3 Creditors Turnover Ratio

The creditors turnover ratio or the creditors velocity states the relationship between net credit purchase and average accounts payable. This ratio calculates the rate at which money is disbursed to creditors and credit transactions are made. This ratio thus evaluates how effectively a company uses credit to make purchases of goods.

$$\text{Creditors Turnover Ratio} = \frac{\text{Net credit purchases}}{\text{Average accounts payable}}$$

Average accounts payable = Creditors + Bills payable

The creditors turnover ratio shows the punctuality in making payment of credit purchases.

## Significance of creditors turnover ratio

Examining the creditors turnover ratio has been an essential step for businesses deciding if they want to trade with a specific partner. A low ratio could be an indication of financial difficulty, whereas a high ratio indicates that you will likely receive your money sooner or later. High ratio shows payment on time to suppliers for credit purchases and vice versa.

Calculate stock velocity

Cost of goods sold	₹500000
Average stock	₹250000

$$\text{Stock velocity} = \frac{\text{Cost of goods sold}}{\text{Average stock}}$$

$$= \frac{500000}{250000}$$

$$= 2 \text{ times}$$

### Illustration 4.4.2

Calculate stock turnover ratio

Sales	₹100000
Gross Profit	40% on Sales
Average Stock	₹10000

### Solution

$$\begin{aligned} \text{Gross Profit} &= 40\% \text{ on sales} \\ &= 100000 \times 40/100 \\ &= 40000 \end{aligned}$$

$$\begin{aligned} \text{Cost of Goods Sold} &= \text{Net Sales} - \text{Gross Profit} \\ &= 100000 - 40000 \\ &= 60000 \end{aligned}$$

$$\begin{aligned} \text{Stock Turnover Ratio} &= (\text{Cost of goods sold}) / (\text{Average stock}) \\ &= 60000 / 10000 \\ &= 6 \text{ times} \end{aligned}$$



### Illustration 4.4.3

Calculate inventory turnover ratio/stock turnover ratio.

Opening Stock	₹40000
Closing Stock	₹50000
Purchases	₹80000
Carriage Inwards	₹20000

### Solution

Cost of Goods Sold = Opening Stock + Purchases + Carriage Inwards - Closing Stock

$$= 40000 + 80000 + 20000 - 50000$$

$$= 90000$$

$$\text{Average stock} = \frac{\text{Opening stock} + \text{Closing stock}}{2}$$

$$= \frac{40000 + 50000}{2}$$

$$= 45000$$

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

$$= \frac{90000}{45000}$$

$$= 2 \text{ times}$$

### Illustration 4.4.4

Calculate debtor's turnover ratio.

Net credit sales	₹600000
------------------	---------

Debtors	₹20000
Bills Receivable	₹100000

### Solution

$$\begin{aligned}
 \text{Average Accounts Receivable} &= \text{Debtors} + \text{Bills Receivable} \\
 &= 20000 + 100000 \\
 &= 120000
 \end{aligned}$$

$$\begin{aligned}
 \text{Debtor's Turnover Ratio} &= \frac{\text{Net Credit sales}}{\text{Average accounts receivable}} \\
 &= \frac{600000}{120000} \\
 &= 5 \text{ times}
 \end{aligned}$$

### Illustration 4.4.5

Calculate debtors turnover ratio

Total Sales	₹300000
Cash Sales	₹50000
Debtors as on 01.01.2020	₹30000
Debtors as on 31.12.2020	₹40000
Bills Receivable on 01.01.2020	₹20000
Bills Receivable on 31.12.2020	₹30000

### Solution

$$\begin{aligned}
 \text{Credit Sales} &= \text{Total Sales} - \text{Cash Sales} \\
 &= 300000 - 50000 \\
 &= 250000
 \end{aligned}$$



*Average accounts receivable*

$$= \frac{(\text{Opening debtors} + \text{opening bills receivable}) + (\text{Closing debtors} + \text{closing bills receivable})}{2}$$

$$= \frac{(30000 + 20000) + (40000 + 30000)}{2}$$

$$= \frac{50000 + 70000}{2}$$

$$= \frac{120000}{2}$$

$$= 60000$$

$$\text{Debtors Turnover Ratio} = \frac{\text{Net credit sales}}{\text{Average account receivable}}$$

$$= \frac{250000}{60000}$$

$$= 4.1 \text{ times}$$

#### Illustration 4.4.6

Calculate creditors turnover ratio.

Net credit purchase ₹300000

Average accounts payable ₹100000

#### Solution

$$\text{Creditors Turnover Ratio} = \frac{\text{Net credit Purchases}}{\text{Average account payable}}$$

$$= \frac{300000}{100000}$$

$$= 3 \text{ times}$$

### Illustration 4.4.7

Calculate creditors turnover ratio

Net credit purchases	₹400000
Creditors as on 1.1.2020	₹150000
Creditors as on 31.12.2020	₹50000
Bills payable as on 1.1.2020	₹25000
Bills payable as on 31.12.2020	₹175000

### Solution

*Average accounts payable*

$$= \frac{(\text{Opening creditors} + \text{Opening bills payable}) + (\text{Closing creditors} + \text{Closing bills payable})}{2}$$

$$= \frac{(150000 + 25000) + (50000 + 175000)}{2}$$

$$= \frac{175000 + 225000}{2}$$

$$= \frac{400000}{2}$$

$$= 200000$$

$$\text{Creditors Turnover Ratio} = \frac{\text{Net credit purchases}}{\text{Average accounts payable}}$$

$$= \frac{400000}{200000}$$

$$= 2 \text{ times}$$



## Recap

- ◇ Turnover Ratio: measures the speed of assets conversion into sales
- ◇ Stock Turnover Ratio: the link between the cost of goods sold and the average stock
- ◇ Debtors Turnover Ratio: talks about the credit collection power and policy of the firm
- ◇ Creditors Turnover Ratio; relationship between net credit purchase and average accounts payable

## Objective Questions

1. What is turnover ratio?
2. How to calculate debtors turnover ratio?
3. What is cost of goods sold?
4. What is creditors turnover ratio?

## Answers

1. Measures the speed of asset conversion into sales.
2. 
$$\frac{\text{Net credit sales}}{\text{Average accounts receivable}}$$
3. Sales - Gross Profit
4. Relationship between net credit purchase and average accounts payable

### Self-Assessment Questions

1. What is turnover ratio? Explain different types of turnover ratio?
2. Explain the significance of Debtors Turnover ratio
3. Explain the significance of Creditors Turnover ratio

### Assignments

1. Calculate Debtors Turnover Ratio from the given data: Sales – 6,00,000 (20% only in Cash), Opening Receivable - 80,000, Closing Receivable - 1,60,000 (Ans. 4)
2. Determine the opening stock using the following data: The Stock turnover ratio is 1, while the cost of sales is 16,000 and the opening stock is six times greater than the closing stock. (Ans. Opening Stock – 28000)
3. Use the following data to calculate the creditor turnover ratio. Credit purchases total 10,00,000 from 2016 to 2017. On April 1, 2016, the opening balance of creditors and bills due was ₹40000 and ₹5000, and on March 31, 2017, the closing balance of creditors and bills payable was ₹35000 and ₹10000. (Ans. 22.22)
4. Explain how the terms credit sales and credit purchase affect the firm's activity focusing on the turnover ratios.

### Suggested Reading

1. Atrill, Peter and McLaney, Eddie (2013). *Financial Accounting for Decision-makers*.
2. Shukla, M.C, Grewal, T.S: *Advanced Accounts*, S. Chand & Company Ltd., New Delhi
3. Jain S.P. & Narang, K.L. *Advanced Accountancy*, Kalyani publishers, New Delhi
4. Gupta, R.L., Radhaswamy M: *Advanced Accountancy*, Sultan Chand & Sons, New Delhi.



# Unit 5

## Solvency Ratio or Leverage Ratios

### Learning Outcomes

This unit aims at:

- ◇ explaining the solvency ratio
- ◇ describing the different types of solvency ratio
- ◇ familiarising the calculation and the significance of solvency ratios

### Prerequisite

MCP Pvt. Ltd is a popular company in their area of operations and they are interested in investing some money in a new business. What are the things MCP Pvt. Ltd. should analyse before considering new investments?

- ◇ Will this investment affect the current business?
- ◇ How much should they invest?
- ◇ Will a new investment generate profit or loss? etc.

Firstly, the firm should observe the current financial position. How will they identify whether the current financial position is adequate to invest or not? For that, the firm should find out the solvency position. Solvency means the capability to pay long-term debts and financial commitments. It helps to make a decision on investment, financial health, etc. This unit tries to elaborate the solvency ratios.

### Keywords

Solvency ratio, Debt-equity ratio, Interest coverage ratio

## Discussion

Generally, the solvency position of any organisation is assessed using solvency ratios. There are several ratios coming in this category. Let us examine these in detail.

### 4.5.1 Solvency Ratio

The solvency ratio helps MCP Pvt. Ltd. to measure the potential of the firm to meet the long-term financial obligations. Solvency ratios are used by lenders to know and analyse the solvency status of the firm.

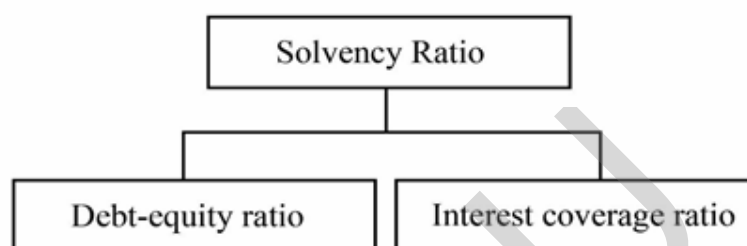


Figure 4.5.1: Classification of solvency ratio

#### 4.5.1.1 Debt Equity Ratio

This ratio is used to analyse the connection between Debt (outsider's fund) and equity (shareholder's fund). The proportion of the company's assets that have been financed by debt is shown by the debt-equity ratio (D/E). The debt-equity ratio, which measures a company's long-term solvency, shows how good its long-term financial strategies are.

$$\text{Debt Equity Ratio} = \frac{\text{Total debt or outsiders fund}}{\text{Total equity or owners fund}}$$

Debt means total outside liabilities (involves all current liabilities and outside liabilities such as debenture, loan, etc.)

Equity means Total Shareholder's Fund

Equity = Share Capital (Equity + Preference) + Reserve and Surplus- Fictitious Assets.

#### Significance of Debt-Equity Ratio

The debt-equity ratio (D/E) is a statistic that sheds light on a company's borrowing

practises. In general, lenders and investors view businesses with high D/E ratios as riskier investment because they may be financing a sizable portion of their prospective growth through borrowing. The satisfied norm for the Debt Equity ratio is 2:1. A high Debt-Equity ratio shows a greater claim of creditors than the owners and a low Debt-Equity ratio shows the claim of creditors is lower than the owners.

#### 4.5.1.2 Interest Coverage Ratio

Interest coverage ratio or debt service ratio shows the link between EBIT (Earnings before Interest and Tax) and fixed interest charges. It describes how well a company can meet its interest dues. A debt and profitability measure called the interest coverage ratio is used to assess how easily a business can pay the interest on its existing debt.

$$\text{Interest Coverage Ratio} = \frac{\text{Net profit before interest and tax or EBIT}}{\text{Fixed interest charges}}$$

#### Significance of Interest Coverage Ratio

The ability of a company to pay the interest on outstanding debt is gauged using the interest coverage ratio. The high interest coverage ratio is satisfactory, but the standard value for this ratio varies from industry to industry. This ratio significance how efficiently a company can manage their fixed investment expenses using the income generated in a year.

#### Illustration 4.5.1

Calculate debt-equity ratio from the given data

Current liabilities	₹25000
Loan	₹200000
Shareholders fund	₹150000

#### Solution

$$\text{Debt Equity Ratio} = \frac{\text{Total debt or outsiders fund}}{\text{Total equity or owners fund}}$$

$$= \frac{225000}{150000}$$

$$= 1.5$$

### Illustration 4.5.2

Calculate debt- equity ratio.

Debentures	₹30000
Equity shares	₹500000
Preference shares	₹300000
Reserve and surpluses	₹50000
Fictitious asset	₹25000
Loan	₹500000

### Solution

$$\begin{aligned} \text{Debt} &= \text{Debentures} + \text{Loan} \\ &= 30000 + 500000 \\ &= 530000 \end{aligned}$$

$$\begin{aligned} \text{Equity} &= \text{Share capital (Equity shares + Preference shares) + Reserve and Surpluses} \\ &- \text{Fictitious Asset} \\ &= (5,00,000 + 300,000) + 50,000 - 25,000 \\ &= 8,25,000 \end{aligned}$$

$$\text{Debt Equity Ratio} = \frac{\text{Total debt or outsiders fund}}{\text{Total equity or owners fund}}$$

$$\frac{530000}{825000}$$

$$0.64$$



### Illustration 4.5.3

From the following calculate Interest coverage ratio

Earnings Before Interest and Tax	₹360000
Fixed Interest Charges	₹30000

$$\text{Interest Coverage Ratio} = \frac{\text{Net profit before interest and tax or EBIT}}{\text{Fixed interest charges}}$$

$$= \frac{360000}{30000}$$
$$= 12 \text{ times}$$

### Illustration 4.5.4

From the following Balance Sheet calculate the current ratio and Debt-Equity ratio

Liabilities	Amount(₹)	Asset	Amount(₹)
Capital	500000	Fixed Asset	800000
Debentures	400000	Current Asset	150000
Current Liabilities	50000		
Total	950000	Total	950000

### Solution

◆ Calculation of Current Ratio

$$\text{Current ratio} = \frac{\text{Current asset}}{\text{Current liabilities}}$$

$$= \frac{150000}{50000}$$

$$= 3:1$$

◆ Calculation of Debt Equity Ratio

$$\begin{aligned} \text{Debt Equity Ratio} &= \frac{\text{Total debt or outsiders fund}}{\text{Total equity or owners fund}} \\ &= \frac{450000}{500000} \\ &= 0.9:1 \end{aligned}$$

### Recap

- ◇ Solvency ratio: Measures the potential to meet financial obligations
- ◇ Debt equity ratio: Connection between Debt and Equity
- ◇ Interest coverage ratio: Relation between EBIT and Fixed Interest Charges

### Objective Questions

1. How to calculate the Debt-Equity Ratio?
2. What is the full form of EBIT?
3. What is the Interest coverage ratio?
4. How to calculate Total Equity?
5. What is debt-equity ratio?

### Answers

1.  $\frac{\text{Total debt or outsiders fund}}{\text{Total equity or owners fund}}$
2. Earnings Before Interest and Tax
3. Relation between EBIT and Fixed Interest Charges
4. Equity= Share Capital (Equity & Preference)+Reserve & Surplus- Fictitious Assets.
5. The connection between Debt and Equity



## Self-Assessment Questions

1. What is solvency ratio? Explain different types of solvency ratio with suitable examples?
2. Explain the significance of Debt-Equity Ratio
3. Explain the significance of Interest Coverage Ratio

## Assignments

1. From the following information calculate Debt Equity Ratio:-

Share capital (10,000 shares of 10 each)	₹1,00,000
Debentures	₹75,000
General Reserve	₹45,000
Long term provision	₹25,000
Surplus	₹30,000
Outstanding Expenses	₹10,000

(Ans. 0.62:1)

2. From the following details, calculate interest coverage ratio:

Net Profit after tax ₹60,000; 15% Long-term debt ₹10,00,000; and Tax rate 40%.

(Ans. 0.67 times)

3. Calculate Interest Coverage Ratio from the following

Particulars	Amount
Profit after interest and taxes	497000
Rate of Income tax	30%
12% Debentures	600000

(Ans. 10.86)

4. Make a list of 10 companies from different industries and find out their Debt to Equity ratio using their final accounts and discuss your inferences.

### Suggested Reading

1. Atrill, Peter and McLaney, Eddie (2013). *Financial Accounting for Decision-makers*.
2. Shukla, M.C, Grewal, T.S: *Advanced Accounts*, S. Chand & Company Ltd. Ltd, New Delhi
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**BLOCK  
05**

**Introduction to  
Cost Accounting**

# Unit 1

## Introduction to Cost Accounting

### Learning Outcomes

Upon the completion of this unit, the learner will be able to;

- ◇ explain the concept of cost.
- ◇ describe the classification of cost based on the nature of elements.
- ◇ analyse the classification of cost based on the traceability to the product.
- ◇ elaborating the classification of cost based on the change in volume of output.

### Prerequisite

Wooden Arks, a well-established furniture maker, recently expanded their product line by introducing a new variety of chairs. After a year of dull sales and unsatisfactory profits, the company held a meeting to address the issue. They found the chairs' high production costs were preventing the desired profit margins. To reduce costs and restore profitability, Wooden Arks needed a detailed analysis of their manufacturing expenses. Financial accounting alone could not provide the cost information. Wooden Arks needed to know the exact costs involved in making the new chairs. This highlights the importance of cost accounting. Unlike financial accounting, cost accounting focuses on identifying all costs related to producing and selling individual products. With accurate cost data, companies can pinpoint where the expenses are too high and take steps to improve efficiency and reduce spending. For businesses like Wooden Arks introducing new products, understanding precise manufacturing costs through cost accounting is essential to setting prices that yield profits. So while financial accounting provides predominant financial reports, cost accounting offers the detailed cost insights companies need to make and sell products profitably. This makes learning cost accounting vital for managers, allowing informed decisions that maximize profits.

### Keywords

Cost, Cost accounting, Material cost, Labour cost, Expenses, Direct cost, Indirect cost, Prime cost, Overheads, Fixed cost, Variable cost.



## Discussion

Estimating cost can help entrepreneurs in many ways as we discussed earlier. Let us try to understand the term cost and its implications in detail.

### 5.1.1 Cost

Wooden Arks had introduced this new variety of chairs with an objective of expanding their business by capturing the attention and interest of a larger section of customers. This decision to introduce a new product was not just a cakewalk for the company. They had to make a lot of adjustments and sacrifices in terms of their operations to achieve this. Let us analyse some of the additional efforts taken by Wooden Arks to produce the new variety of chair.

- ◇ Use of high quality teak wood, as it is the core raw material of the chair.
- ◇ Use of other supplementary components such as cushions, nails, glue, bushes, rollers.
- ◇ Efforts taken for transporting these teak wood and other components to the factory location.
- ◇ Use of highly skilled workers who can manufacture the chairs in required numbers and with highest efficiency in terms of time and raw materials usage.
- ◇ Efforts taken for marketing the chair to the potential customers and also for transporting the final product to the retailers and customers for sale.

Wooden Arks has gone through all these additional efforts with respect to the new chair production, for the sake of gaining a better profit share from its operations. So, in order to analyse whether these efforts or sacrifices they have borne, resulted in the desired objective, first the company needs to convert all these additional efforts and sacrifices into monetary terms so that they can compare it with the profit generated from the sale of the new chairs. The combined monetary value of all the additional efforts and sacrifices experienced by Wooden Arks with respect to the new chair production is known as its production cost. So, in general you can define cost as the amount of resource exchanged or sacrificed which is expressed in monetary terms for the purpose of attaining some goods and services in return.

### 5.1.2 Classification of Cost

We know that Wooden Arks have decided to reduce the selling price of the new chairs and they plan on achieving this by reducing the production cost associated with them. So how can the manager of Wooden Arks go about reducing the production cost associated with the chair? The information available to the manager in the beginning will be that of the total production cost of the chair. He/ She will have to identify the

various factors involved in the production process of chair and find the cost associated with each of the factors.

We have discussed different costs associated with production of new chairs in the cost section. As you can see from that, the total cost associated with the chair is differentiated on the basis of the material, labour and other expenses. What is the reason behind segregating the cost like this?

Characterisation of the cost of production according to their nature will help the management in identifying the areas where cost is high and take necessary steps as to bring it under control. This procedure of assembling the components of cost on the basis of similarities of nature, traceability to the product etc. is called classification of cost. Cost can be classified in many ways on the basis of variety of factors. In this section we are going to discuss the following classifications.

1. Classification on the basis of the nature of elements.
2. Classification on the basis of the traceability to the product.
3. Classification based on the variability.

### 5.1.3 Classification on the basis of the nature of elements.

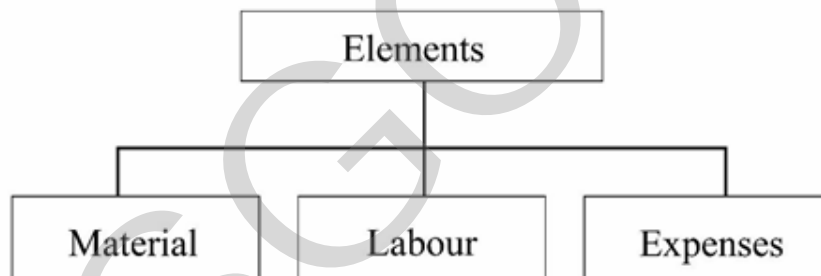


Figure 5.1.1 Classification on the basis of the nature of elements

In the figure 5.3.1 the costs are classified on the basis of constituent elements of the product, such as the cost of material, cost of labour and other expenses. Now let us see how the manager of Wooden Arks classifies the cost associated with the chair on the basis of the nature of the elements.

- ◇ For Wooden Arks, material cost includes cost of teak wood, nails, bush, glue, packaging material, cushions, etc. used for production and sale of the chair. So, we can say materials cost are cost of raw materials that are used for manufacturing a product.
- ◇ Labour cost is the compensations paid to all the workers who assist in the production and sale of the product. For instance, labour cost includes all remunerations paid to the skilled workers, floor managers, office staff, security, etc. who work in Wooden Arks.

- ◇ Expenses include all cost other than material cost and labour cost incurred in the production and selling of goods and services. In case of Wooden Arks, expenses consist of rent paid for Wooden Arks factory, transportation cost for bringing the teak wood and other raw materials to the factory, marketing expenses, and the cost for distributing the finished chair for sale.

### 5.1.4 Classification based on the traceability to the product.

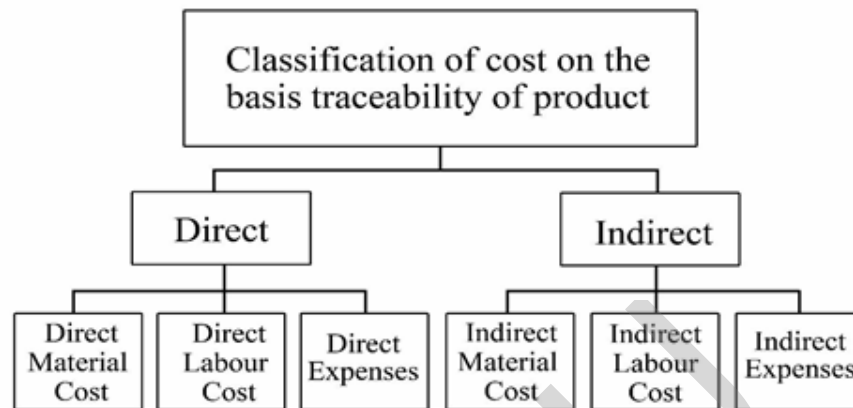


Figure 5.1.2 Classification on the basis of traceability to the product

In the figure 5.1.2 the costs are classified on the basis of its traceability to the product, which means the costs are classified based on how they can be linked to the product. We will see how this classification of cost is done for production of chairs in case of Wooden Arks.

#### 5.1.4.1 Direct Cost

In the previous classification, the cost associated with the chair was segregated as material cost, labour cost and expenses. Now these three costs can be further classified as direct cost and indirect cost based on how they can be allocated to a particular chair. Direct cost includes all the cost that can be directly allocated to a particular chair. It includes direct material cost, direct labour cost and direct expenses incurred by Wooden Arks in the production of the chair. We will discuss it one by one:

- ◇ Direct materials cost includes cost of those raw materials directly used in the product. Teak wood, nails, cushions, glue, bushes etc. are materials that are used for manufacturing the chair. Without these items, chair cannot be properly finished as a single unit. One could directly observe the presence of these items in the chair. The cost associated with these materials is called direct material cost.
- ◇ Direct Labour cost is the remuneration paid to all labourers who take part in the production. Wooden Arks purchase the direct materials and provide them to the carpenters. They work with the wood, shape it in the desired form and assemble it with other materials using their skills and tools. After days of quality work, they convert the direct materials into the chair as desired by Wooden Arks.

Wages paid for the work done by these carpenters are called direct labour.

- ◇ Direct Expenses include all those expenses that can be specifically linked to the manufacturing of a particular product or service other than direct material cost and direct labour cost. Suppose Wooden Arks had imported the cushions for chair from Australia, they need to pay tax as import duty to the government. Expenses will be incurred by Wooden Arks for transporting the teak woods from the wood mill to the Wooden Arks premises in trucks. Wooden Arks factory should have electricity, lighting ventilation, etc. for the carpenters to carry out their work. These expenses are incurred in direct association with the production of the chair. But they cannot be put under direct material cost or direct labour cost so they are categorised as direct expenses.

Aggregation of all direct costs such as cost of teakwood and other materials, wages paid to carpenters, cost of transportation of wood, import duty, etc. together form about 50% to 80% of the total manufacturing cost of the chair. Since this cost is of prime importance with respect to the production process it is known as Prime cost.

$$\text{Prime cost} = \text{Direct material} + \text{Direct labour} + \text{Direct expense}$$

### 5.1.4.2 Indirect Cost

Apart from the direct cost, Wooden Arks incurs some indirect cost as well in the production and sale of the chair. These costs are not directly incurred from the production of the chair and it cannot be linked to a particular chair but rather it acts commonly to all the chairs. Indirect cost is also classified as indirect material cost, indirect labour cost and indirect expenses. We will separately look at each category.

- ◇ Indirect material cost is the cost of materials used by the company which cannot be directly allotted to a product or service but it can be shared among various products or services. For instance, tools used by the carpenters need to be properly oiled and lubricated for it to function well. The production department also requires cleaning tools for cleaning the production floor, equipment, etc. But these items are not directly associated with the production process and they cannot be linked to a particular unit of chair. These materials are called indirect materials with respect to the chair production.
- ◇ Indirect labour cost includes payments made to the labourers for activities other than production of goods and services. For example, apart from the carpenters Wooden Arks also has general manager, office staff, security staff, etc. in their pay roll. These people are important for running the company but they do not directly take part in the production of the chair. Salaries paid to these people are the indirect labour cost incurred by Wooden Arks.
- ◇ Wooden Arks also incurs some other expenses as well in running their facility. Let us examine them from the following scenario.
  - a. If Wooden Arks needs to achieve the desired sales target with respect to the chair, they will have to spend some money for advertising their



product to attract the potential customers.

- b. There is a high possibility of loss occurring for Wooden Arks facility due to damages from fire, natural calamities, etc. So, in order to safeguard the company from this contingency, management insures the factory and warehouse.

These expenses incurred by the factory do not come under indirect material cost or indirect labour cost. And they cannot be linked to a particular chair but rather it is applicable to entire operations of the factory. These expenses are called indirect expenses.

Combination of all indirect costs like cost of oil, lubricants, cleaning supplies, salaries of office staff, advertising expenses together form Overhead cost.

$$\text{Overheads} = \text{Indirect material} + \text{Indirect labour} + \text{Indirect expense}$$

### 5.1.5 Classification based on variability

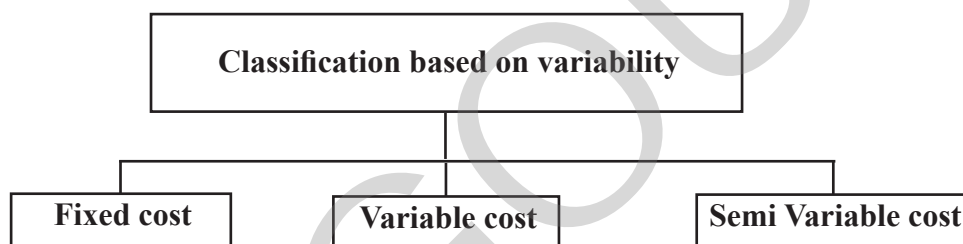


Figure 5.1.3 Classification based on variability

In the figure 5.1.3 costs are classified on the basis of variability i.e., how the cost associated with the production of the chair are affected by the change in the number of units of chairs produced. According to this criterion all the costs associated with the production of the chair can be divided into fixed cost and variable cost.

#### 5.1.5.1 Fixed Cost

Wooden Arks will have incurred certain cost even before producing a single unit of their products. Let us check some of the mandatory costs incurred by Wooden Arks as a result of its inception.

- ◇ They will have to pay rent for the land and building where the factory operates.
- ◇ Wooden Arks will require certain vehicles of their own for assisting their operations.
- ◇ They will have to pay for insuring their factory against damages from industrial risk.

You can see that these costs incurred by Wooden Arks have no relation to the number of chairs manufactured by them, which means even if Wooden Arks manufacture hundred chairs or zero chair these costs incurred by them will remain the same. These costs are called fixed cost. Fixed cost is the ‘cost which remains unaffected by variations in the volume of output’.

But this does not mean that fixed cost will always remain constant. In the case of Wooden Arks, the land and the building in which they operate are taken on lease for a period of fifteen years, and it means the management of Wooden Arks has contractually agreed to pay a certain amount of money to the original owner of the land and building for using their facility for an agreed period of fifteen years. Thus, the lease amount paid will be independent of the operations and number of units of furniture produced by Wooden Arks during these 15 years. This lease amount incurred by Wooden Arks is the fixed cost and which will remain constant for a period of fifteen years and after that it will change. Since fixed cost remains constant for a certain period, it is also known as period cost. Now, let us graphically see the relationship between fixed cost and volume of output.

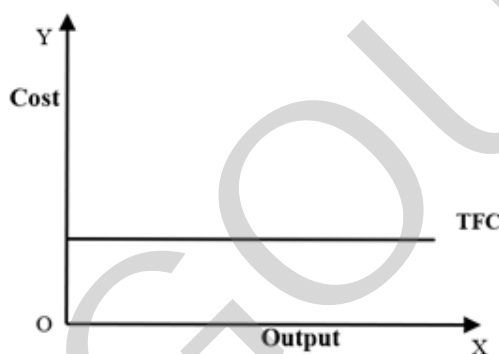


Figure 5.1.4 Fixed cost relation with volume of output

In the figure 5.1.4 total fixed cost (TFC) is plotted against output of production (number of chairs) in the x-axis and cost incurred (lease amount) by Wooden Arks in the y-axis. TFC curve does not start from the origin because even at zero production (zero chairs produced) Wooden Arks will have to pay fixed cost (lease amount). TFC curve remains horizontal to the x-axis as it is constant at all levels of output (number of chairs produced). The starting point of TFC curve is set by the lease agreement formed between Wooden Arks management and the owner of the land and the building.

### 5.1.5.2 Variable cost

Now think about the cost that Wooden Arks will experience as they start the production of the chairs. They are as follows:

- ◇ Cost for the teak wood, cushion, glue, nails bushes, etc..
- ◇ Wages paid to the carpenters involved in production of the chairs.

- ◇ Cost for transportation of raw materials to the factory.
- ◇ Cost of electricity, ventilation, lighting, etc.. used by the factory to assist the carpenters in their work.

These costs have a very direct association with the production of the chair and they will increase with the increase in number of chairs produced. As these costs vary with the number of output (chairs) produced, they are called variable cost. Suppose the variable cost for producing one unit of chair is ₹200. So, if you manufacture 10 chairs, then the total variable cost will be ₹2000 as it increases with increase in number of chairs being manufactured. Variable cost per unit of chair is constant which is ₹200, but total variable cost increases with increase in the number of chairs manufactured. Given below is the calculation for the total variable cost incurred by Wooden Arks in producing 10 chairs.

$$\begin{aligned}
 \text{Total Variable cost} &= \text{variable cost per unit of output} \times \text{volume of output} \\
 &= ₹ 200 \times 10 \\
 \text{Total Variable cost} &= ₹2000
 \end{aligned}$$

Let us check the graphical representation of the relationship between total variable cost and volume of output.

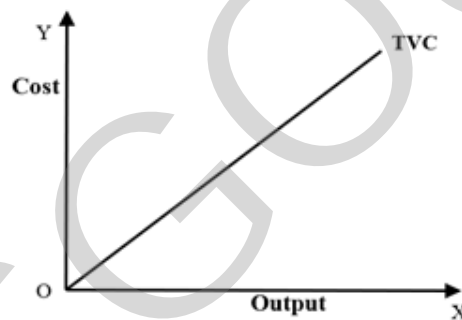


Figure 5.1.5 Variable cost relation with output

In the figure 5.1.5 variable cost is plotted against volume of output (number of chairs) in the x-axis and total cost incurred by the firm in the y-axis. As you can see from the figure, the total variable cost curve (TVC) starts from the origin (zero) because the variable cost directly depends on units of production. In the beginning when no chairs are produced, variable cost incurred is zero. With gradual increase in the number of chairs, variable cost also increases there by resulting in an upward sloping variable cost curve.

### 5.1.5.3 Semi- variable Cost

Semi - variable costs contain both a fixed and a variable component. A portion of the cost remains constant regardless of the level of activity of while the otehr portion varies with the level of activity. For eg: telephone bills (a fixed months fee plus changes for usage)

## Recap

- ◇ Cost is the monetary value of resources utilized for producing goods or services
- ◇ Grouping of costs with similar attributes is classification of cost
- ◇ Materials cost are cost of raw materials
- ◇ Labour costs are remuneration paid to workers
- ◇ Traceability to product classification includes direct cost and indirect cost
- ◇ Cost of complimentary materials form indirect material cost
- ◇ Volume of output classification of cost includes fixed cost and variable cost
- ◇ Fixed cost remains constant with output produced
- ◇ Variable cost changes with volume of output
- ◇ Semi-variable cost contains both fixed and variable component

## Objective Questions

1. How are sacrifices associated with production of a commodity monetarily represented?
2. What is the main consideration while fixing the selling price of a commodity?
3. What can be determined from the production cost and selling price of a commodity?
4. Write any one the application of Cost Accounting?
5. What type of cost is transportation cost of raw materials?
6. What are the components of Prime cost?
7. What are the components of Overheads?
8. What is the other name of fixed cost?
9. What cost changes in direct properties to the level of output.



## Answers

1. As cost
2. Cost of production
3. Profit.
4. Cost reduction
5. Direct expense
6. Direct material cost, Direct labour cost, Direct expense
7. Indirect material cost, Indirect labour cost, Indirect expenses
8. Period cost
9. Variable cost

## Self-Assessment Questions

1. What is the cost?
2. Explain cost accounting with examples?
3. What are the Classifications of cost on the basis of the nature of elements?
4. Write a short note on the Classification of cost on the basis of traceability to the product.
5. What are types of cost based on change in volume of output?

## Assignments

1. Try to obtain a rough estimate of the production cost of items like bags, shoes, etc.. from someone who is associated with its production and compare it with market selling price to determine the profit the companies are making.
2. Consider some daily used product like mobile phones and try to identify the direct cost and indirect cost associated with it.
3. Try to identify the fixed cost and variable cost associated with a factory in your locality.

### Suggested Reading

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# Unit 2

## Cost Accounting

### Learning Outcomes

This unit aims at:

- ◇ learning the concept, objectives, and scope of Cost Accounting.
- ◇ examining the difference between Cost Accounting and Financial Accounting.
- ◇ describing the difference between Cost Accounting and Management Accounting.
- ◇ introducing the concept of Marginal Costing

### Prerequisite

Wooden Arks, an established furniture company, relies on different branches of accounting to meet its diverse needs. Financial accounting is crucial for assessing the company's profit and financial position. The owners aim to increase the company's overall value, where as creditors focus on ensuring the company can repay its debts. Financial accounting provides this important information. However, when it comes to determining the exact cost of manufacturing furniture, financial accounting falls short. For that purpose, Wooden Arks turns to cost accounting, which helps in controlling expenses, analysing manufacturing costs, and setting appropriate prices. Cost accounting is essential for internal decision-making and cost management.

In certain situations, arises the dilemma of whether to make the cushions for the chairs within the firm or buy it from other suppliers, here the company needs to make informed decision. This is where management accounting comes into play. Management accounting provides accurate and timely reports to assist the management in making efficient and economic decisions. It helps in analysing different options, evaluating costs, and maximising profitability.

These three branches of accounting - financial, cost, and management - cater to the distinct needs of Wooden Arks, enabling the company to effectively manage its operations, finances, and decision-making processes. We will discuss this in detail in this Unit.

## Keywords

Cost Accounting, Financial Accounting, Management Accounting, Marginal Costing, Contribution, Breakeven Point, Margin of Safety

## Discussion

Cost accounting has emerged as an important field of accounting due to its invaluable applications in business. Let us explore the branch of cost accounting here.

### 5.2.1 Cost Accounting

Recall the scenario from previous unit, that Wooden Arks was not able to achieve the desired objective by introducing the new chair into the market. All the major inputs that came from the market with respect to the chairs' poor performance, pinpoints to the fact that the customers were mainly dissatisfied at its selling price. So, the company management was left with no alternative but to reduce the selling price of the chairs. The management has the understanding that this is not an easy task. So, you might be wondering why the management is showing so much of concern for reducing the selling price of a commodity that they had initially fixed. It is because of the fact that selling price of any commodity is fixed on the basis of production cost and desired amount of profit the company expects out of the commodity's sale. You can understand it from the following relations:

$$\text{Selling price} = \text{Cost of production} + \text{Profit}$$

For instance, if production cost of the new chair is ₹200 and Wooden Arks expects to earn a profit of ₹100 out of its sale, then they will fix the selling price of the new chair at ₹300, which means if wooden Arks are selling the chair anywhere below the price of ₹300 then their profit margin of ₹100 will be affected. The company has no intention of lowering the profit expectation. So, Wooden Arks can reduce the selling price only by reducing the production cost associated with the new chair.

For the cost reduction process to be in motion, Wooden Arks will have to first accurately determine the total cost associated with the production of the new chair. Cost Accounting keeps a detailed record of all the cost associated with various factors of chair production, such as raw material cost, transportation cost, labour cost, marketing cost, distribution cost etc. This classification and recording of cost associated with various factors help the Wooden Arks in determining in which area of production they are experiencing additional cost. Suppose if teak wood is very expensive, then Wooden Arks can look at some other less expensive wood as raw material. The total cost of production of the chairs can be controlled that way. So, we can say that Cost Accounting is a general procedure by which the cost associated with goods and services are determined and controlled.



## 5.2.2 Objectives of Cost Accounting

In order to accurately estimate the cost of goods and services, it is important to understand how expenses for materials, labour, and overheads are recorded, categorised, and allocated. But, as commerce and industry advance, the objectives of cost accounting are always shifting. Following are some of the important objectives of Cost Accounting:

a. Estimation of cost

Costs incurred by the company should be accumulated, charged and calculated for each of the cost object concerned. The cost object can be a unit, job, process, department.

b. Find out selling price as well as profit

Cost accounting helps in setting the price at which each product has to be sold and thereby ascertaining the profitability of that item.

c. Cost control

To have discipline in the spending behaviour of a firm is necessary for its success. Cost accounting helps to keep balance in the expenditures of the firm. This involves planning the expenditure in advance and comparing the actual spending with the planned expenditure on a timely basis.

d. Cost reduction

By finding out the most cost effective ways to produce an item, the company can cut costs up to an optimum level. The goal of cost reduction is to improve profitability by lowering costs through various means such as eliminating waste renegotiably contrarily or adopting new technologies while maintaining business performance in the long run.

e. Act as key to decision making

Cost accounting provides the management with inputs that helps managers to take informed decisions on day to day affairs of the business.

## 5.2.3 Scope of Cost Accounting

Cost accounting has a broad use. For the purpose of assessing costs and controlling them, cost accounting makes use of a wide variety of methodologies, tools, procedures, processes, and systems. But in essence, we categorise its scope into three main categories.



Figure 5.2.1 Scope of Cost Accounting

i. Cost Ascertainment:

Cost accounting gathers a product's material, labour, and overhead costs and attempts to determine the overall and per-unit costs of the product. The overall cost will be determined using historical, industry-standard, or predicted data. The cost accountant will then employ any method of costing, such as direct costing technique, particular order costing, and operation costing. These procedures and methodologies can be applied to the calculation of various natural products within the same business.

ii. Cost Records

Cost accountants maintain cost books, vouchers, ledgers, reports, and other cost-related documentation for comparison and future use. It will also fall within the purview of cost accounting.

iii. Cost Control

Cost control is the process of stunning and monitoring the costs associated with a business to ensure that a business operates within its financial limits. Several strategies and procedures were employed by cost accountants in this area to control costs. Saving one rupee on a product's price equates to earning one rupee from the manufacture of that product. Thus, budgetary control, standard costing, break-even analysis, and many other approaches are used by cost accountants to control costs.

## 5.2.4 Financial Accounting

From the discussions we had about accounting in general in the first block reflects Financial Accounting. We can define financial accounting as systematic reporting of the financial position and performance of a company through financial statements for the sake of shareholders/owners, creditors. Financial accounting was the first branch of accounting that existed initially in the world. Later, it evolved into other branches to satisfy the additional requirements.

The difference between Financial Accounting and Cost Accounting are given in the table below:

Table 5.2.1: Difference between Financial Accounting and Cost Accounting

<b>Basis for comparison</b>	<b>Financial Accounting</b>	<b>Cost Accounting</b>
What does it contain?	General information regarding overall profit and loss.	Specific information regarding the cost of manufacturing
When is it prepared?	Normally by the end of the financial year.	As and when the manufacturing process is going on.
For whom is it prepared?	Prepared for shareholders, creditors, government, public, etc..	Prepared for the internal management.
What kind of transactions does it record?	Monetary transactions are only recorded.	Monetary transactions and non-monetary transactions like working hours, number of units produced, etc. are also recorded.
Does it measure efficiency of inputs?	It does not indicate the productivity of workers and machinery.	It can give details as to the productivity of workers and machinery.
Will the reports be published?	Financial statements will be published for the sake for external parties.	Cost reports will not be available to the general public.
Does it give suggestions for improvement?	It merely states the facts as it is.	It gives suggestions as to control cost and attain efficiency.
Is it compulsory?	They are mandatory as per the Companies Act, 2013 Sec 128 and Income Tax Act, 1961	They are usually non mandatory and are prepared on the requirement of the management.
Does it have a standard format?	Based on prescribed format.	Have standard format but it is not compulsory.

### 5.2.5 Management Accounting

As a company, Wooden Arks always have intentions about expanding its operations and to attain a better financial position in the future. For that, the company management will have to be on be on their toes and act spontaneously according to changing market demands. The company will be faced with serious strategic decision-making at various stages of its operations. In order take the right decisions the company management should have access to detailed information with respect to the circumstances. Let us try to understand some of the decision-making that Wooden Arks have to do come across from the following scenarios:

- ◇ Suppose Wooden Arks is manufacturing more tables at present and they get information from a forecast study with respect to the customer needs and changing trends that wooden cushioned chairs will be in demand in the near future. Then Wooden Arks will give more priority to cushioned chair manufacturing.
- ◇ If the company management is having a doubt with respect to making or buying the cushions for the chairs, then it will also be sorted out from the detailed information that helps them to compare the cost associated with making and buying the cushions and choose any of this method in order reduce cost.

Where do management get this information? Management Accounting provides this information which aids in decision-making process of the management. Management accounting helps an organisation to achieve all their goals by providing accounting information from internal and external sources in a refined manner so as to assist management in forecasting and decision-making.

### 5.2.5.1 Difference between Management Accounting and Cost Accounting

Differences between management accounting and cost accounting can be understood based on following questions:

**Table 5.2.2 Differences between Management Accounting and Cost Accounting**

Basis for comparison	Management Accounting	Cost Accounting
How does it originate?	Originated as a result of requirement of the modern business world.	Originated during industrial revolution to find cost of complex products.
What is its objective?	To formulate policies and plans for the future.	To accurately record manufacturing cost.
What is its scope?	It has wider scope as it utilizes data from financial accounting and cost accounting for making accurate decisions.	It has narrow scope as it deals with only cost data.
How is the data used?	Mainly uses data to forecast the future decision-making.	Past and present data are used for cost estimation.
Are they interdependent?	Can function only in accordance with cost accounting.	Can function independently.
Do they follow any rules and regulations?	Do not follow any rules in report preparation	Certain principles are followed for recording cost.

So far, we have discussed various branches of accounting and its features. We have



also learned tools like cash flow statement, fund flow statement, ratio analysis which helps managers in decision making. Similarly, there are several other techniques in cost accounting which aids managers in decision making. Marginal costing is one of such technique which has wide applications in business decision making. Let us discuss this in the coming section.

## 5.2.6 Marginal Costing

Marginal Costing is a technique which considers only the marginal costs associated with production for decision making. In order to understand the concept of marginal cost, let us have a look at an example.

Try to recollect the illustration we did in the previous chapter about variable cost. In that scenario Wooden Arks manufactured 10 chairs and their total variable cost is ₹ 2000 as the variable cost for producing a single chair is ₹ 200. Wooden Arks now goes on to manufacture one additional unit of chair i.e., 11<sup>th</sup> unit, now the total variable cost of production is ₹ 2200. It means that when Wooden Arks increases its production by one unit, its total production cost increases by ₹ 200. This additional ₹ 200 incurred from the production of an additional unit of chair is the marginal cost of Wooden Arks.

Marginal cost can be defined as the cost of producing an additional unit of a commodity. It is also known as differential cost as the marginal cost varies with the difference in the volume of output. From this scenario, we can also understand that both the variable cost and the marginal cost for producing a single chair is ₹ 200. So, we can also conclude that in accounting variable cost per unit and marginal cost for a company are the same.

Following are some of the important terminologies you need to be familiar with for understanding the marginal costing technique.

◇ Contribution:

Continuing with the same scenario where Wooden Arks produces 11 chairs at a production cost (total variable cost) of ₹2200 and if these 11 chairs are sold for a total of ₹ 3300, then Wooden Arks gets a benefit of ₹ 1100 from this process. This benefit (₹ 1100) the company receives from its operations is known as Contribution. So, contribution is the difference between Sales revenue and Variable cost. So, contribution can be represented as:

$$\text{Contribution} = \text{Sales revenue} - \text{Variable cost}$$

◇ Profit Volume Ratio:

If the company need to know what will happen to their profit if they further increase the production and sale of the chairs, a relationship needs to be established between contribution and the sales. This relationship will help firms in the decision-making process with respect to the level of output to be sold to obtain a desired amount of profit. Since, the contribution and the sales revenue are of same nature (both are expressed in monetary terms), their relationship can be established through a ratio. This ratio is

known as Profit/ Volume ratio or P/V ratio. It gives the rate at which profit increases with respect to increase in sales. P/V ratio can be represented as:

$$\frac{P}{V} \text{ ratio} = \frac{\text{Contribution}}{\text{sales}} \times 100$$

◇ Breakeven Point:

Breakeven point gives an idea to the management regarding the minimum level of production to be undertaken to become economically viable. The point where total cost and total revenue equates denotes the break-even point. At this point the sales revenue is equal to the total production cost. It is the point of no profit or no loss for the company. This can be calculated as;

$$\text{Breakeven point} = \frac{\text{Fixed Cost}}{\text{Sales Revenue} - \text{Variable cost}}$$

$$\text{Breakeven point} = \frac{\text{Fixed Cost}}{\text{Contribution per unit}}$$

$$\text{Breakeven sales (in Rs)} = \frac{\text{Fixed Cost}}{\frac{P}{V} \text{ Ratio}}$$

◇ Margin of Safety:

Margin of safety is the difference between actual sales and break-even sales. It is necessary to ensure that there is adequate margin of safety for the smooth functioning of the organisation. This can be calculated as;

$$\text{Margin of Safety} = \text{Actual Sales} - \text{Breakeven Sales}$$

OR

$$\text{Margin of Safety} = \frac{\text{Profit}}{\frac{P}{V} \text{ Ratio}}$$

### 5.2.6.1 Application of Marginal Costing in Decision Making

Managers can rely on marginal costing technique to solve many business-related problems. Some of the important situations where marginal costing can be applied is discussed below.

- ◇ **Make or buy decision** – Suppose the variable cost for making an item comes to ₹ 50 and an outside supplier is ready to provide the same to you for ₹ 60, then as rational person you should go for making it inhouse as it is less expensive. So, in general if purchase price of a component is less than the variable cost of manufacturing it, then the firm should go for the buy decision.



- ◇ **Pricing decision** - Your company will experience different conditions in the market depending upon the competition present from time to time. Marginal costing technique assists the management in setting price according to market conditions, such as normal conditions, competition, exceptional cases. Marginal costing helps in fixing prices
- ◇ **Profit planning** - We know that both variable cost and selling price determine the contribution which in turn affects the profit. If this change is left unchecked it will adversely affect the future profit earning capacity of the firm. Now what is the role of marginal costing in profit planning? Marginal costing through break even analysis helps firms to assess the breakeven point with respect to the changes in variable cost and selling price in order to obtain desired profit. Break even analysis determines output needed to obtain desired profit.
- ◇ **Product mix selection** – Marginal costing helps in determination of the most profitable product in the product mix of the company. This is done by calculating the contribution of various products in the product mix. Product with highest contribution will be the most profitable.
- ◇ **Production method selection** – Each production technique, whether it is manual or automated has its advantage and disadvantage and its suitability to a company can be identified through marginal costing method. Marginal costing technique provide them with an insight into the benefit (Contribution) they will get out of different techniques. The company can choose a technique with highest contribution which will be the most profitable one.
- ◇ **Reduction of cost** – Marginal Costing technique can suggest different alternatives for expensive variable costs. In order to reduce the cost of production the management can pin point various variable cost factors like cost of direct materials, cost of direct labour, etc., which are expensive and look for alternatives to replace them, thereby reducing the variable cost which in turn reduces the total cost of production.
- ◇ **Shutdown decision** - Marginal costing through breakeven analysis lets firms know the exact volume of output to produce, so that they do not suffer loss even if they are not earning profit. The production and sale of this breakeven level of ensure that the company gets sufficient contribution for covering the total production cost which allows them to sustain in business or otherwise to stop operation.

## Recap

- ◇ Cost Accounting aids in determination and control of cost associated with goods.
- ◇ Cost accounting aims at:
  - Determination of production cost
  - Finding profitability of a product
  - Introducing cost control/reduction measures
- ◇ Cost Accounting helps in determination of cost associated with goods.
- ◇ Financial Accounting presents an organisation's financial information to its stakeholders.
- ◇ Management Accounting provides adequate and timely information for decision-making.
- ◇ Marginal costing is used to find the effect of volume of production has on profit of the company.
- ◇ Marginal cost is the cost of producing an additional unit of commodity.
- ◇ Marginal Costing helps managers to take several key decisions like profit planning, fixation of selling price, etc.

## Objective Questions

1. What was the first branch of accounting that came into being?
2. How often are financial accounts prepared in a company?
3. Which type of accounting aids in ascertainment of production cost?
4. Which branch of accounting is to be mandatorily followed by a business?
5. Where does business get accounting information for future decision-making?
6. Which branch of accounting has a futuristic approach and wider scope?
7. What term represents the change in total cost to change in quantity?



## Answers

1. Financial Accounting
2. Once in an accounting year.
3. Cost Accounting
4. Financial Accounting
5. From Management Accounting
6. Management Accounting
7. Marginal Costing

## Self-Assessment Questions

1. What is financial accounting?
2. What are the differences between Cost Accounting and Financial Accounting?
3. What is management accounting?
4. Explain the major difference between Cost Accounting and Management Accounting?
5. What is meant by Contribution?
6. Calculate the contribution of the following: Sales = ₹ 90,000, Variable cost = ₹ 50,000, Fixed cost = ₹ 20,000

## Assignments

1. We have understood that financial accounting reports are prepared in a standard format whereas management accounting reports do not follow any prescribed standard format. Think about it and try to find the logic behind it.

2. In accounting we have taken marginal cost and variable cost as the same mainly because of the assumption that the variable cost per unit remains constant. Do you think variable cost per unit always remains constant in real conditions? If not try to think about a few reasons why variable cost per unit tend to change.

### Suggested Reading

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