UNIT-I-Introduction to FinancialAccounting

SYLLABUS

Introduction to Financial, Cost and Management Accounting - Financial accounting Vs Management accounting- Objectives and functions of Management Accounting- Generally accepted accounting principles, IFRS, Conventions and Concepts– Journal – Ledger - Trial Balance.

ACCOUNTING

Meaning of Accounting

Accounting, as an information system is the process of identifying, measuring and communicating the economic information of an organization to its users who needthe information for decision making. It identifies transactions and events of a specificentity. A transaction is an exchange in which each participant receives or sacrificesvalue (e.g. purchase of raw material). An event (whether internal or external) is ahappening of consequence to an entity (e.g. use of raw material for production). Anentity means an economic unit that performs economic activities.

DEFINITION OF ACCOUNTING

American Institute of Certified Public Accountants (AICPA) which definesaccounting as "the art of recording, classifying and summarizing in a significantmanner and in terms of money, transactions and events, which are, in part at least, of afinancial character and interpreting the results thereof".

OBJECTIVE OF ACCOUNTING

Objective of accounting may differ from business to business depending upontheir specific requirements. However, the following are the general objectives ofaccounting.

i) To keeping systematic record:

It is very difficult to remember all the business transactions that take place. Accounting serves this purpose of record keeping by promptly recording all the business transactions in the books of account.

ii) To ascertain the results of the operation:

Accounting helps in ascertaining result i.e., profit earned or loss suffered in business during a particular period. For this purpose, a business entity prepares either a Trading and Profit and Loss account or an Income and Expenditure account which shows the profit or loss of the business by matching the items of revenue and expenditure of the some period.

iii) To ascertain the financial position of the business:

In addition to profit, a businessman must know his financial position i.e., availability of cash, position of assets and liabilities etc. This helps the businessman to know his financial strength. Financial statements are barometers of health of a business entity.

iv) To portray the liquidity position:

Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, cash dividends and other distributions of resources by the enterprise to owners and about other factors that may affect an enterprise's liquidity and solvency.

v) To protect business properties:

Accounting provides up to date information about the various assets that the firm possesses and the liabilities the firm owes, so that nobody can claim a payment which is not due to him.

vi) To facilitate rational decision – making: Accounting records and financial statements provide financial information which help the business in making rational decisions about the steps to be taken in respect of various aspects of business.

vii) To satisfy the requirements of law: Entities such as companies, societies, public trusts are compulsorily required to maintain accounts as per the law governing their operations such as the Companies Act, Societies Act, and Public Trust Act etc. Maintenance of accounts is also compulsory under the Sales Tax Act and Income TaxAct.

IMPORTANCE OF ACCOUNTING (USERS OF ACCOUNTING INFORMATION)

i) Owners: The owners provide funds or capital for the organization. Theypossess curiosity in knowing whether the business is being conducted on sound linesor not and whether the capital is being employed properly or not. Owners, beingbusinessmen, always keep an eye on the returns from the investment. Comparing theaccounts of various years helps in getting good pieces of information.

ii) Management: The management of the business is greatly interested inknowing the position of the firm. The accounts are the basis; the management canstudy the merits and demerits of the business activity. Thus, the management isinterested in financial accounting to find whether the business carried on is profitableor not. The financial accounting is the "eyes and ears of management and facilitatesin drawing future course of action, further expansion etc."

iii) Creditors: Creditors are the persons who supply goods on credit, orbankers or lenders of money. It is usual that these groups are interested to know thefinancial soundness before granting credit. The progress and prosperity of the firm,two which credits are extended, are largely watched by creditors from the point ofview of security and further credit. Profit and Loss Account and Balance Sheet arenerve centers to know the soundness of the firm.

iv) Employees: Payment of bonus depends upon the size of profit earned bythe firm. The more important point is that the workers expect regular income for thebread. The demand for wage rise, bonus, better working conditions etc. depend uponthe profitability of the firm and in turn depends upon financial position. For thesereasons, this group is interested in accounting.

v) Investors: The prospective investors, who want to invest their money in afirm, of course wish to see the progress and prosperity of the firm, before investingtheir amount, by going through the financial statements of the firm. This is tosafeguard the investment. For this, this group is eager to go through the accountingwhich enables them to know the safety of investment.

vi) Government: Government keeps a close watch on the firms which yieldgood amount of profits. The state and central Governments are interested in thefinancial statements to know the earnings for the purpose of taxation. To compilenational accounting is essential.

vii) Consumers: These groups are interested in getting the goods at reducedprice. Therefore, they wish to know the establishment of a proper accounting control,which in turn will reduce to cost of production, in turn less price to be paid by theconsumers. Researchers are also interested in accounting for interpretation.

viii) Research Scholars: Accounting information, being a mirror of thefinancial performance of a business organization, is of immense value to the researchscholar who wants to make a study into the financial operations of a particular firm.

To make a study into the financial operations of a particular firm, the research scholarneeds detailed accounting information relating to purchases, sales, expenses, cost ofmaterials used, current assets, current liabilities, fixed assets, long-term liabilities andshare-holders funds which is available in the accounting record maintained by thefirm.

FUNCTIONS OF ACCOUNTING

i) Record Keeping Function: The primary function of accounting relates to recording, classification and summary of financial transactions- journalisation, posting, and preparation of final statements. These facilitate to know operating results and financial positions. The purpose of this function is to report regularly t the interested parties by means of financial statements. Thus accounting performs historical function i.e., attention on the past performance of a business; and this facilitates decision making programme for future activities.

ii) Managerial Function: Decision making programme is greatly assisted by accounting. The managerial function and decision making programmes, without accounting, may mislead. The day-to-day operations are compared with some predetermined standard. The variations of actual operations with pre-determined standards and their analysis is possible only with the help of accounting.

iii) Legal Requirement function: Auditing is compulsory in case of registered firms. Auditing is not possible without accounting. Thus accountingbecomes compulsory to comply with legal requirements. Accounting is a base andwith its help various returns, documents, statements etc., are prepared.

iv) Language of Business: Accounting is the language of business. Varioustransactions are communicated through accounting. There are many parties-owners,creditors, government, employees etc., who are interested in knowing the results of thefirm and this can be communicated only through accounting. The accounting shows areal and true position of the firm or the business.

ADVANTAGES OF ACCOUNTING

The following are the advantages of accounting to a business:

i) It helps in having complete record of business transactions.

ii) It gives information about the profit or loss made by the business at theclose of a year and its financial conditions. The basic function ofaccounting is to supply meaningful information about the financialactivities of the business to the owners and the managers.

iii) It provides useful information from making economic decisions.

iv) It facilitates comparative study of current year's profit, sales, expensesetc., with those of the previous years.

v) It supplies information useful in judging the management's ability toutilize enterprise resources effectively in achieving primary enterprisegoals.

vi) It provides users with factual and interpretive information abouttransactions and other events which are useful for predicting, comparingand evaluation the enterprise's earning power.

vii) It helps in complying with certain legal formalities like filing of incometaxand sales-tax returns. If the accounts are properly maintained, theassessment of taxes is greatly facilitated.

LIMITATIONS OF ACCOUNTING

i) Accounting is historical in nature: It does not reflect the current financialposition or worth of a business.

ii) Transactions of non-monetary mature do not find place in accounting.Accounting is limited to monetary transactions only. It excludesqualitative elements like management, reputation, employee morale,labour strike etc.

iii) Facts recorded in financial statements are greatly influenced byaccounting conventions and personal judgments of the Accountant orManagement. Valuation of inventory, provision for doubtful debts andassumption about useful life of an asset may, therefore, differ from one
business house to another.

iv) Accounting principles are not static or unchanging-alternativeaccounting procedures are often equally acceptable. Therefore,accounting statements do not always present comparable data. Cost concept is found in accounting. Price changes are not considered.Money value is bound to change often from time to time. This is astrong limitation of accounting.

vi) Accounting statements do not show the impact of inflation.The accounting statements do not reflect those increases in net assetvalues that are not considered realized.

METHODS OF ACCOUNTING

Business transactions are recorded in two different ways.

Single Entry

Double Entry

Single Entry: Itis incomplete system of recording business transactions. The business organization maintains only cash book and personal accounts of debtors and creditors. So the complete recording of transactions cannot be made and trail balance cannot be prepared.

Double Entry: It this system every business transaction is having a two foldeffect of benefits giving and benefit receiving aspects. The recording is made on thebasis of both these aspects. Double Entry is an accounting system that records theeffects of transactions and other events in at least two accounts with equal debits andcredits.

STEPS INVOLVED IN DOUBLE ENTRY SYSTEM

(a) Preparation of Journal: Journal is called the book of original entry. Itrecords the effect of all transactions for the first time. Here the job of recording takesplace.

(b) Preparation of Ledger: Ledger is the collection of all accounts used by abusiness. Here the grouping of accounts is performed. Journal is posted to ledger.

(c) Trial Balance preparation: Summarizing. It is a summary of ledgebalances prepared in the form of a list.

(d) Preparation of Final Account: At the end of the accounting period toknow the achievements of the organization and its financial state of affairs, the finalaccounts are prepared.

Advantages of Double Entry System

i) Scientific system: This system is the only scientific system of recordingbusiness transactions in a set of accounting records. It helps to attain the objectives ofaccounting.

ii) Complete record of transactions: This system maintains a completerecord of all business transactions.

iii) A check on the accuracy of accounts: By use of this system the accuracyof accounting book can be established through the device called a Trail balance.

iv) Ascertainment of profit or loss: The profit earned or loss suffered duringa period can be ascertained together with details by the preparation of Profit and LossAccount.

v) Knowledge of the financial position of the business: The financialposition of the firm can be ascertained at the end of each period, through thepreparation of balance sheet.

vi) Full details for purposes of control: This system permits accounts to beprepared or kept in as much detail as necessary and, therefore, affords significantinformation for purposes of control etc.

vii) Comparative study is possible: Results of one year may be comparedwith those of the precious year and reasons for the change may be ascertained.

viii) Helps management in decision making: The management may be alsoto obtain good information for its work, specially for making decisions.

ix) No scope for fraud: The firm is saved from frauds and misappropriationssince full information about all assets and liabilities will be available.

Meaning of Debit and Credit

The term ‘debit’ is supposed to have derived from ‘debit’ and the term ‘credit’ from‘creditable’. For convenience ‘Dr’ is used for debit and ‘Cr’ is used for credit.

Recording of transactions require a thorough understanding of the rules of debit andcredit relating to accounts. Both debit and credit may represent either increase ordecrease, depending upon the nature of account.

TYPES OF ACCOUNTS

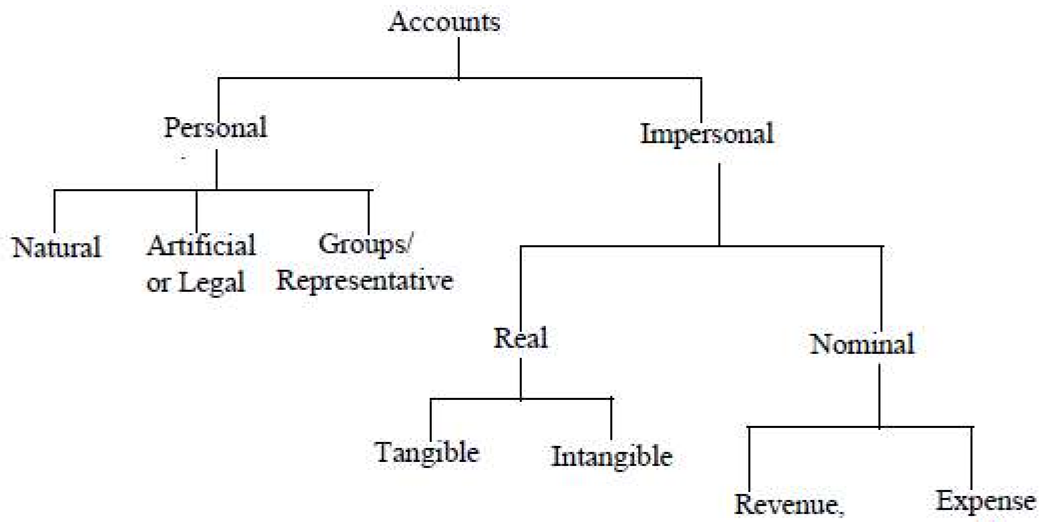
The object of book-keeping is to keep a complete record of all the transactionsthat place in the business. To achieve this object, business transactions have beenclassified into three categories:

(i) Transactions relating to persons.

(ii) Transactions relating to properties and assets

(iii) Transactions relating to incomes and expenses.

The accounts falling under the first heading are known as ‘personal Accounts’.The accounts falling under the second heading are known as ‘Real Accounts’, Theaccounts falling under the third heading are called ‘Nominal Accounts’. The accountscan also be classified as personal and impersonal. The following chart will show thevarious types of accounts:



PERSONAL ACCOUNTS: Accounts recording transactions with a person or group ofpersons are known as personal accounts. These accounts are necessary, in particular,to record credit transactions. Personal accounts are of the following types:

(a) Natural persons: An account recording transactions with an individualhuman being is termed as a natural persons' personal account. eg., Kamal's account,Mala's account, Sharma's accounts. Both males and females are included in it.

(b) Artificial or legal persons: An account recording financial transactionswith an artificial person created by law or otherwise is termed as an artificial person,personal account, e.g. Firms' accounts, limited companies' accounts, educationalinstitutions' accounts, Co-operative society account.

(c) Groups/Representative personal Accounts: An account indirectlyrepresenting a person or persons is known as representative personal account. Whenaccounts are of a similar nature and their number is large, it is better tot group themunder one head and open representative personal accounts. e.g., prepaid insurance,outstanding salaries, rent, wages etc.

When a person starts a business, he is known as proprietor. This proprietor isrepresented by capital account for all that he invests in business and by drawings accounts for all that which he withdraws from business. So, capital accounts and drawings account are also personal accounts.

The rule for personal accounts is: **Debit the receiver**
Credit the giver

REAL ACCOUNTS: Accounts relating to properties or assets are known as 'Real Accounts', A separate account is maintained for each asset e.g., Cash Machinery, Building, etc., Real accounts can be further classified into tangible and intangible.

(a) Tangible Real Accounts: These accounts represent assets and propertieswhich can be seen, touched, felt, measured, purchased and sold. e.g. Machineryaccount Cash account, Furniture account, stock account etc.

(b) Intangible Real Accounts: These accounts represent assets and propertieswhich cannot be seen, touched or felt but they can be measured in terms of money.e.g., Goodwill accounts, patents account, Trademarks account, Copyrights account,etc.

The rule for Real accounts is: **Debit what comes in**

Credit what goes out

NOMINAL ACCOUNTS: Accounts relating to income, revenue, gain expenses and losses are termed asnominal accounts. These accounts are also known as fictitious accounts as they do not represent any tangible asset. A separate account is maintained for each head orexpense or loss and gain or income. Wages account, Rent account Commissionaccount, Interest received account are some examples of nominal account

The rule for Nominal accounts is: **Debit all expenses and losses**

Credit all incomes and gains

BRANCHES OF ACCOUNTING

The changing business scenario over the centuries gave rise to specializedbranches of accounting which could cater to the changing requirements. The branchesof accounting are;

i) Financial accounting;

ii) Cost accounting; and

iii) Management accounting.

Now, let us understand these terms.

Financial Accounting

The accounting system concerned only with the financial state of affairs andfinancial results of operations is known as Financial Accounting. It is the originalfrom of accounting. It is mainly concerned with the preparation of financialstatements for the use of outsiders like creditors, debenture holders, investors andfinancial institutions. The financial statements i.e., the profit and loss account and thebalance sheet, show them the manner in which operations of the business have beenconducted during a specified period.

Cost Accounting

In view of the limitations of financial accounting in respect of informationrelating to the cost of individual products, cost accounting was developed. It is thatbranch of accounting which is concerned with the accumulation and assignment ofhistorical costs to units of product and department, primarily for the purpose ofvaluation of stock and measurement of profits. Cost accounting seeks to ascertain thecost of unit produced and sold or the services rendered by the business unit with aview to exercising control over these costs to assess profitability and efficiency of theenterprise. It generally relates to the future and involves an estimation of future coststo be incurred. The process of cost accounting based on the data provided by thefinancial accounting.

Management Accounting

It is an accounting for the management i.e., accounting which providesnecessary information to the management for discharging its functions. According tothe Anglo-American Council on productivity, “Management accounting is thepresentation of accounting information is such a way as to assist management in thecreation of policy and the day-to-day operation of an undertaking.”

It covers allarrangements and combinations or adjustments of the orthodox information to providethe Chief Executive with the information from which he can control the business e.g.Information about funds, costs, profits etc. Management accounting is not onlyconfined to the area of cost accounting but also covers other areas (such as capitalexpenditure decisions, capital structure decisions, and dividend decisions) as well.

Financial A/C **Management A/C**

Objectives	The main objectives of financial accounting are to disclose the end results of the business, and the financial condition of the business on a particular date.	The main objective of managerial accounting is to help management by providing information that is used to plan, set goals and evaluate these goals.
Audience	Financial accounting produces information that is used by external parties, such as shareholders and lenders.	Managerial accounting produces information that is used within an organization, by managers and employees.
Optional?	It is legally required to prepare financial accounting reports and share them with investors.	Managerial accounting reports are not legally required.
Segment reporting	Pertains to the entire organization. Certain figures may be broken out for materially significant business units.	Pertains to individual departments in addition to the entire organization.
Focus	Financial accounting focuses on history; reports on the prior quarter or year.	Managerial accounting focuses on the present and forecasts for the future.
Format	Financial accounts are reported in a specific format, so that different organizations can be easily compared.	Format is informal and is on a per department/company basis as needed.
Rules	Rules in financial accounting are prescribed by standards such as GAAP or IFRS. There are legal requirements for companies to follow financial accounting standards.	Managerial accounting reports are only used internally within the organization; so they are not subject to the legal requirements that financial accounts are.
Reporting frequency and duration	Defined - annually, semi-annually, quarterly, yearly.	As needed - daily, weekly, monthly.

OBJECTIVES OF MANAGEMENT ACCOUNTING:

1) Measuring performance: Management accounting measures two types of performance. First is employee performance and the second is efficiency measurement. The actual performance is measured with the standardized performance and a report of deviation from the standard performance is reported to the management for the effective decision making and also to indicate the effectiveness of the methods in use. Both types of performance management are used to make corrective actions in order to improve performance.

2) Assess Risk: The aim of management accounting is to assess risk in order to maximize risk.
3) Allocation of Resources: is an important objective of Management Accounting.
4) Presentation of various financial statements to the Management.

FUNCTIONS OF MANAGEMENT ACCOUNTING

The main objective of management accounting is to help the management to take quality decision for controlling the business activities effectively. The other objectives and the following functions of management accounting are performed to achieve all the objectives.

1. Presentation of Data

Both profit and loss account and balance sheet are not useful for taking a decision. Hence, the contents of profit and loss account and balance sheet are modified and rearranged in such a manner that helps the management for taking decision through various techniques.

2. Modifies Data

The financial accounting information is modified according to the management expectations. For example, total purchase figures are modified month wise, product wise, supplier wise and territory wise.

3. Forecasting

The management can forecast the achievement of objectives for short term and long term. The accountant provides necessary information and data for forecasting.

4. Analysis and Interpretation of Data

The financial accounting data is rearranged for proper analysis. Comparative and common size statements are prepared for the meaningful interpretation of data. Ratios are calculated and likely trends are projected.

5. Help in Organizing

Organizing refers to allocation of company resources to various departments and assignment of duties to employees at various levels of management. The modified data and analysis and interpretation are helping the management for organizing.

6. Means of Communication

The analysis and interpretation of modified data is conveyed to the employees of an organization as a whole. More meaningful information is supplied to all levels of management executives. In this way, rearranged and modified data are used as means of communication under management accounting system.

7. Planning

The fund flow statement, cash flow statement, budgeting, standard costing, capital budgeting and marginal costing are used for planning purpose. These are important tools of management accounting.

8. Facilitates Control

Management accounting translates the objectives into achievements within a specified time. This is possible through budgetary control and standard costing which are an integral part of management accounting. In this way, management accounting facilitates control.

9. Decision-making

Modified data, analyzed and interpreted information are highly useful to management for taking quality decision and policy formulation.

10. Using of Qualitative Information

Qualitative information means data cannot be measured in terms of rupees, units, kgs, tons, metres and the like. Employees efficiency, policy of management, employer and employee relationship etc are the examples for qualitative information. These types of information are also used in the management accounting system.

11. Coordination

The preparation of budgets on functional basis is the fixation of targets for each department separately. The objectives of organization is achieved through attainment of targets of all the departments. The preparation of periodical performance report of all the departments under management accounting system brings coordination among all the departments.

12. Special Cost and Economic Studies

The special cost and economic studies are considered in the management accounting system in order to increase the profits of the concern.

13. Motivating Employees

The preparation of budgets and adoption of standard costing technique are automatically motivating the employees indirectly. If the budgets are achieved and if there is any favorable variances under standard costing technique, a suitable monetary and non-monetary motivating schemes are prepared and implemented.

ACCOUNTING PRINCIPLES

The word 'Principle' has been differently viewed by different schools ofthought. The American Institute of Certified Public Accountants (AICPA) has viewedthe word 'principle' as a general law of rule adopted or professed as a guide to action;a settled ground or basis of conduct of practice"

Accounting principles refer, to certain rules, procedures and conventions whichrepresent a consensus view by those indulging in good accounting practices andprocedures. Canadian Institute of Chartered Accountants defined accounting principleas "the body of doctrines commonly associated with the theory and procedure ofaccounting, serving as an explanation of current practices as a guide for the selectionof conventions or procedures where alternatives exist. Rules governing the formationof accounting axioms and the principles derived from them have arisen from

commonexperiences, historical precedent, statements by individuals and professional bodiesand regulations of Governmental agencies”. To be more reliable, accounting
statements are prepared in conformity with these principles. If not, chaotic conditionswould result. But in reality as all the businesses are not alike, each one has its ownmethod of accounting. However, to be more acceptable, the accounting principlesshould satisfy the following three basic qualities, viz., relevance, objectivity andfeasibility. The accounting principle is considered to be relevant and useful to theextent that it increases the utility of the records to its readers. It is said to be objectiveto the extent that it is supported by the facts and free from personal bias.

It isconsidered to be feasible to the extent that it is practicable with the least complicationor cost. Though accounting principles are denoted by various terms such as concepts,conventions, doctrines, tenets, assumptions, axioms, postulates, etc., it can beclassified into two groups, viz., accounting concepts and accounting conventions.

ACCOUNTING CONCEPTS AND CONVENTIONS

Accounting concepts:

The term ‘concept’ is used to denote accounting postulates, i.e., basicassumptions or conditions upon the edifice of which the accounting super-structure isbased. The following are the common accounting concepts adopted by many businessconcerns.

1. Business Entity Concept 2. Money Measurement Concept

3. Going Concern Concept 4. Dual Aspect Concept

5. Periodicity Concept 6. Historical Cost Concept

7. Matching Concept 8. Realization Concept

9. Accrual Concept 10. Objective Evidence Concept

i) Business Entity Concept: A business unit is an organization of personsestablished to accomplish an economic goal. Business entity concept implies that thebusiness unit is separate and distinct from the persons who provide the requiredcapital to it. This concept can be expressed through an accounting equation, viz.,

Assets = Liabilities + Capital. The equation clearly shows that the business itselfowns the assets and in turn owes to various claimants. It is worth mentioning here thatthe business entity concept as applied in accounting for sole trading units is differentfrom the legal concept. The expenses, income, assets and liabilities not related to thesole proprietorship business are excluded from accounting. However, a soleproprietor is personally liable and required to utilize non-business assets or privateassets also to settle the business creditors as per law. Thus, in the case of soleproprietorship, business and non-business assets and liabilities are treated alike in theeyes of law. In the case of a partnership, firm, for paying the business liabilities thebusiness assets are used first and it any surplus remains thereafter, it can be used forpaying off the private liabilities of each partner. Similarly, the private assets are firstused to pay off the private liabilities of partners and if any surplus remains, it istreated as part of the firm's property and is used for paying the firm's liabilities. In thecase of a company, its existence does not depend on the life span of any shareholder.

ii) Money Measurement Concept: In accounting all events and transactionsare recode in terms of money. Money is considered as a common denominator, bymeans of which various facts, events and transactions about a business can beexpressed in terms of numbers. In other words, facts, events and transactions whichcannot be expressed in monetary terms are not recorded in accounting. Hence, theaccounting does not give a complete picture of all the transactions of a business unit.This concept does not also take care of the effects of inflation because it assumes a stable value for measuring.

iii) Going Concern Concept: Under this concept, the transactions arerecorded assuming that the business will exist for a longer period of time, i.e., abusiness unit is considered to be a going concern and not a liquidated one. Keepingthis in view, the suppliers and other companies enter into business transactions withthe business unit. This assumption supports the concept of valuing the assets athistorical cost or replacement cost. This concept also supports the treatment ofprepaid expenses as assets, although they may be practically unsaleable.

iv) Dual Aspect Concept: According to this basic concept of accounting,every transaction has a two-fold aspect, Viz., 1.giving certain benefits and 2.Receiving certain benefits. The basic principle of double entry system is that everydebit has a corresponding and equal amount of credit. This is the underlyingassumption of this concept. The accounting equation viz., Assets = Capital +Liabilities or Capital = Assets – Liabilities, will further clarify this concept, i.e., at anypoint of time the total assets of the business unit are equal to its total liabilities.Liabilities here relate both to the outsiders and the owners. Liabilities to the ownersare considered as capital.

V) Periodicity Concept: Under this concept, the life of the business issegmented into different periods and accordingly the result of each period isascertained. Though the business is assumed to be continuing in future (as per goingconcern concept), the measurement of income and studying the financial position ofthe business for a shorter and definite period will help in taking corrective steps at theappropriate time. Each segmented period is called "accounting period" and the sameis normally a year. The businessman has to analyze and evaluate the resultsascertained periodically. At the end of an accounting period, an Income Statement isprepared to ascertain the profit or loss made during that accounting period andBalance Sheet is prepared which depicts the financial position of the business as onthe last day of that period. During the course of preparation of these statementscapital revenue items are to be necessarily distinguished.

vi) Historical Cost Concept: According to this concept, the transactions arerecorded in the books of account with the respective amounts involved. For example,if an asset is purchases, it is entered in the accounting record at the price paid toacquire the same and that cost is considered to be the base for all future accounting. Itmeans that the asset is recorded at cost at the time of purchase but it may bemethodically reduced in its value by way of charging depreciation. However, in thelight of inflationary conditions, the application of this concept is considered highlyirrelevant for judging the financial position of the business.

vii) Matching Concept: The essence of the matching concept lies in the viewthat all costs which are associated to a particular period should be compared with therevenues associated to the same period to obtain the net income of the business.Under this concept, the accounting period concept is relevant and it is this concept(matching concept) which necessitated the provisions of different adjustments forrecording outstanding expenses, prepaid expenses, outstanding incomes, incomesreceived in advance, etc., during the course of preparing the financial statements at theend of the accounting period.

viii) Realization Concept: This concept assumes or recognizes revenue whena sale is made. Sale is considered to be complete when the ownership and propertyare transferred from the seller to the buyer and the consideration is paid in full.However, there are two exceptions to this concept, viz., 1.

Hire purchase systemwhere the ownership is transferred to the buyer when the last installment is paid and 2.Contract accounts, in which the contractor is liable to pay only when the wholecontract is completed, the profit is calculated on the basis of work certified each year.

ix) Accrual Concept: According to this concept the revenue is recognized onits realization and not on its actual receipt. Similarly the costs are recognized whenthey are incurred and not when payment is made. This assumption makes it necessaryto give certain adjustments in the preparation of income statement regarding revenuesand costs. But under cash accounting system, the revenues and costs are recognizedonly when they are actually received or paid. Hence, the combination of both cashand accrual system is preferable to get rid of the limitations of each system.

x) Objective Evidence Concept: This concept ensures that all accountingmust be based on objective evidence, i.e., every transaction recorded in the books ofaccount must have a verifiable document in support of its, existence.

ACCOUNTING CONVENTIONS

The following conventions are to be followed to have a clear and meaningful
information and data in accounting:

i) Consistency: The convention of consistency refers to the state of accountingrules, concepts, principles, practices and conventions being observed and appliedconstantly, i.e., from one year to another there should not be any change. Ifconsistency is there, the results and performance of one period can he compared easilyand meaningfully with the other. It also prevents personal bias as the persons involvedhave to follow the consistent rules, principles, concepts and conventions. Thisconvention, however, does not completely ignore changes. It admits changes whereverindispensable and adds to the improved and modern techniques of accounting.

ii) Disclosure: The convention of disclosure stresses the importance ofproviding accurate, full and reliable information and data in the financial statementswhich is of material interest to the users and readers of such statements. Thisconvention is given due legal emphasis by the Companies Act, 1956 by prescribingformats for the preparation of financial statements. However, the term disclosure doesnot mean all information that one desires to get should be included in accountingstatements. It is enough if sufficient information, which is of material interest to theusers, is included.

iii) Conservatism: In the prevailing present day uncertainties, the conventionof conservatism has its own importance. This convention follows the policy of cautionor playing safe. It takes into account all possible losses but not the possible profits orgains. A view opposed to this convention is that there is the possibility of creation ofsecret reserves when conservatism is excessively applied, which is directly opposed tothe convention of full disclosure. Thus, the convention of conservatism should beapplied very cautiously

IFRS

What are 'International Financial Reporting Standards - IFRS'

International Financial Reporting Standards (IFRS) are a set of international accounting standards stating how particular types of transactions and other events should be reported in financial statements. IFRS are issued by the International Accounting Standards Board (IASB), and they specify exactly how accountants must maintain and report their accounts. IFRS were established in order to have a common accounting language, so business and accounts can be understood from company to company and country to country.

Standard IFRS Requirements

IFRS covers a wide range of accounting activities. There are certain aspects of business practice for which IFRS set mandatory rules.

- Statement of Financial Position: This is also known as a balance sheet. IFRS influences the ways in which the components of a balance sheet are reported.
- Statement of Comprehensive Income: This can take the form of one statement, or it can be separated into a profit and loss statement and a statement of other income, including property and equipment.
- Statement of Changes in Equity: Also known as a statement of retained earnings, this documents the company's change in earnings or profit for the given financial period.
- Statement of Cash Flow: This report summarizes the company's financial transactions in the given period, separating cash flow into Operations, Investing, and Financing.

In addition to these basic reports, a company must also give a summary of its accounting policies. The full report is often seen side by side with the previous report, to show the changes in profit and loss. A parent company must create separate account reports for each of its subsidiary companies.

IFRS vs. American Standards

Differences exist between IFRS and other countries' Generally Accepted Accounting Principles (GAAP) that affect the way a financial ratio is calculated. For example, IFRS is not as strict on defining revenue and allow companies to report revenue sooner, so consequently, a balance sheet under this system might show a higher stream of revenue than GAAP's. IFRS also has different requirements for expenses; for example, if a company is spending money on development or an investment for the future, it doesn't necessarily have to be reported as an expense (it can be capitalized).

Another difference between IFRS and GAAP is the specification of the way inventory is accounted for. There are two ways to keep track of this, first in first out (FIFO) and last in first out (LIFO). FIFO means that the most recent inventory is left unsold until older inventory is sold; LIFO means that the most recent inventory is the first to be sold. IFRS prohibits LIFO, while American standards and others allow participants to freely use either.

History of IFRS

IFRS originated in the European Union, with the intention of making business affairs and accounts accessible across the continent. The idea quickly spread globally, as a common language allowed greater communication worldwide. Although only a portion of the world uses IFRS, participating countries are spread all over the world, rather than being confined to one geographic region. The United States has not yet adopted IFRS, as the GAAP is viewed as the "gold standard".

Currently, about 120 countries use IFRS in some way, and 90 of those require them to fully conform to IFRS regulations.

IFRS is maintained by the IFRS Foundation. The mission of the IFRS Foundation is to "bring transparency, accountability and efficiency to financial markets around the world." Not only does the IFRS Foundation supply and monitor these standards, but it also provides suggestions and advice to those who deviate from the practice guidelines.

JOURNAL AND LEDGER

When the business transactions take place, the first step is to record the samein the books of original entry or subsidiary books or books of prime or journal. Thusjournal is a simple book of accounts in which all the business transactions areoriginally recorded in chronological order and from which they are posted to theledger accounts at any convenient time. Journalsing refers to the act of recording eachtransaction in the journal and the form in which it is recorded, is known as a journalentry.

ADVANTAGES OF JOURNAL

The following are the inherent advantages of using journal, though thetransactions can also be directly recorded in the respective ledger accounts;1. As all the transactions are entered in the journal chronologically, a datewise record can easily be maintained;

2. All the necessary information and the required explanations regarding alltransactions can be obtained from the journal; and

3. Errors can be easily located and prevented by the use of journal or book ofprime entry.

The specimen journal is as follows:

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
1	2	3	4	5
			-	-

The journal has five columns, viz. (1) Date; (2) Particulars; (3) Ledger Folio;
(4) Amount (Debit); and (5) Amount (Credit) and a brief explanation of thetransaction by way of narration is given after passing the journal entry.

(1) Date: In each page of the journal at the top of the date column, the year iswritten and in the next line, month and date of the first entry are written. The year andmonth need not be repeated until a new page is begun or the month or the yearchanges. Thus, in this column, the date on which the transaction takes place is alonewritten.

(2) Particulars: In this column, the details regarding account titles anddescription are recorded. The name of the account to be debited is entered first at theextreme left of the particularscolumn next to the date and the abbreviation 'Dr.' iswritten at the right extreme of the same column in the same line. The name of theaccount to be credited is entered in the next line preceded by the word "To" leaving afew spaces away from the extreme left of the particulars column. In the next lineimmediately to the account credited, a short about the transaction is given which isknown as "Narration". "Narration" may include particulars required to identify andunderstand the transaction and should be adequate enough to explain the transaction.

It usually starts with the word "Being" which means what it is and is written withinparentheses. The use of the word "Being" is completely dispense with, in modernparlance. To indicate the completion of the entry for a transaction, a line is usuallydrawn all through the particulars column.

(3) Ledger Folio: This column is meant to record the reference of the mainbook, i.e., ledger and is not filled in when the transactions are recorded in the journal.The page number of the ledger in which the accounts are appearing is indicated in thiscolumn, while the debits and credits are posted o the ledger accounts.

(4) Amount (Debit): The amount to be debited along with its unit ofmeasurement at the top of this column on each page is written against the accountdebited.

(5) Amount (Credit): The amount to be credited along with its unit ofmeasurement at the top of this column on each page is written against the accountcredited.

SUB-DIVISION OF JOURNAL

When innumerable number of transactions takes place, the journal, as the solebook of the original entry becomes inadequate. Thus, the number and the number andtype of journals required are determined by the nature of operations and the volume oftransactions in a particular business. There are many types of journals and thefollowing are the important ones:

1. Sales Day Book- to record all credit sales.
2. Purchases Day Book- to record all credit purchases.
3. Cash Book- to record all cash transactions of receipts as well as payments.
4. Sales Returns Day Book- to record the return of goods sold to customerson credit.
5. Purchases Returns Day Book- to record the return of goods purchased fromsuppliers on credit.
6. Bills Receivable Book- to record the details of all the bills received.
7. Bills Payable Book- to record the details of all the bills accepted.
8. Journal Proper-to record all residual transactions which do not find place inany of the aforementioned books of original entry.

Illustration:

Analyse the following transactions.

(a) Ramesh started his business with cash

(b) Borrowed from Nikhil

(c) Purchased furniture

(d) Purchased furniture from Mohan on credit

(e) Purchased goods for cash

(f) Purchased goods from Ram on credit

(g) Sold goods for cash

(h) Sold goods to Hari on credit

(i) Received cash from Hari

(j) Paid cash to Ram

(k) Deposited into bank

(l) Withdrew cash for personal use

(m) Withdrew from bank for office use

(n) Withdrew from bank for personal use

(o) Received cash from a customer, Shyam

(p) Paid salary by cheque

(q) Received donation in cash

(r) Paid to Ram by cheque

(s) Paid salary

(t) Paid rent by cheque

(u) Goods withdrawn for personal use

(v) Paid an advance to suppliers of goods

(w) Received an advance from customers

(x) Paid interest on loan

(y) Paid instalment of loan

(z) Interest allowed by bank.

Solution

ANALYSIS OF TRANSACTIONS

Transaction	Accounts involved	Nature of accounts	How affected	Whether to be debited or credited
(a)	Cash A/c	Real	Cash is coming in	Debit
	Capital A/c	Personal	Ramesh is the giver	Credit
(b)	Cash A/c	Real	Cash in coming in	Debit
	Loan from Nikhil A/c	Personal	Nikhil is the giver	Credit
(c)	Furniture A/c	Real	Furniture is coming in	Debit
	Cash A/c	Real	Cash is going out	Credit
(d)	Furniture A/c	Real	Furniture is coming in	Debit
	Mohan's A/c	Personal	Mohan is the giver	Credit
(e)	Purchases A/c	Real	Goods are coming in	Debit
	Cash A/c	Real	Cash is going out	Credit
(f)	Purchases A/c	Real	Goods are coming in	Debit
	Ram's A/c	Personal	Ram is the giver	Credit
(g)	Cash A/c	Real	Cash is coming in	Debit
	Sales A/c	Real	Goods are going out	Credit
(h)	Hari's A/c	Personal	Hari is the receiver	Debit
	Sales A/c	Real	Goods are going out	Credit
(i)	Cash A/c	Real	Cash is coming in	Debit
	Hari's A/c	Personal	Hari is the giver	Credit
(j)	Ram's A/c	Personal	Ram is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(k)	Bank A/c	Personal	Bank is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(l)	Drawings A/c	Personal	Ramesh is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit

Transaction	Accounts involved	Nature of accounts	How affected	Whether to be debited or credited
(m)	Cash A/c	Real	Cash is coming in	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(n)	Drawings A/c	Personal	Ramesh is the receiver	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(o)	Cash A/c	Real	Cash is coming in	Debit
	Shyam's A/c	Personal	Shyam is the giver	Credit
(p)	Salary A/c	Nominal	Salary is an expense	Debit
	Bank A/c	Personal	Bank is the receiver	Credit
(q)	Cash A/c	Real	Cash is coming in	Debit
	Donation A/c	Nominal	Donation is a gain	Credit
(r)	Ram's A/c	Personal	Ram is the receiver	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(s)	Salary A/c	Nominal	Salary is an expense	Debit
	Cash A/c	Real	Cash is going out	Credit
(t)	Rent A/c	Nominal	Rent is an expense	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(u)	Drawing's A/c	Personal	Ramesh is the receiver	Debit
	Purchases A/c	Real	Goods are going out	Credit
(v)	Advance to Suppliers A/c	Personal	Suppliers are the receivers	Debit
	Cash A/c	Real	Cash is going out	Credit
(w)	Cash A/c	Real	Cash is coming in	Debit
	Adv. from Customers A/c	Personal	Customers are the givers	Credit
(x)	Interest on Loan A/c	Nominal	Interest on loan is an expense	Debit
	Cash A/c	Real	Cash is going out	Credit
(y)	Loan A/c	Personal	Lender is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(z)	Bank A/c	Personal	Bank is the receiver	Debit
	Bank Interest A/c	Nominal	Bank Interest is a gain	Credit

Illustration: Prepare Journal in the books of K.K. Co. from the following transactions:

1999		Rs.	1999		Rs.
Dec. 1	Started business with a capital of	50,000	Dec. 15	Purchased goods from Ram	4,000
Dec. 6	Paid into bank	20,000	Dec. 18	Paid wages to workers	300
Dec. 8	Purchased goods for cash	4,000	Dec. 20	Recd. from Pankaj Allowed him discount Rs. 50	1,000
Dec. 9	Paid to Ram	1,980	Dec. 22	Withdrawn from bank	3,000
Dec. 9	Discount allowed by him	20	Dec. 25	Paid Ram by cheque	500
Dec. 10	Cash sales	3,000	Dec. 31	Withdrawn for personal use	200
Dec. 12	Sold to Hari for cash	2,000			

Solution

IN THE BOOKS OF K.K. CO.

Journal

Date	Particulars		L.F.	Dr. Rs.	Cr. Rs.
1999					
Dec. 1.	Cash A/c	Dr.		50,000	
	To Capital A/c				50,000
	(Being business started with capital)				
6.	Bank A/c	Dr.		20,000	
	To Cash A/c				20,000
	(Being cash paid into bank)				
8.	Purchase A/c	Dr.		4,000	
	To Cash A/c				4,000

	(Being goods purchased for cash)				
9.	Ram A/c	Dr.		2,000	
	To Cash A/c				1,980
	To Discount Received A/c				20
	(Being cash paid to Ram and discount received Rs. 20)				
10.	Cash A/c	Dr.		3,000	
	To Sales A/c				3,000
	(Being goods sold for cash)				
12.	Cash A/c	Dr.		2,000	
	To Sales A/c				2,000
	(Being goods sold for cash)				
15	Purchases A/c	Dr.		4,000	
	To Ram A/c				4,000
	(Being goods purchased from Ram)				
18.	Wages A/c	Dr.		300	
	To Cash A/c				300
	(Being wages paid)				
20.	Cash A/c	Dr.		1,000	
	Discount Allowed A/c	Dr.		50	
	To Pankaj A/c				1,050
	(Being cash received from Pankaj and allowed him discount Rs. 50)				
22.	Cash A/c	Dr.		3,000	
	To Bank A/c				3,000
	(Being cash withdrawn from bank)				
25.	Ram A/c	Dr.		500	
	To Bank A/c				500
	(Being paid by cheque)				
31.	Drawings A/c	Dr.		200	
	To Cash A/c				200
	(Being withdrawn for personal use)				
	Grand Total			**90,050**	**90,050**

Goods Account

Generally, the term goods include every type of property such as Land, Building, Machinery, Furniture, Cloth etc. However, in accountancy its meaning is restricted to only those articles which are purchased by a businessman with an intention to sell it. For example, if a businessman purchased typewriter, it will be goods for him if he deals in typewriter but if he deals in other business say clothes then typewriter will be asset for him and clothes will be goods.

Sub-Division of Goods Accounts

The goods account is not opened in accounting books and it is to be noted goods includes purchases, sales, sales returns, purchases return of goods. However, purchase account, sales account, sales return account and purchase return account are opened in the books of account.

Purchases Account: This is opened for goods purchased on cash and credit.

Sales Account: This account is opened for the goods sold on cash and credit.

Purchase Returns Account or Return Outward Account: This account is opened for the goods returned to suppliers.

Sales Returns Account or Return Inward Account: This account is opened for the goods returned by customers.

Opening Entry

In case of going concern at the beginning of the new year, new books of accounts are opened and the balances relating to personal and real Accounts appearing in the books at the close of the previous year are brought forward in new books. The entry for this purpose in the books is called opening entry.

The opening entry is passed by debiting all assets and crediting all liabilities including capital. If the amount of capital is not given then this can be found out with the help of the accounting equation:

Assets = Liabilities + capital

Capital = Assets- Liabilities

Illustration: On 1st April 1998, Singh's assets and liabilities stood as follows:

Assets: Cash Rs. 6,000, Bank Rs. 17,000, Stock Rs. 3,000;

Bills receivable 7,000; Debtors 3,000; Building 70,000; Investments 30,000; Furniture 4,000

Liabilities: Bills payable 5000, Creditors 9000, Ram's loan 13,000

Pass on opening Journal entry.

Date	Particulars		L.F.	Debit Amount	Credit Amount
1998					
April 1	Cash Account	Dr.		6,000	
	Bank Account	Dr.		17,000	
	Stock Account	Dr.		3,000	
	Bills receivable Account	Dr.		7,000	
	Debtors Account	Dr.		3,000	
	Building Account	Dr.		70,000	
	Investment Account	Dr.		30,000	
	Furniture	Dr.		4,000	
	To Bills payable Account				5,000
	To Creditor's Account				9,000
	To Ram's loan Account				13,000
	To Singh's capital				1,13,000
	(Being the opening balances of assets and liabilities)				
				1,40,000	1,40,000

IMPORTANT CONSIDERATIONS FOR RECORDING THE BUSINESS TRANSACTIONS

1. Trade Discount

Trade discount is usually allowed on the list price of the goods. Itmay be allowed by producer to wholesaler and by wholesaler to retailerfor purchase of goods in large quantity. It is not recorded in the books ofaccount and entry is made only with the net amount paid or received, forexample, purchased goods of list price Rs. 8,000 at 15% trade discountfrom X. In this case the following entry will be passed:

Purchases Account Dr. 6,800

To X 6,800

(Being goods purchased at 15% trade discount Less list price)

2. Amount paid or received in full settlement or cash

discount

Cash discount is a concession allowed by seller to buyer toencourage him to make early cash payment. It is a Nominal Account. Theperson who allows discount, treat it as an expenses and debits is hisbooks and it is called discount allowed and the person who receivesdiscount, treat as an income and it is called discount received and creditsin his books of account "Discount Received Account." For example, Xowes Rs. 6,000 to Y. He pays Rs. 5,950 in full settlement against theamount due. In the books of X the journal entry will be:

Y Dr. 6,000
To Cash Account 5,950
To Discount Received account 50
(Being Cash paid and discount received)

In the books of Y Rs. Rs.
Cash Account Dr. 5,950
Discount Allowed Account Dr. 50
To X 6,000
(Being cash received and discount allowed)

3. Goods distributed as free samples

Some times business distributes goods as free samples for thepurpose of advertisement. In this case Advertisement Account is debitedand Purchases Accounts is credited. For example, goods costing Rs. 8000were distributed as free sample. to record this transactions followingentry will be passed:

Advertisement Account Dr. 8,000
To Purchases Account 8,000

4. Interest on capital

Interest paid on capital is an expense. Therefore interest accountshould be debited. On the other hand the capital of the business isincreases. So the capital account should be credited. The entry will be asfollows:

Interest on Capital Account Dr.
To Capital Account

5. Interest charged on Drawings

If the interest is charged on drawings then it will be an increase inthe income of business, so interest on drawings will be credited. On theother hand there will be increase in Drawings or decrease in Capital. SoDrawings Account will be debited. To record this, following entry will be passed:

Drawing Account or Dr.

Capital Account Dr.

To Interest on Drawing Account

6. Depreciation charged on Fixed Assets

Depreciation is the gradual, permanent decrease in the value of anassets due to wear and tear and many other causes. Depreciation is anexpense so the following entry will be passed:

Depreciation Account Dr.

To Asset Account

7. Bad Debts

Sometimes a debtor of business fails to pay the amount due fromhim. Reasons may be many e.g. he may become insolvent or he may die.Such irrecoverable amount is a loss to the business. To record thisfollowing entry will be passed:

Bad Debts Account Dr.To Debtor's Account

8. Bad Debts Recovered

When any amount becomes irrecoverable from any costumer ordebtor his account is closed in the books. If in future any amount isrecovered from him then his personal account will not be creditedbecause that does not exist in the books. So the following entry is passed:

Cash Account Dr.

To Bad Debts Recovered Account

9. Purchase and Sale of investment

When business has some surplus money it may invest this amountis shares, debentures or other types of securities. When these securitiesare purchased, these are recorded at the purchase price paid. At the timeof sale of investment the sale price of an investment is recorded in thebooks of accounts. The following entry is passed to record the purchaseof investment:

Investment Account Dr.

To Cash Account

In case of sale of these securities the entry will be:

Cash Account Dr.

To Investment Account

10. Loss of Goods by Fire/Accident/theft

A business may suffer loss of goods on account of fire, theft oraccident. It is a business loss and a nominal account. It also reduces thegoods at cost price, and increases the loss/expenses of the business. Theentry will be passed as:

Loss by fire/Accident/theft Account Dr (for loss)

Insurance Company Account Dr. (for insurance claimadmitted)

To Purchases Account

11. Income Tax Paid

Income Tax paid should be debited to Capital Account or DrawingsAccount and credited to cash Account in case of sole proprietorship andpartnership firms. The reason behind this is that income tax is apersonal expense for the sole trader and partners because it is paid onincome of proprietor. The entry will be as follows:

Capital Account Dr.

Drawing Account Dr.

To Cash Account

12. Bank Charges

Bank provide various services to their customers. Bank deductssome charges by debiting the account of customers. It is an expenses forthe business. To record this following entry will be passed in the books ofbusinessman/customer:

Bank Charges Account Dr.

To Bank Account

13. Drawings Account

It is a personal account of the proprietor. When the businessmanwithdraws cash or goods form the business for his personal/domesticuse it is called as ‘drawings’. Drawings reduce the capital as well asgoods/cash balance of the business. The journal entry is:

Drawings Account Dr.

To Cash Account

To Purchases Account

14. Personal expenses of the proprietor

When the private expenses such as life insurances premium,income tax, home telephone bill, tuition fees of the son of the proprietoretc. are paid out of the cash or bank account of business it should bedebited to the Drawing Account of the proprietor. The journal entry is:

Capital/Drawings Account Dr.

To Cash/Bank

15. Sale of Asset/Property

When the asset of a business is sold, there may occur a profit orloss on its sale. It should be noted carefully that sales account is nevercredited on the sale of asset. The journal entry is:

(i) In case there is a profit on sale of Property/Assets

Cash/Bank Account Dr.

To Asset/Property Account

To Profit on sale of Asset Account

(ii) In case of a loss on sale of asset

Cash/Bank Account Dr.

Loss on sale of Asset Account Dr.

To Asset Account

16. Amount paid or Received on behalf of customer

(i) When the business entity pays the amount on behalf of oldreputed customers such as carriage in anticipation of recovering thesame later on, carriage account should not be opened because carriage isnot the expense of the seller. It should be debited/charged to customer'sPersonal account. The journal entry is:

Customer/Debtor's Account Dr.

To Cash/Bank Account

(ii) When the business entity receives the amount on behalf ofcustomers from the third party as mutually settled between the thirdparty and the customer, the account of the third party/person makingthe payment should not be opened in the books of the receiving entity.

The journal entry in the books of the entity is:

Cash/Bank Account Dr.

To Customer/Debtor's Account

17. Amount paid on behalf of creditors

When the creditors/supplier instructs the business entity to makepayment on their behalf, the amount so paid should be debited tocreditors account and liability of the business will decrease accordingly. The journal entry is:

Suppliers/Creditors Account Dr.

To Cash/Bank Account

18. The events affecting business but they do not involve anytransfer/exchange of money for the time being, they would not berecorded in the financial books. Examples of them are:

(i) On 1st January 2006 placed on order to Geeta& Sons for thesupply of goods worth Rs. 1,00,000.

(ii) Babanjot, a B.Com. graduate has been appointed SalesAssistant on a salary of Rs. 5,000 p.m. on Jan., 2006.

(iii) Raman, a proprietor contracted with Bahia Builders Ltd. Forthe renovation of the building at an estimated cost of Rs.5,00,000.

(iv) A shop in Adalt Bazar Patiala contracted to be taken on arent @ Rs. 4,000 pm.

19. Paid wages/installation charges for erection of machinery

Wages and installation charges are the expenses of nominalnature. But for erection of machinery no separate account should beopened for such expenses because these expenses are of capital natureand it will be merged/debited to the cost of assets i.e. machinery. Thejournal entry is:

Machinery Account Dr.

To Cash/Bank Account

(Being wages/installation charges paid for the erection ofmachinery)

Illustration: Journalise the following transactions for the month of

January 2006:

2006

Jan.1 Invested in shares of Tata Cotton Mills Ltd. and paid for the samein cash Rs. 2,000.

2 Placed on order with Mr. Shah for goods to be received a monthlater Rs. 1,500.

3 Invoiced goods to Mr. Love worth Rs. 1,000 and allowed a tradediscount of 2 per cent.

4 Carriage Rs. 25 and freight Rs. 70 were paid by the proprietor forthe above goods but which are to be charged to Mr. Love Account.the above goods but which are to be charged to Mr. Love Account.

5 Paid rent to landlord of office premises- Rs. 150, which he spenton purchase of our goods.

6 Goods valued at Rs. 700 were delivered to Ahmedabad Merchantsunder instructions from Mr. Gobind. They were to be charged tothe latter's Account.

7 Mr. Love paid Rs. 500 due from him, and the same was spent onpurchasing goods from Mr. Deepu.

8 Sold one old motor car belonging to the proprietor for Rs. 5,000and the amount was invested in the business.

9 The proprietor paid Rs. 180 in full settlement of Mr. Manpreet forgoods worth Rs. 200 purchased by him for personal use.

10 Mr. Gobind was declared insolvent and paid Rs. 450 in fullsettlement. The balance Rs. 250 was written off as a bad debt.

11 Mohinder our debtors, on our advice, directly paid Narinder, ourcreditor Rs. 2,000.

Solution

JOURNAL

Date	Particulars		L.F.	Dr. Rs.	Cr. Rs.
2006					
Jan. 1	Investment Account	Dr.		2,000	
	To Cash Account				2,000
	(Being purchase of shares of Tata Cotton Mills Ltd. paid in cash)				
2	No entry is passed as "placing of an order is not a business transaction."				
3	Mr. Love's Account	Dr.		980	
	To Sales Account				980
	(Being the entry for credit sale of goods to				

4.	Mr. Love's Account Dr. To Cash Account (Being payment of freight and carriage on behalf of Mr. Love)			95	95
5	Rent Account Dr. To Sales Account (Being rent paid to the landlord in the form of goods, instead of in cash)			150	150
6	Mr. Gobind Account Dr. To Sales account (Being goods sold to Mr. Govind but delivered to A. Merchants as per instructions)			700	700
7	Cash Account Dr. To Love's Account (Being in amount received in cash from Love)			500	500
7	Purchases Account Dr. To Cash Account (Being entry for goods purchased from Mr. Deepu from in cash received from Love)			500	500
8	Cash Account Dr. To Proprietor's Capital Account (Being amount invested in business out of the sale process of the owner's personal car)			5,000	5,000
9	Proprietor's Capital Account/Drawing A/c Dr. To Cash Account (Being the amount paid to Manpreet for goods purchased for his personal use)			180	180
10	Cash Account Dr. Bad Debts Account Dr. To Gobind's Account (Being the amount received from Gobind in full settlement of his debts)			450 250	700
11	Narinder Dr. To Mohinder (Being cash paid by Mohinder to Narinder)			2,000	2,000

1. Mr. Ravindra's position as on 1st Jan. 1999 is follows:

   Property and Assets: Buildings Rs. 15,000

Furniture Rs. 1,500.
Stock of Goods Rs. 20,000
Cash at Bank Rs. 5,000
Cash in hand Rs. 1,000, and
Customer's Accounts Rs. 15,000.
Liabilities: Suppliers Accounts Rs. 12,500 and
Loan Account Rs. 30,000.

Pass necessary entries to record the above.

2. Miss Twinkle Punia started a restaurant investing Rs.5,00,000 on Jan. 1, 2000 and further submits the details ofthe transactions:

2006

Jan.5: She purchased furniture for Rs. 2,75,000; Crockery Rs.75,000 and cooking utensils Rs. 38,000

Jan. 10: She paid Rs. 1,00,000 as Salami for taking the shop onlease for ten years at Daryaganj, Delhi.

Jan. 15: She took a temporary loan of Rs. 75,000 from herbrother Rupinder, a financier.

Jan. 25: She took a bank loan of Rs. 50,000 and repaid the loantaken from her brother, Rupinder partly.

Jan. 31: She appointed Lavina as a manager at a salary of Rs.5000 p.m. and took from her a security deposit of Rs.50,000.

Pass Journal entire in the books of Twinkle Punia.

LEDGER

Ledger is a main book of account in which various accounts of personal, realand nominal nature, are opened and maintained. In journal, as all the businesstransactions are recorded chronologically, it is very difficult to obtain all thetransactions pertaining to one head of account together at one place. But, thepreparation of different ledger accounts helps to get a consolidated picture of thetransactions pertaining to one ledger account at a time. Thus, a ledger account may bedefined as a summary statement of all the transactions relating to a person, asset,expense, or income or gain or loss which have taken place during a specified periodand shows their net effect ultimately. From the above definition, it is clear that whentransactions take place, they are first entered in the journal and subsequently posted tothe concerned accounts in the ledger. Posting refers to the process of entering in theledger the information given in the journal. In the past, the ledgers were kept in boundbooks. But with the passage of time, they became loose-leaf ones and the advantagesof the same lie in the removal of completed accounts, insertion of new accounts andarrangement of accounts in any required manner.

RULING OF LEDGER ACCOUNT

The ruling of a ledger account is as follows:

Type- 1

Dr. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
	To name of the account to be credited				By name of the account to be debited		

Type: 2

26

Date	Particulars	J.F.	Dr. Rs.	Cr. Rs.	Dr. / Cr.	Balance Rs.
	To name of the account to be credited				By name of the account to be debited	

Ledger Account Type 1 is followed in almost all the business concerns, whereas Type 2 is followed only in banking institutions to save space, time and clerical work involved.

SUB-DIVISION OF LEDGER

In a big business, the number of accounts is numerous and it is foundnecessary to maintain a separate ledger for customers, suppliers and for others.Usually, the following three types of ledgers are maintained in such big businessconcerns.

(i) Debtors' Ledger: It contains accounts of all customers to whom goodshave been sold on credit. From the Sales Day Book, Sales Returns Book and CashBook, the entries are made in this ledger. This ledger is also known as sales ledger.

(ii) Creditors' Ledger: It contains accounts of all suppliers from whom goodshave been bought on credit. From the Purchases Day Book, Purchases Returns Bookand Cash Book, the entries are made in this ledger. This ledger is also known asPurchase Ledger.

(iii) General Ledger: It contains all the residual accounts of real and nominalnature. It is also known as Nominal Ledger.

DISTINCTION BETWEEN JOURNAL AND LEDGER

(i) Journal is a book of prime entry, whereas ledger is a book of final entry.

(ii) Transactions are recorded daily in the journal, whereas posting in theledger is made periodically.

(iii) In the journal, information about a particular account is not found at oneplace, whereas in the ledger information about a particular account is foundat one place only.

(iv) Recording of transactions in the journal is called journalizing and recordingof transactions in the ledger is called posting.

(v) A journal entry shows both the aspects debit as well as credit but eachentry in the ledger shows only one aspect.

(vi) Narration is written after each entry in the journal but no narration is givenin the ledger.

(vii) Vouchers, receipts, debit notes, credit notes etc., from the basic documentsform journal entry, whereas journal constitutes basic record for ledgerentries.

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

1998			Rs.
June	1	Started business with a capital of	60,000
June	2	Paid into bank	30,000

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

Solution:

In the books of Shankar & Co.

Date		Particulars		L.F.	Dr. Rs.	Cr. Rs.
1998 June	1	Cash A/c To Capital A/c (Capital brought into the business)	Dr.		60,000	60,000
June	2	Bank A/c To Capital A/c (Cash paid into bank)			30,000	30,000
June	4	Purchases A/c To Kamal's A/c (Purchased goods from Kamal on credit)			10,000	10,000
June	6	Shriram's A/c To Cash A/c (Cash paid to Shriram)	Dr.		4,920	4,920
June	6	Shriram's A/c To Cash A/c (Cash allowed by Shriram)	Dr.		80	80
June	8	Cash A/c To Sales A/c (Cash sales effected)	Dr.		20,000	20,000
June	12	Hameed's A/c To Sales A/c (Goods sold to Hameed)	Dr.		5,000	5,000
June	15	Purchases A/c To Bharat's A/c (Purchased goods from Bharat)	Dr.		7,500	7,500
June	18	Salaries A/c To Cash A/c (salaries paid)	Dr.		4,000	4,000
June	20	Cash A/c	Dr.		2,480	

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		To Prem's A/c (Cash received from Prem)				2,480
June	20	Discount A/c To Prem's A/c (Discount allowed to Prem)	Dr.		20	20
June	25	Cash A/c To Bank A/c (Cash withdrawn from bank)	Dr.		5,000	5,000
June	28	Drawings A/c To Cash A/c (Cash withdrawn from bank for personal use	Dr.		1,000	1,000
June	30	Hanif's A/c To Bank A/c (Paid to Hanif by cheques)	Dr.		3,000	3,000

Illusration-2

Journalise the following transactions:

1998

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

Solution:

Journal

Date		Particulars		L.F.	Dr. Rs.	Cr. Rs.
1998 June	1	Purchases A/c To Vimal's A/ c To Kamal's A/c (Purchased goods from Vimal and Kamal on credit	Dr.		800	300 500
June	3	Balram's A/c Dhanram A/c To Sales A/c (Sales of goods to Balram and Dhanram)	Dr. Dr.		1,000 700	1,700
June	5	Cash A/c To Ramasamy's A/c To Krishnasamy's A/c (Cash received from Ramasamy and Krishnasamy)	Dr.		1,700	900 800
June	7	Pradeep's A/c Kuldeep's A/c To Cash A/c (Paid Pradeep and Kuldeep)	Dr. Dr.		800 500	1,300
June	9	Cash A/c Drawings A/c To Bank A/c	Dr. Dr.		600 300	900

		(Withdrawn from bank for office use and personal use)			

Illustration - 3

Journalise the following transactions, post the same in relevant ledger account and balance the same.

1998

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

Solution:

Journal

Date	Particular		L.F.	Dr. Rs.	Cr. Rs.
1998 June 1	Cash A/c To Karthik's Capital A/c (Capital brought into the business by Karthik)	Dr		20,000	20,000
June 2	Bank A/c To Cash A/c (Cash Paid in to bank)	Dr		5,000	5,000

June 3	Plant A/c To Modi & Co's. A/c (Plant purchased from Modi & Co.)	Dr	10,000	10,000
June 4	Purchase A/c To Answar's A/c (Goods purchased from Anwar)	Dr	5,000	5,000
June 6	Anbu's A/c To Sales A/c (Goods sold to Anbu)	Dr	4,000	4,000
June 8	Cash A/c To Sales A/c (Goods sold for cash)	Dr	2,000	2,000
June 10	Sales Returns A/c To Anbu's A/c (Goods returned by Anbu)	Dr	50	50
June 15	Rent A/c To Cash A/c (Rent paid)	Dr	250	250
June 18	Cash A/c To Bank A/c (Withdrawn from bank for office use)	Dr	2,500	2,500
June 20	Salaries A/c To Cash A/c (Salaries paid)	Dr	1,800	1,800
June 25	Drawing A/c To Cash A/c (Withdrawn for personal use)	Dr	250	250
June 26	Anwar's A/c To Purchases Returns A/c (Goods returned to Anwar)	Dr	100	100
June 27	Furniture A/c To Bank A/c (Payment by cheque for office furniture)	Dr	1,500	1,500
June 28	Cash A/c Discount A/c To Anbu's A/c (Cash received from Anbu and discount allowed Rs.50)	Dr Dr	3,900 50	 3,950
June 29	Anwar's A/c To Cash A/c To Discount A/c (Cash paid to Anwar and discount allowed by him)	Dr	4,900	 4,800 100

Ledger

Cash A/c

Dr. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
1998				1998			

June	1	To Karthik's Capital A/c		20,000	June	2	By Bank A/c		5,000
June	8	To Sales A/c		2,000.	June	15	By Rent A/c		250
June	18	To Bank A/ c		2,500	June	20	By Salaries A/c		1,800
June	28	To Anbu's A/c		3,900	June	25	By Drawings A/c		250
					June	29	By Anwar's A/c		4,800
					June	30	By Balance c/d		16,300
				28,400					28,400
July	1	To Balance b/d		16,300					

Bank

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	2	To Cash A/c		5,000	June	18	By Cash A/c		2,500
					June	27	By Furniture A/c		1,500
					June	30	By Balance c/d		1,000
				5,000					5,000
July	1	To Balance b/d		1,000					

Karthik's Capital A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	30	To Balance c/d		20,000	June	1	By Cash A/c		20,000
				20,000					20,000
					July	1	By Balance b/d		20,000

Plant A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	3	To Modi & Co's. A/c		10,000	June	30	By Balance c/d		10,000
				10,000					10,000
July	1	To Balance c/d		10,000					

Modi & Co's. A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	30	To Balance c/d		10,000	June	3	By Plant A/c		10,000
				10,000					10,000
					July	1	By Balance b/d		10,000

Purchase A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	4	To Anwar's A/c		5,000	June	30	By Balance C/d		5,000
				5,000					5,000
July	1	To Balance b/d		5,000					

Anwar's A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	26	To Purchases Returns A/c		100	June	4	By Purchases A/c		5,000
June	29	To Cash A/c		4,800					
June	29	To Discount A/c		100					
				5,000					5,000

Sales A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	30	To Balance c/d		6,000	June	6	By Anbu's A/c		4,000
					June	8	By Cash A/c		2,000
				6,000					6,000
					July	1	To Balance b/d		6,000

Anbu's A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	6	To Sales A/c		4,000	June	10	By Sales Returns A/c		50
					June	28	By Cash A/c		3,900
					June	28	By Discount A/c		50
				4,000					4,000

Purchases Returns A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	30	To Balance c/d		100	June	26	By Anwar's A/c		100
				100					100
					July	1	By Balance b/d		100

Sales Returns A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	10	To Anbu's A/c		50	June	30	By Balance c/d		50
				50					50
July	1	To Balance b/d		50					

Furniture A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	27	To Bank A/c		1,500	June	30	By Balance c/d		1,500
				1,500					1,500
July	1	To Balance b/d		1,500					

Discount A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	28	To Anbu's A/c		50	June	29	By Anwar's A/c		100
June	30	To Balance c/d		50					10,000
				100	July	1	By Balance b/d		100
									50

Drawings A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	25	To Cash A/c		250	June	30	By Balance c/d		250
				250					250
July	1	To Balance b/d		250					

Rent A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998 June	15	To Cash A/c		250	1998 June	30	By Balance c/d		250
				250					250
July	1	To Balance b/d		250					

Salaries A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998 June	20	To Cash A/c		1,800	1998 June	30	By Balance c/d		1,800
				1,800					1,800
July	1	To Balance b/d		1,800					1,800

1.Journalize the following transactions in the books of Mr.Chandran**:** 2001

Apr. 1 Started business with cash Rs.40,000 and furniture Rs.10,000.

5 Paid tuition fee of the son Rs.1,000

8 Paid household expenses Rs.1,400.

10 Sold personal car for Rs.18,000 and the amount is brought into the business.

15 Withdrew goods for personal use Rs.2,000.

16 Sold goods to Navin on credit Rs.8,000.

18 Sold old typewriter Rs.1,000.

19 Purchase goods on credit from Ramesh Rs.20,000

20 Received interest on investment Rs.6,000.

22 Received commission from Manohar Rs.2,000.

23 Receive a cheque from NavinRs.5,000.

25 Issued a cheque to Ramesh Rs.12,000

26 Received cash from Anand on account Rs.4,000

27 Paid cash to Bhagwan on account Rs.1,000.

28 Returned goods to Ramesh Rs.1,000.

29 Navin returned goods Rs.500.

30 Paid rent Rs.1,000.

30 Paid salaries Rs.12,000.

2.Journalise the following transactions in the books of Sabitha and post them in the Ledger:
2000
Apr.1 Bought goods for cash Rs. 15,000

3 Sold goods for cash Rs. 19,000

5 Bought goods on credit from PeraraRs. 12,000

6 Sold goods on credit to RavindarRs. 16,000

8 Received from RavindarRs. 12,000

10 Paid to PeraraRs. 7,500

25 Bought furniture for cash Rs. 4,500

3. Enter the following transactions in the journal and ledger of Murali of New Delhi:
2001

Mar. 1 Murali commenced business with cash 90,000

4 Purchased goods for cash 6,000

5 Deposited into bank 40,000

6 Withdrew from bank for office use 4,500

8 Sold goods to Raja 4,800

12 Purchased goods on credit from Kathar 1,380

15 Received from Raj Rs.4,650 and allowed him discount 150

20 Cash sales 7,200

28 Paid to Kathar in full settlement 1,300

30 Paid rent 300

Paid salary 1,600

Accounts are closed on 31st March 2001.

4. Journalise the following transactions and Post them in relevant ledger accounts: 1991

Jan. 1. Bought from Das 1,000

Jan. 2. Sold to Sen 400

Jan. 3. Sold to Ramesh 250

Jan. 4. Purchased from Suresh 200

Jan. 5. Sales returns by Sen 50

Jan. 10. Bought from Shyam 600

Jan. 12. Returned to Suresh 100

Jan. 15. Sold to Roy 800

Jan. 16. Roy returned goods 200

Jan. 17. Sold goods to Ram 300

Jan. 19. Bough from Naresh 650

Jan. 21. Sold to Bhatanger 750

Jan. 22. Returned to Naresh 50

Jan. 25. Bought from Khatju 850

Jan. 27. Sold to Dheeran 260

Jan. 29. Returns from Bhatanger 100

Jan. 30. Dheeran Returned 60

Jan. 31. Returns to Khatju 150

TRIAL BALANCE

In case, the various debit balances and the credit balances of thedifferent accounts are taken down in a statement, the statement soprepared is termed as a 'Trial Balance'. In other words, Trial Balance is astatement containing the various ledger balances on a particular date.For example, with the balances of the ledger accounts prepared inIllustration 1. The Trial Balance can be prepared as follows:

Thus, the two sides of the Trial Balance tally. It means the books of accounts are arithmetically accurate.

Objectives of Preparing a Trial Balance

(i) Checking of the arithmetical accuracy of the accountingentries

Trial Balance helps in knowing the arithmeticalaccuracy of the accounting entries. This is because according to the dualaspect concept for every debit, there must be an equivalent credit. TrialBalance represents a summary of all ledger balances and, therefore, if thetwo sides of the Trial Balance tally, it is an indication of this fact that thebooks of accounts are arithmetically accurate. Of course, there may becertain errors in the books of accounts in spite of an agreed TrialBalance. For example, if a transaction has been completely omitted, fromthe books of accounts, the two sides of the Trial Balance will tally, inspite of the books of accounts being wrong.

(ii) Basis for financial statements

Trial Balance forms the basis for preparing financial statementssuch as the Income Statement and the Balance Sheet. The Trial Balancerepresents all transactions relating to different accounts in a summarized form for a particular period. In case, the Trial Balance is not prepared, itwill be almost impossible to prepare the financial statements as statedabove to know the profit or loss made by the business during a particularperiod or its financial position on a particular date.

(iii) Summarized ledger

It has already been stated that a Trial Balance contains the ledgerbalances on a particular date. Thus, the entire ledger is summarized inthe form of a Trial Balance. The position of a particular account can bejudged simply by looking at the Trial Balance. The Ledger may be seenonly when details regarding the accounts are required.

Illustration 2: Journalise the following transactions in the booksof trade. Also make their Ledger Postings and prepare a Trial Balance.

Debit Balances as on Jan. 1, 2006: Cash in hand Rs. 8,000; Cashat Bank Rs. 25,000; Stock of goods Rs. 20,000; Furniture Rs. 2,000;Building Rs. 10,000; Sundry Debtors-Vijay Rs. 2,000, Anil Rs. 1,000 andMadhuRs. 2,000.

Credit Balances on Jan. 1, 2006: Sundry Creditors- AnandRs.5,000; Loan from BabluRs. 10,000.The following were further transactions in the month of Jan, 2006:

Jan. 1: Purchased goods worth Rs. 5,000 for cash less 20%trade discount and 5% cash discount.

Jan. 4: Received Rs. 1,980 from Vijay and allowed him Rs. 20 asdiscount.

Jan. 6: Purchased goods from Bharat Rs. 5,000.

Jan. 8: Purchased plant from Mukesh for Rs. 5,000 and paidRs. 100 as cartage for bringing the plant to the factoryand another Rs. 200 as installation charges.

Jan. 12: Sold goods to Rahim on credit Rs. 600.

Jan. 15: Rahim became insolvent and could pay only 50 paise ina rupee.

Jan. 18: Sold goods to Ram for cash Rs. 1,000

Jan. 20: Paid salary to RatanRs. 2,000

Jan. 21: Paid AnandRs. 4,800 in full settlement.

Jan. 26: Interest received from MadhuRs. 200

Jan. 28: Paid to Bablu interest on Loan Rs. 500

Jan. 31: Sold goods for cash Rs. 500

Jan. 31: Withdraw goods from business for personal use Rs. 200

Solution:

JOURNAL

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
2006					
Jan. 1	Cash A/c	Dr.		8,000	
	Bank A/c	Dr.		25,000	
	Stock A/c	Dr.		20,000	
	Furniture A/c	Dr.		2,000	
	Building A/c	Dr.		10,000	
	Vijay	Dr.		2,000	
	Anil	Dr.		1,000	
	Madhu	Dr.		2,000	
	To Anand				5,000
	To Bablu's Loan A/c				10,000
	To Capital A/c				55,000
	(Being balances brought forward from last year)				
Jan.1	Purchase A/c	Dr.		4,000	
	To Cash A/c				3,800
	To Discount A/c				200
	(Being purchase of goods on discount)				
Jan. 4	Cash A/c	Dr.		1,980	
	Discount A/c	Dr.		20	
	To Vijay				2,000
	(Being cash received from Vijay, allowed discount Rs. 20)				
	Total carried forward (C/F)			76,000	76,000

	Total brought forward (B/F)			76,000	76,000
Jan. 6	Purchase A/c	Dr.		5,000	
	To Bharat				5,000
	(Being goods purchased)				
Jan. 8	Plant A/c	Dr.		5,300	
	To Mukesh				5,000
	To Cash A/c				300
	(Being plant purchased and payment of charges of Rs. 300)				
Jan. 12	Rahim		Dr.	600	
	To Sales A/c				600
	(Being sale of goods to Rahim)				
Jan. 15	Cash A/c	Dr.		300	
	Bad Debts A/c	Dr.		300	
	To Rahim				600
	(Being cash received from Rahim) 50 paise in a rupee				

Jan. 18	Cash A/c Dr. To Sales A/c (Being cash sale)		1,000	 1,000
Jan. 20	Salary A/c Dr. To Cash A/c (Being salary paid)		2,000	 2,000
Jan. 21	Anand Dr. To Cash A/c To Discount A/c (Being cash paid to Anand and discount received Rs. 200)		5,000	 4800 200
Jan. 26	Cash A/c Dr. To interest A/c (Being receipt of interest)		200	 200
	Total carried forward (C/F)		95,700	95,700

	Total brought forward (B/F)		95,700	95,700
Jan. 28	Interest on Loan Dr. To cash A/c (Being payment of interest on loan)		500	 500
Jan. 31 Jan. 31	Cash A/c Dr. To Sales A/c (Being cash sale) Drawings A/c Dr. To Purchase A/c (Being goods withdrawn for personal use)		500 200	 500 200
	Total		96,900	96,900

Ledger Posting

CASH ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount (Rs.)	Date	Particular	L.F.	Amount (Rs.)
2006				2006			
Jan.1	To Balance b/d		8,000	Jan.1	By Purchase A/c		3,800
Jan.4	To Vijay		1,980	Jan. 8	By Plant A/c		300
Jan.15	To Rahim		300	Jan.20	By Salary A/c		2,000
Jan.18	To Sales A/c		1,000	Jan.21	By Anand		4,800
Jan. 26	To Interest A/c		200	Jan. 28	By Interest on loan A/c		500
Jan. 31	To Sales A/c		500	Jan. 31	By Balance c/d		580
			11,980				11,980
Feb. 1	To Balance b/d		580				

INTEREST ACCOUNT

Dr. Cr.

Jan. 31	To Balance c/d	200	Jan. 26	By Cash A/c	200
		200			200
			Feb. 1	By Balance b/d	200

BANK ACCOUNT

Dr. Cr.

Jan. 1	To Balance b/d	25,000	Jan. 31	By Balance c/d	25,000
		25,000			25,000
Feb. 1.	To Balance b/d	25,000			

STOCK ACCOUNT

Dr. Cr.

Jan.1	To Balance b/d	20,000	Jan. 31	By Balance c/d	20,000
		20,000			20,000
Feb. 1	To Balance b/d	20,000			

FURNITURE ACCOUNT

Dr. Cr.

Jan. 1	To Balance b/d	2,000	Jan. 31	By Balance c/d	2,000
		2,000			2,000
Feb. 1	To Balance b/d	2,000			

BUILDING ACCOUNT

Dr. Cr.

Jan. 1	To Balance b/d	10,000	Jan. 31	By Balance c/d	10,000
		10,000			10,000
Feb. 1	To Balance b/d	10,000			

VIJAY ACCOUNT

Dr. Cr.

Jan. 1.	To Balance b/d	2,000	Jan. 4	By Cash A/c	1,980
				By Discount A/c	20
		2,000			2,000

ANIL ACCOUNT

Dr. Cr.

Jan. 1.	To Balance b/d	1,000	Jan. 31	By Balance	1,000
		1,000			1,000
Feb. 1	To Balance b/d	1,000			

MADHU ACCOUNT

Dr. Cr.

Jan. 1.	To Balance b/d	2,000	Jan. 31	By Balance c/d	2,000
		2,000			2,000
Feb. 1	To balance b/d	2,000			

ANAND ACCOUNT

Dr. Cr.

Jan. 21	To Cash A/c	4,800	Jan. 1	By Balance b/d	5,000
Jan. 21	To Discount A/c	200			
		5,000			5,000

CAPITAL ACCOUNT

Dr. Cr.

Jan. 31.	To Balance c/d	55,000	Jan. 1	By Balance b/d	55,000
		55,000			55,000
			Feb. 1	By Balance b/d	55,000

BABU'S LOAN ACCOUNT

Dr. Cr.

Jan. 31.	To Balance c/d	10,000	Jan. 1	By Balance b/d	10,000
		10,000			10,000
			Feb. 1	By Balance b/d	10,000

PURCHASE ACCOUNT

Dr. Cr.

Jan. 1.	To Cash A/c	3,800	Jan. 31	By Drawings A/c	200
Jan. 1	To Discount A/c	200	Jan. 31	By Balance c/d	8,800
Jan. 6	To Bharat	5,000			
		9,000			9,000
Feb. 1.	To Balance b/d	8,800			

DISCOUNT ACCOUNT

Dr. Cr.

Jan. 4.	To Vijay	20	Jan. 1	By Purchases A/c	200
Jan. 31	To Balance c/d	380	Jan. 21	By Anand	200
		400			400
			Feb. 1	By Balance	380

BHARAT ACCOUNT

Dr. Cr.

Jan. 31.	To Balance c/d	5,000	Jan. 6	By Purchases A/c	5,000
		5,000			5,000
			Feb. 1	By Balance b/d	5,000

PLANT ACCOUNT

Dr. Cr.

Jan. 8.	To Mukesh	5,000	Jan. 31	By Balance c/d	5,300
Jan. 8	To Cash A/c	300			
		5,300			5,300
Feb. 1	To Balance b/d	5,300			

INTEREST ON LOAN ACCOUNT

Dr. Cr.

Jan. 28.	To Cash A/c	500	Jan. 31	By Balance	500
		500			500
Feb. 1	To Balance b/d	500			

MUKESH

Dr. Cr.

Jan. 31.	To Balance c/d	5,000	Jan. 8	By Plant A/c	5,000
		5,000			5,000
			Feb. 1	By Balance b/d	5,000

SALES ACCOUNT

Dr. Cr.

Jan. 31.	To Balance c/d	2,100	Jan. 21	By Rahim	600
			Jan. 18	By Cash A/c	1,000
			Jan. 31	By Cash A/c	500
		2,100			2,100
			Feb. 1	By Balance b/d	2,100

RAHIM

Dr. Cr.

Jan. 12.	To Sales A/c	600	Jan. 15	By Cash A/c	300
			Jan. 15	By Bad Debts A/c	300
		600			600

BAD DEBTS ACCOUNT

Dr. Cr.

Jan. 15	To Rahim	300	Jan. 31	By Balance c/d	300
		300			300
Feb. 1	To Balance b/d	300			

SALARY ACCOUNT

Dr. Cr.

Jan. 20.	To Cash A/c	2,000	Jan. 31	By Balance b/d	2,000
		2,000			2,000
Feb. 1	To Balance b/d	2,000			

DRAWING ACCOUNT

Dr. Cr.

Jan. 31.	To Purchases A/c	200	Jan. 31	By Balance c/d	200
		200			200
Feb. 1	To Balance	200			

TRIAL BALANCE

(AS ON 31ST JANUARY, 2006)

Particular	Debit Amount	Credit Amount
Cash Account	580	
Interest Account		200
Bank Account	25,000	

Stock Account	20,000	
Furniture Account	2,000	
Building Account	10,000	
Anil	1,000	
Madhu	2,000	
Capital Account		55,000
Babu's Loan Account		10,000
Purchases Account	8,800	
Discount Account		380
Bharat		5,000
Plant Account	5,300	
Interest on Loan Account	500	
Mukesh		5,000
Sales Account		2,100
Bad Debts Account	300	
Salary Account	2,000	
Drawings Account	200	
	77,680	77,680

Part A (ONE Mark)

Multiple Choice Questions

Online Examination

Part B

(2 Marks)

1. Define accounting.

2. Journalize the following transactions:
   2014 April
   a. Arun Commenced business with Rs. 25,000
   b. Bought goods for cash Rs. 9,200
   c. Paid rent by cheque Rs. 1,500
   d. Furniture purchased for cash Rs. 15, 000
3. List out the principles of accounting.
4. Define Journal
5. Pass necessary journal entries:
Commenced business with a capital Rs. 60,000

Salary paid Rs. 5000

Sold goods for cash 5,000

Purchase from GanesanRs. 2,500

6. What is meant by IFRS?

7.What do you mean by ledger.

8. Write a short note on Trial balance
9. Explain the Going Concern Concept?

10. Give journal entries for the following transactions

Kumar started business with cash Rs. 1,000

Paid Salary Rs. 500

Sold goods to Krishna for cash Rs. 5,000

Purchase goods for cash Rs. 4,000

Part C (8 Marks)

1. Elaborate the accounting principles with suitable examples?

2. Journalize the following transaction of Manisha & Co.:

July 2015	Rs.
1 Commenced business with cash	15, 00, 000
2 Purchased goods for cash	10, 000
4 Sold goods for cash	25, 000
6 Purchased goods from Mohan	5, 000
7 Sold goods to Rahul	35, 000
8 Rent paid	6, 500
9 Received cash from Rahul in full settlement	34, 950
and discount allowed	50
13 Paid cash to Mohan in full settlement	4, 950
and discount received	50
15 Commission paid	200
25 Interest received	500

3. From the following Trial balance, prepare a Trading and Profit and Loss account for the year ended 31.12.2014 and a balance sheet on that date:

Trial balance

Particulars	**Debit (Rs.)**	**Credit (Rs.)**
Capital	-	40, 000
Sales	-	25, 000
Purchases	15, 000	-
Salaries	2, 000	-
Rent	1, 500	-
Insurance	300	-
Drawings	5, 000	-
Machinery	28, 000	-
Bank balance	4,500	-
Cash	2, 000	-
Stock 1.1.2014	5,200	-
Debtors	2,500	-
Creditors	-	1, 000
Total	**66,000**	**66, 000**

Adjustments required:

a) Stock on 31.12.2014 Rs. 4, 900

b) Salaries unpaid Rs. 300

c) Rent paid in advance Rs. 200
d) Insurance prepaid Rs. 90

(or)

4.From the following Profit and Loss Accounts and the Balance Sheet of Swadeshi polytex Ltd. For the year ended 31st December, 2009 and 2010, you are required to prepare a comparative Income Statement and Comparative Balance Sheet.

PROFIT AND LOSS ACCOUNT(In Lakhs of Rs.)

Particular	2009	2010	Particulars	2009	2010
	Rs.	Rs.		Rs.	Rs.
To Cost of Goods sold	600	750	By Net Sales	800	1,000
To operating Expenses					
Administrative Expenses	20	20			
Selling Expenses	30	40			
To Net Profit	150	190			
	800	1,000		800	1,000

Balance Sheet As On 31st December

(In Lakhs of Rs.)

Liabilities	2009	2010	Assets	2009	2010
	Rs.	Rs.		Rs.	Rs.
Bills Payable	50	75	Cash	100	140
Sundry Creditors	150	200	Debtors	200	300
Tax Payable 6%	100	150	Stock	200	300
Debentures 6%	100	150	Land	100	100
Preference Capital	300	300	Building	300	270
Equity Capital	400	400	Plant	300	270
Reserves	200	245	Furniture	100	140
	1300	1520		1300	1520

5.Define accounting and explain the Concepts and Conventions?

6. Prepare Trail balance from the following information as on 31st March 2015

Particulars	**Rs.**
Capital	16, 800
Wages	5, 000
Stock	21, 000

Purchases	36, 000
Sales	72, 000
Purchase Return	2, 000
Sales Return	3, 000
Debtors	4, 500
Creditors	2, 500
Furniture	900
Bills receivable	2, 300
Bills payable	4, 200
Rent	1, 300
Expenses on advertising	600
Commission received	600
Machinery	20, 000
Cash	3,500

(or)

7. ‘The managerial objectives of accounting are to provide data to help the management in planning, decision-making, coordinating and controlling operations’- Discuss.

Part D (11 Marks)

Prepare Trail balance from the following information as on 31st December, 2013

Particulars	Rs.
Cash in hand	540
Cash at Bank	2,630
Purchases Account	40,675
Sales Account	98,780
Returns Inwards Account	680
Returns Outwards Account	500
Wages Account	10,480
Fuel and Power Account	4,730
Carriage Inward	3,200
Rent	2,040
Opening Stock	5,760
Buildings	30,000
Land	10,000
Machinery	20,000
Electricity charges	7,500

Salaries Account	15,000
General Expenses Account	3,000
Insurance Account	600
Commission	5,245
Capital	71,000
Sundry Debtors	14,500
Sundry Creditors	6,300

UNIT 1

S.No	Questions	Opt 1	Opt 2	Opt 3	Opt 4	Answer
1	Capital are recorded in the balance sheet on_______	Liability side	Asset Side	Both Liability and Asset side	May not appear in the balance sheet	Liability side
2	Cash comprises cash on hand and _____ deposit with banks	Current	fixed	Demand	Saving	Saving
3	Financial statements of a company does not include________________	Sales	Purchase	Management decisions	Cash	Management decisions
4	Management Accounting is primarily concerned with the supply of information which is useful to ___________	Suppliers	Employees	Management	Supervisors	Management
5	Entries passed to transfer the revenue accounts to profit and loss a/c is called __________	Opening Entries	Closing Entries	Adjustment Entries	Personal Entries	Closing Entries
6	Fixing the price of the product is dealt with in	Social accounting	Management Accounting	Financial Accounting	Cost Accounting	Cost Accounting
7	When does an accountant record a transaction___________	If it is materialized by a concrete document	If it has a tax implication	On managers' demand	On the demand of material	If it is materialized by a concrete document
8	Accounting is the process of matching___________	Benefits and Costs	Revenues and Expenses	Cash inflows and Outflows	Potential and real performance	Revenues and Expenses
9	The concept that recognizes revenues and expenses as they are earned or incurred is _________________	Cost	Realization	Accrual	Matching	Matching
10	Furniture is______________	Fixed asset	Current asset	Liquid assets	Tangible assets	Fixed asset

11	While putting the value or price of an entity in financial records the lowest price is recorded not the current price or current market value. This is know as____________	Business Entity Concept	Conservatism	Cost Concept	Money Measurement Concept	Cost Concept
12	The Financial record should always be published in a definite time period according to ____________	Accounting Period Concept	Cost Concept	Money Measurement Concept	Consistency	Accounting Period Concept
13	The matching concept is often referred to as	Accrual Concept	Profit Concept	Going concern Concept	Business Entity Concept	Accrual Concept
14	The concept that states the business is commercially viable is called	Accounting Period Concept	Business Entity Concept	Money Measurement Concept	Going concern Concept	Going concern Concept
15	The main objective of accounting is to see concern ____________	Financial position	Position of the cash book	Position of purchases	Position of sales	Financial position
16	___________ is a current asset	Cash balance	Furniture	Investments	Closing stock	Cash balance
17	Which of the following groups use financial accounting_________________	Management, employees, shareholders and lenders	Management, Lenders and Debtors	Employers, Maufacturers and Creditors	Shareholdelrs, Employees and Creditors	Management, employees, shareholders and lenders
18	The concept that assumes that the business will operate for a long time is called	Business Entity Concept	Accounting Period Concept	Cost Concept	Money Measurement Concept	Business Entity Concept
19	When asset is purchased for cash, _______ a /c is debited	Cash	Bank	Debtors	Asset	Asset
20	The example of intangible asset is___________	Land	Building	Furniture	Patents.	Patents

UNIT 1

21	An entry required for transferring an account from one ledger to another is ______________	Single entry	Transfer entry	Double entry	No entry	Transfer entry
22	All transactions are first recorded in _____________	Journal	Ledger	Papers	Noted materials	Journal
23	The transactions are posted in the ______ from the books of original entry	Journal	Ledger	Papers	Noted materials	Ledger
24	Returns inwards and outwards are _____ accounts	Real	Nominal	Personal	Persons	Real
25	Expenses like wages, salaries, lighting are _______	Nominal account	Real account	Personal account	Cash account	Nominal account
26	An example which increase the debtors is ______	Credit sales	Credit purchase	Purchase return	Sales return	Credit sales
27	Which of the following is real account	Drawings	Cash	Rent	Salary	Cash
28	Debtors ledger is otherwise known as _________	Creditors	Bought	Sales	General	Sales
29	An example of nominal account is ________	Freight Charges	Good will	Sales	Purchase	Freight Charges
30	A ________ account usually shows credit balance	Debtors account	Creditors account	Capital account	Debenture account	Debtors account
31	A firm has assets worth rs.60,000 and capital worth Rs.45,000, then its liabilities is__________	Rs. 10,000	Rs.15,000	Rs.20,000	Rs.25,000	Rs.15,000
32	The total assets of a proprietor are Rs.5,00,000. His liabilities Rs. 3,50,000. Then his capital	Rs. 1,00,000	Rs.1,50,000	Rs.3,00,000	Rs. 2,50,000	Rs.1,50,000

	in the business is ________					
33	Cash purchases at Rs.9,000 and credit purchases at Rs.11,000, then total purchases at ______________	Rs. 20,000	Rs.10,000	Rs.30,000	Rs.11,000	Rs.20,000
34	Total sales at Rs. 8,000 and cash sales at Rs. 5,000 then credit sales is	Rs.13,000	Rs.8000	Rs.3000	Rs.5000	Rs.3000
35	Credit sales can be ascertained as the balancing figure in the__________	Creditors a/c	Debtors a/c	Profit & Loss a/c	Balancesheet	Debtors a/c
36	Credit purchase can be ascertained as the balancing figure in the __________________	Creditors a/c	Debtors a/c	Profit & Loss a/c	Balancesheet	Creditors a/c
37	Commission received is ____________	Expenditure for the business	Income for the business	No income and expenditure	loss to the business	Income for the business
38	Commission Paid is ________	Expenditure for the business	Income for the business	No income and expenditure	loss to the business	Expenditure for the business
39	The primary function of accounting is _____________	Recording financial data	Recording non-financial transactions	Recording and classifying business operations	Recording of transactions	Recording financial data
40	Financial accounting deals with _______________	Determination of profit	Determination of price	Determination of cost	Determination of value	Determination of profit
41	The only long lasting asset in an organisation is	Cash	People	Machinery	Cost	People
42	Non-financial quantitative information is not recorded in	Dual concept	Money measurement	Accrual concept	Periodic concept	Money measurement

	accounts in the ______________		concept			concept
43	Journal is a book of ___________	Original entry	Secondary entry	Petty cash transaction	Credit records	Original entry
44	Financial accounts records only ____________	Actual figures	Budgeted figures	Standard figures	Market cost	Actual figures
45	The process of recording the journal is called__________	Journalising	Costing	Ledger	Posting	Journalising
46	Which of the following is correct___________	Asset = Liabilities – Capital	Capital = Assets – Liabilities	Capital = Assets + Liabilities	Capital = Asset	Capital = Assets – Liabilities
47	IFRS stands for __________	Indian Financial Ranking Standards	Indian Financial Reporting Standards	International Financial Reporting Standards	International Financial Ranking Standards	International Financial Reporting Standards
48	The accounting that shows the changes in purchasing power is called	Inflation Accounting	Green Accounting	Social Responsibility Accounting	International Accounting	Inflation Accounting
49	The accounting that increases social awareness is called	Inflation Accounting	Green Accounting	Social Responsibility Accounting	International Accounting	Social Responsibility Accounting
50	The concept of treating the business as a separate entity is called _________________	Money measurement concept	Dual aspect concept	Business entity concept	Matching concept	Business entity concept
51	Which of the following shows chronological records of transaction _________________	Ledger	Trial Balance	Journal	Subsidary books	Trial Balance
52	Debtors ledger is also known as ____________	Customers ledger	General ledger	Suppliers ledger	Specific ledger	Customers ledger
53	A statement below the journal is _________	Narration	Description	Transaction	Descreptive	Narration
54	The process of recording in the	Posting	Ledger	Journalising	Summarizing	Posting

	ledger is _____________					
55	Cash account is a ____________	Personal account	Nominal account	Real account	Book	Real account
56	The sales made to Surya for cash should be debited______	Cash account	Purchases account	Sales account	Surya account	Cash account
57	Trial Balance is prepared with the principle of__________	Single entry system of book-keeping	Double entry system of book-keeping	Transaction	Jouranlising	Double entry system of book-keeping
58	An irrecovable debt is called _____________	Bad debts	Doubtful debts	Debts	Non fund	Bad debts
59	Abbreviate CFO - ______________	Chief Finance Operations	Chief Financial Organisation	Chief Finance Officer	Chief of Finance Operations	Chief Finance Officer
60	Accounting Information does not include	Operating Information	Qualitative Information	Quantitative Information	Management Information	Qualitative Information

UNIT-II-Three Golden Principles
SYLLABUS

Three Golden Principles,Journal entry and Ledger entry. Final Accounts– Preparing Trading Account - Profit and Loss account - Balance sheet, with and without adjustments)

UNIT – II

THREE GOLDEN PRINCIPLES OF ACCOUNTING

Introduction

Accounting principles refer, to certain rules, procedures and conventions whichrepresent a consensus view by those indulging in good accounting practices andprocedures. Canadian Institute of Chartered Accountants defined accounting principleas "the body of doctrines commonly associated with the theory and procedure ofaccounting, serving as an explanation of current practices as a guide for the selectionof conventions or procedures where alternatives exist. Rules governing the formationof accounting axioms and the principles derived from them have arisen from commonexperiences, historical precedent, statements by individuals and professional bodiesand regulations of Governmental agencies". To be more reliable, accounting
statements are prepared in conformity with these principles. If not, chaotic conditionswould result. But in reality as all the businesses are not alike, each one has its ownmethod of accounting. However, to be more acceptable, the accounting principlesshould satisfy the following three basic qualities, viz., relevance, objectivity andfeasibility. The accounting principle is considered to be relevant and useful to theextent that it increases the utility of the records to its readers. It is said to be objectiveto the extent that it is supported by the facts and free from personal bias.

Three Golden Principles are:

1. Debit the receiver, Credit the giver
2. Debit what comes in, Credit what goes out
3. Debit all expenses and losses, Credit all incomes and gains

JOURNAL ENTRY AND LEDGER ENTRY

When the business transactions take place, the first step is to record the samein the books of original entry or subsidiary books or books of prime or journal. Thusjournal is a simple book of accounts in which all the business transactions areoriginally recorded in chronological order and from which they are posted to theledger accounts at any convenient time. Journaling refers to the act of recording eachtransaction in the journal and the form in which it is recorded, is known as a journalentry.

Illustration:

Analyse the following transactions.

(a) Ramesh started his business with cash

(b) Borrowed from Nikhil

(c) Purchased furniture

(d) Purchased furniture from Mohan on credit

(e) Purchased goods for cash

(f) Purchased goods from Ram on credit

(g) Sold goods for cash

(h) Sold goods to Hari on credit

(i) Received cash from Hari

(j) Paid cash to Ram

(k) Deposited into bank

(l) Withdrew cash for personal use

(m) Withdrew from bank for office use

(n) Withdrew from bank for personal use

(o) Received cash from a customer, Shyam

(p) Paid salary by cheque

(q) Received donation in cash

(r) Paid to Ram by cheque

(s) Paid salary

(t) Paid rent by cheque

(u) Goods withdrawn for personal use

(v) Paid an advance to suppliers of goods

(w) Received an advance from customers

(x) Paid interest on loan

(y) Paid instalment of loan

(z) Interest allowed by bank.

Solution

ANALYSIS OF TRANSACTIONS

Transaction	Accounts involved	Nature of accounts	How affected	Whether to be debited or credited
(a)	Cash A/c	Real	Cash is coming in	Debit
	Capital A/c	Personal	Ramesh is the giver	Credit
(b)	Cash A/c	Real	Cash in coming in	Debit
	Loan from Nikhil A/c	Personal	Nikhil is the giver	Credit
(c)	Furniture A/c	Real	Furniture is coming in	Debit
	Cash A/c	Real	Cash is going out	Credit
(d)	Furniture A/c	Real	Furniture is coming in	Debit
	Mohan's A/c	Personal	Mohan is the giver	Credit
(e)	Purchases A/c	Real	Goods are coming in	Debit
	Cash A/c	Real	Cash is going out	Credit
(f)	Purchases A/c	Real	Goods are coming in	Debit
	Ram's A/c	Personal	Ram is the giver	Credit
(g)	Cash A/c	Real	Cash is coming in	Debit
	Sales A/c	Real	Goods are going out	Credit
(h)	Hari's A/c	Personal	Hari is the receiver	Debit
	Sales A/c	Real	Goods are going out	Credit
(i)	Cash A/c	Real	Cash is coming in	Debit
	Hari's A/c	Personal	Hari is the giver	Credit
(j)	Ram's A/c	Personal	Ram is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(k)	Bank A/c	Personal	Bank is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(l)	Drawings A/c	Personal	Ramesh is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit

Transaction	Accounts involved	Nature of accounts	How affected	Whether to be debited or credited
(m)	Cash A/c	Real	Cash is coming in	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(n)	Drawings A/c	Personal	Ramesh is the receiver	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(o)	Cash A/c	Real	Cash is coming in	Debit
	Shyam's A/c	Personal	Shyam is the giver	Credit
(p)	Salary A/c	Nominal	Salary is an expense	Debit
	Bank A/c	Personal	Bank is the receiver	Credit
(q)	Cash A/c	Real	Cash is coming in	Debit
	Donation A/c	Nominal	Donation is a gain	Credit
(r)	Ram's A/c	Personal	Ram is the receiver	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(s)	Salary A/c	Nominal	Salary is an expense	Debit
	Cash A/c	Real	Cash is going out	Credit
(t)	Rent A/c	Nominal	Rent is an expense	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(u)	Drawing's A/c	Personal	Ramesh is the receiver	Debit
	Purchases A/c	Real	Goods are going out	Credit
(v)	Advance to Suppliers A/c	Personal	Suppliers are the receivers	Debit
	Cash A/c	Real	Cash is going out	Credit
(w)	Cash A/c	Real	Cash is coming in	Debit
	Adv. from Customers A/c	Personal	Customers are the givers	Credit
(x)	Interest on Loan A/c	Nominal	Interest on loan is an expense	Debit
	Cash A/c	Real	Cash is going out	Credit
(y)	Loan A/c	Personal	Lender is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(z)	Bank A/c	Personal	Bank is the receiver	Debit
	Bank Interest A/c	Nominal	Bank Interest is a gain	Credit

Illustration: Prepare Journal in the books of K.K. Co. from the following transactions:

1999		Rs.	1999		Rs.
Dec. 1	Started business with a capital of	50,000	Dec. 15	Purchased goods from Ram	4,000
Dec. 6	Paid into bank	20,000	Dec. 18	Paid wages to workers	300
Dec. 8	Purchased goods for cash	4,000	Dec. 20	Recd. from Pankaj Allowed him discount Rs. 50	1,000
Dec. 9	Paid to Ram	1,980	Dec. 22	Withdrawn from bank	3,000
Dec. 9	Discount allowed by him	20	Dec. 25	Paid Ram by cheque	500
Dec. 10	Cash sales	3,000	Dec. 31	Withdrawn for personal use	200
Dec. 12	Sold to Hari for cash	2,000			

Solution

IN THE BOOKS OF K.K. CO.

Journal

Date	Particulars		L.F.	Dr. Rs.	Cr. Rs.
1999					
Dec. 1.	Cash A/c	Dr.		50,000	
	To Capital A/c				50,000
	(Being business started with capital)				
6.	Bank A/c	Dr.		20,000	
	To Cash A/c				20,000
	(Being cash paid into bank)				
8.	Purchase A/c	Dr.		4,000	
	To Cash A/c				4,000

	(Being goods purchased for cash)			
9.	Ram A/c Dr.		2,000	
	To Cash A/c			1,980
	To Discount Received A/c			20
	(Being cash paid to Ram and discount received Rs. 20)			
10.	Cash A/c Dr.		3,000	
	To Sales A/c			3,000
	(Being goods sold for cash)			
12.	Cash A/c Dr.		2,000	
	To Sales A/c			2,000
	(Being goods sold for cash)			
15	Purchases A/c Dr.		4,000	
	To Ram A/c			4,000
	(Being goods purchased from Ram)			
18.	Wages A/c Dr.		300	
	To Cash A/c			300
	(Being wages paid)			

20.	Cash A/c Dr.		1,000	
	Discount Allowed A/c Dr.		50	
	To Pankaj A/c			1,050
	(Being cash received from Pankaj and allowed him discount Rs. 50)			
22.	Cash A/c Dr.		3,000	
	To Bank A/c			3,000
	(Being cash withdrawn from bank)			
25.	Ram A/c Dr.		500	
	To Bank A/c			500
	(Being paid by cheque)			
31.	Drawings A/c Dr.		200	
	To Cash A/c			200
	(Being withdrawn for personal use)			
	Grand Total		**90,050**	**90,050**

LEDGER

Ledger is a main book of account in which various accounts of personal, realand nominal nature, are opened and maintained. In journal, as all the businesstransactions are recorded chronologically, it is very difficult to obtain all thetransactions pertaining to one head of account together at one place. But, thepreparation of different ledger accounts helps to get a consolidated picture of thetransactions pertaining to one ledger account at a time. Thus, a ledger account may bedefined as a summary statement of all the transactions relating to a person, asset,expense, or income or gain or loss which have taken place during a specified periodand shows their net effect ultimately. From the above definition, it is clear that whentransactions take place, they are first entered in the journal and subsequently posted tothe concerned accounts in the ledger. Posting refers to the process of entering in theledger the information given in the journal. In the past, the ledgers were kept in boundbooks. But with the passage of time, they became loose-leaf ones and the advantagesof the same lie in the removal of completed accounts, insertion of new accounts andarrangement of accounts in any required manner.

RULING OF LEDGER ACCOUNT

The ruling of a ledger account is as follows:

Type- 1

Dr. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
	To name of the account to be credited				By name of the account to be debited		

Type: 2

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Date	Particulars	J.F.	Dr. Rs.	Cr. Rs.	Dr. / Cr.	Balance Rs.
	To name of the account to be credited				By name of the account to be debited	

Ledger Account Type 1 is followed in almost all the business concerns, whereas Type 2 is followed only in banking institutions to save space, time and clerical work involved.

SUB-DIVISION OF LEDGER

In a big business, the number of accounts is numerous and it is foundnecessary to maintain a separate ledger for customers, suppliers and for others.Usually, the following three types of ledgers are maintained in such big businessconcerns.

(i) Debtors' Ledger: It contains accounts of all customers to whom goodshave been sold on credit. From the Sales Day Book, Sales Returns Book and CashBook, the entries are made in this ledger. This ledger is also known as sales ledger.

(ii) Creditors' Ledger: It contains accounts of all suppliers from whom goodshave been bought on credit. From the Purchases Day Book, Purchases Returns Bookand Cash Book, the entries are made in this ledger. This ledger is also known asPurchase Ledger.

(iii) General Ledger: It contains all the residual accounts of real and nominalnature. It is also known as Nominal Ledger.

Illustration - 3

Journalise the following transactions, post the same in relevant ledger account and balance the same.

1998

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

Solution:

Journal

Date	Particular		L.F.	Dr. Rs.	Cr. Rs.
1998 June 1	Cash A/c To Karthik's Capital A/c (Capital brought into the business by Karthik)	Dr		20,000	20,000
June 2	Bank A/c To Cash A/c (Cash Paid in to bank)	Dr		5,000	5,000
June 3	Plant A/c To Modi & Co's. A/c (Plant purchased from Modi & Co.)	Dr		10,000	10,000
June 4	Purchase A/c To Answar's A/c (Goods purchased from Anwar)	Dr		5,000	5,000
June 6	Anbu's A/c To Sales A/c (Goods sold to Anbu)	Dr		4,000	4,000
June 8	Cash A/c To Sales A/c (Goods sold for cash)	Dr		2,000	2,000
June 10	Sales Returns A/c To Anbu's A/c (Goods returned by Anbu)	Dr		50	50
June 15	Rent A/c To Cash A/c (Rent paid)	Dr		250	250
June 18	Cash A/c To Bank A/c (Withdrawn from bank for office use)	Dr		2,500	2,500
June 20	Salaries A/c To Cash A/c (Salaries paid)	Dr		1,800	1,800

June 25	Drawing A/c To Cash A/c (Withdrawn for personal use)	Dr	250	 250
June 26	Anwar's A/c To Purchases Returns A/c (Goods returned to Anwar)	Dr	100	 100
June 27	Furniture A/c To Bank A/c (Payment by cheque for office furniture)	Dr	1,500	 1,500
June 28	Cash A/c Discount A/c To Anbu's A/c (Cash received from Anbu and discount allowed Rs.50)	Dr Dr	3,900 50	 3,950
June 29	Anwar's A/c To Cash A/c To Discount A/c (Cash paid to Anwar and discount allowed by him)	Dr	4,900	 4,800 100

Ledger
Cash A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	1	To Karthik's Capital A/c		20,000	June	2	By Bank A/c		5,000
June	8	To Sales A/c		2,000.	June	15	By Rent A/c		250
June	18	To Bank A/ c		2,500	June	20	By Salaries A/c		1,800
June	28	To Anbu's A/c		3,900	June	25	By Drawings A/c		250
					June	29	By Anwar's A/c		4,800
					June	30	By Balance c/d		16,300
				28,400					28,400
July	1	To Balance b/d		16,300					

Bank

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	2	To Cash A/c		5,000	June	18	By Cash A/c		2,500
					June	27	By Furniture A/c		1,500
					June	30	By Balance c/d		1,000
				5,000					5,000
July	1	To Balance b/d		1,000					

Karthik's Capital A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	30	To Balance c/d		20,000	June	1	By Cash A/c		20,000
				20,000					20,000
					July	1	By Balance b/d		20,000

Plant A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	3	To Modi & Co's. A/c		10,000	June	30	By Balance c/d		10,000
				10,000					10,000
July	1	To Balance c/d		10,000					

Modi & Co's. A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	30	To Balance c/d		10,000	June	3	By Plant A/c		10,000
				10,000					10,000
					July	1	By Balance b/d		10,000

Purchase A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	4	To Anwar's A/c		5,000	June	30	By Balance C/d		5,000
				5,000					5,000
July	1	To Balance b/d		5,000					

Anwar's A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	26	To Purchases Returns A/c		100	June	4	By Purchases A/c		5,000
June	29	To Cash A/c		4,800					
June	29	To Discount A/c		100					
				5,000					5,000

Sales A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	30	To Balance c/d		6,000	June	6	By Anbu's A/c		4,000
					June	8	By Cash A/c		2,000
				6,000					6,000
					July	1	To Balance b/d		6,000

Anbu's A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	6	To Sales A/c		4,000	June	10	By Sales Returns A/c		50
					June	28	By Cash A/c		3,900
					June	28	By Discount A/c		50
				4,000					4,000

Purchases Returns A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	30	To Balance c/d		100	June	26	By Anwar's A/c		100
				100					100
					July	1	By Balance b/d		100

Sales Returns A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	10	To Anbu's A/c		50	June	30	By Balance c/d		50
				50					50
July	1	To Balance b/d		50					

Furniture A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	27	To Bank A/c		1,500	June	30	By Balance c/d		1,500
				1,500					1,500
July	1	To Balance b/d		1,500					

Discount A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	28	To Anbu's A/c		50	June	29	By Anwar's A/c		100
June	30	To Balance c/d		50					10,000
				100	July	1	By Balance b/d		100
									50

Drawings A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998					1998				
June	25	To Cash A/c		250	June	30	By Balance c/d		250
				250					250
July	1	To Balance b/d		250					

Rent A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998 June	15	To Cash A/c		250	1998 June	30	By Balance c/d		250
				250					250
July	1	To Balance b/d		250					

Salaries A/c

Dr. Cr.

Date		Particulars	J.F.	Rs.	Date		Particulars	J.F.	Rs.
1998 June	20	To Cash A/c		1,800	1998 June	30	By Balance c/d		1,800
				1,800					1,800
July	1	To Balance b/d		1,800					1,800

FINAL ACCOUNTS

INTRODUCTION

The transactions of a business enterprise for the accounting periodare first recorded in the books of original entry, then posted therefrominto the ledger and lastly tested as to their arithmetical accuracy with thehelp of trial balance. After the preparation of the trial balance, everybusinessman is interested in knowing about two more facts. They are: (i)Whether he has earned a profit or suffered a loss during the periodcovered by the trial balance, and (ii) Where does he stand now? In otherwords, what is his financial position?

For the above said purposes, the businessman prepares financialstatements for his business i.e. he prepares the Trading and Profit and LossAccount and Balance Sheet at the end of the accounting period. Thesefinancial statements are popularly known as final accounts. The preparationof financial statements depends upon whether the business concern is atrading concern or manufacturing concern. If the business concern is atrading concern, it has to prepare the following accounts along with theBalance Sheet: (i) Trading Account; and (ii) Profit and Loss Account.

But, if the business concern is a manufacturing concern, it has toprepare the following accounts along with the Balance Sheet:

(i) Manufacturing Account;

(ii) Trading Account; and

(iii) Profit and Loss Account.

Trading Account is prepared to know the Gross Profit or GrossLoss. Profit and Loss Account discloses net profit or net loss of thebusiness. Balance sheet shows the financial position of the business on agiven date. For preparing final accounts, certain accounts representingincomes or expenses are closed either by transferring to Trading Accountor Profit and Loss Account. Any Account which cannot find a place in anyof these two accounts goes to the Balance Sheet.

TRADING ACCOUNT

After the preparation of trial balance, the next step is to prepareTrading Account. Trading Account is one of the financial statementswhich shows the result of buying and selling of goods and/or servicesduring an accounting period. The main objective of preparing the TradingAccount is to ascertain gross profit or gross loss during the accountingperiod. Gross Profit is said to have made when the sale proceeds exceedthe cost of goods sold. Conversely, when sale proceeds are less than thecost of goods sold, gross loss is incurred. For the purpose of calculatingcost of goods sold, we have take into consideration opening stock,purchases, direct expenses on purchasing or manufacturing the goodsand closing stock. The balance of this account i.e. gross profit or grossloss is transferred to the Profit and Loss Account. The specimen of aTrading Account is given below:

TRADING ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 2006

Particulars	Amount Rs.	Particulars	Amount Rs.
To Opening Stock		By Sales	
To Purchases		*Less Sales Returns*	
Less Purchases Returns		By Closing Stock	
To Direct Expenses:		By Gross Loss transferred to P & L A/c	
Carriage Inward			
Wages			
Fuel, Power and Lighting Expenses			
Manufacturing Expenses			
Coal, Water and Gas			
Motive Power			
Octroi			
Import Duty			
Custom Duty			
Consumable Stores			
Freight and Insurance			
Royalty on manufactured Goods			
Packing charges			
To Gross Profit transferred to P & L A/c			

IMPORTANT POINTS REGARDING TRADING ACCOUNT

1. Stock

The term 'stock' includes goods lying unsold on a particular date.

The stock may be of two types:

(a) Opening stock

(b) Closing stock

Opening stock refers to the closing stock of unsold goods at theend of previous accounting period which has been brought forward in thecurrent accounting period. This is shown on the debit side of the TradingAccount.

Closing stock refers to the stock of unsold goods at the end of thecurrent accounting period. Closing stock is valued either at cost price orat market price whichever is less. Such valuation of stock is based on theprinciple of conservatism which lays down that the expected profit should not be taken into account but all possible losses should be duly providedfor.

Closing stock is an item which is not generally available in the trialbalance. If it is given in Trial Balance, it is not to be shown on the creditside of Trading Account but appears only in the Balance Sheet as anasset. But if it is given outside the trial balance, it is to be shown on thecredit side of the Trading Account as well as on the asset side of theBalance Sheet.

2. Purchases

Purchases refer to those goods which have been bought for resale.It includes both cash and credit purchases of goods. The following itemsare shown by way of deduction from the amount of purchases:

(a) Purchases Returns or Return Outwards.

(b) Goods withdrawn by proprietor for his personal use.

(c) Goods received on consignment basis or on approval basis or on hire purchase.

(d) Goods distributed by way of free samples.

(e) Goods given as charity.

3. Direct Expenses

Direct expenses are those expenses which are directly attributableto the purchase of goods or to bring the goods in saleable condition.Some examples of direct expenses are as under:

(a) Carriage Inward: Carriage paid for bringing the goods to thegodown is treated as carriage inward and it is debited to TradingAccount.

(b) Freight and insurance: Freight and insurance paid foracquiring goods or making them saleable is debited to Trading Account. Ifit is paid for the sale of goods, then it is to be charged (debited) to Profitand Loss Account.

(c) Wages: Wages incurred in a business is direct, when it isincurred on manufacturing or merchandise or on making it saleable.Other wages are indirect wages. Only direct wages are debited to theTrading Account. Other wages are debited to the Profit and Loss Account.If it is not mentioned whether wages are direct or indirect, it should beassumed as direct and should appear in the Trading Account.

(d) Fuel, Power and Lighting Expenses: Fuel and powerexpenses are incurred for running the machines. Being directly related toproduction, these are considered as direct expenses and debited toTrading Account. Lighting expenses of factory is also charged to TradingAccount, but lighting expenses of administrative office or sales office arecharged to Profit and Loss Account.

(e) Octroi: When goods are purchased within municipalitylimits, generally octroi duty has to be paid on it. It is debited to TradingAccount.

(f) Packing Charges: There are certain types of goods whichcannot be sold without a container or proper packing. These form a partof the finished product. One example is ink, which cannot be soldwithout a bottle. These type of packing charges are debited to TradingAccount. But if the goods are packed for their safe dispatch tocustomers, i.e. packing meant for transportation or fancy packing meantfor advertisement will appear in the Profit and Loss Account.

(g) Manufacturing Expenses: All expenses incurred inmanufacturing the goods in the factory such in factory rent, factoryinsurance etc. are debited to Trading Account.

(h) Royalties: These are the payments made to a patentee,author or landlord for the right to use his patent, copyright or land. Ifroyalty is paid on the basis of production, it is debited to Trading Accountand if it is paid on the basis of sales, it is debited to Profit and LossAccount.

4. Sales

Sales include both cash and credit sales of those goods which werepurchased for resale purposes. Some customers might return the goodssold to them (called sales return) which are deducted from the sales inthe inner column and net amount is shown in the outer column. While
ascertaining the amount of sales, the following points need attention:

(a) If a fixed asset such as furniture, machinery etc. is sold, itshould not be included in sales.

(b) Goods sold on consignment or on hire purchase or on sale orreturn basis should be recorded separately.

(c) If goods have been sold but not yet dispatched, these shouldnot be shown under sales but are to be included in closingstock.

(d) Sales of goods on behalf of others and forward sales shouldalso be excluded from sales.

CLOSING ENTRIES FOR TRADING ACCOUNT

The journal entries necessary to transfer opening stock, purchases,sales and returns to the Trading Account are called closing entries, asthey serve to close these accounts. These are as follows:

1. For transfer of opening stock, net purchases and directexpenses to Trading A/c.

Trading A/c Dr.

To Stock (Opening) A/c

To Purchases A/c

To Direct Expenses A/c

(Being opening stock, purchases and direct expensestransferred to Trading Account)

2. For transfer of net sales and closing stock to Trading A/c

Sales A/c Dr.

Stock (Closing) A/c Dr.

To Trading A/c

(Being sales, closing stock transferred to Trading Account)

3. (a) For Gross Profit

Trading A/c Dr.

To Profit & Loss A/c

(Being gross profit transferred to Profit and Loss
Account)

(b) For Gross Loss

Profit & Loss A/c Dr.

To Trading A/c

(Being gross loss transferred to Profit and Loss
Account)

Illustration I: From the following balances extracted from thebooks of Mr. Bansi Lal, prepare the Trading Account for the year ending31st March, 2006.

Purchases	42,500	Wages	5,000
Mfg. expenses	1,950	Op. Stock	10,000
Sales	67,500	Sales returns	50
Carriage inwards	100	Purchases returns	200
Freight and duty	5,000		
Stores consumed	200		
Power	300		

The value of stock unsold is Rs. 12,000.

Solution

TRADING ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 2006

To Opening stock		10,000	By Sales	67,500	
To Purchases	42,500		*Less* returns	50	67,450
Less returns	200	42,300	By Closing Stock		12,000
To Manufacturing exp.		1,950			
To Carriage inwards		100			
To Freight and duty		5,000			
To Stores consumed		200			
To Power		300			
To Wages		5,000			
To Gross Profit transferred to Profit & Loss A/c		14,600			
		79,450			79,450

MANUFACTURING ACCOUNT

The concern which are engaged in the conversion of raw materialsinto finished goods, are interested to knowing the cost of production ofthe goods produced. The cost of the goods produced cannot be obtainedfrom the Trading Account. So, it is desirable to prepare a ManufacturingAccount prior to be preparation of the Trading account with the object ofascertaining the cost of goods produced during the accounting period.

The proforma of Manufacturing Account is given as under:

MANUFACTURING ACCOUNT
FOR THE YEAR ENDING..................

Dr. Cr.

	Rs.		Rs.
To Work-in process (Opening) To Raw Materials consumed: Opening Stock *Add* Purchases of Raw Materials *Less* Closing Stock of Raw Materials To Direct or Productive Wages To Factory Overheads: Power & Fuel Repairs of Plant Depreciation on Plant Factory Rent		By Work-in-process (Closing) By Sale of Scrap By Cost of Production of finished goods during the period transferred to the Trading Account	

The Trading Account in case of manufacturers will appear asfollows:

TRADING ACCOUNT
FOR THE YEAR ENDING..............

Dr. Cr.

	Rs.		Rs.
To Opening Stock of Finished Goods To Cost of Production of finished goods transferred from Manufacturing Account To Purchases of Finished Goods *less* Returns To Carriage Charges on goods purchased To Gross Profit transferred to Profit and Loss A/c		By Sales *less* Returns By Closing Stock of Finished goods By Gross Loss transferred to Profit and Loss A/c	

The gross profit or loss shown by the Trading Account will be takento the Profit and Loss Account which will be prepared in the usual way asexplained in the following pages.

IMPORTANT POINTS REGARDING MANUFACTURING ACCOUNT

1. Raw Materials Consumed

The cost of raw materials consumed to be included in the debit sideof the Manufacturing Account shall be calculated as follows:

Rs.

Opening Stock of raw materials..........

Add Purchases of raw materials........... ....

Less Purchase return of raw materials ....

Less Closing stock of raw materials ....

Cost of raw material consumed

2. Direct Expenses

The expenses and wages that are directly incurred in the process ofmanufacturing of goods are included under this head..

3. Factory Overheads

The term "overheads" includes indirect material, indirect labourand indirect expenses. Therefore, the term "factory overheads" stands forall factory indirect material, indirect labour and indirect expenses.

Examples of factory overheads are: rent for the factory, depreciation ofthe factory machines and insurance of the factory, etc.

4. Cost of Production

Cost of production is computed by deducting from the total of thedebit side of the Manufacturing Account, the total of the various itemsappearing on the credit side of the Manufacturing Account.

DIFFERENCE BETWEEN TRADING ACCOUNT AND MANUFACTURING ACCOUNT

	Manufacturing Account	Trading Account
1.	Manufacturing account is prepared to find out the cost of goods produced.	Trading Account is prepared to find out the Gross Profit/Gross Loss.
2.	The balance of the manufacturing Account is transferred to the Trading Account.	The balance of the Trading account is transferred to the Profit and Loss Account.
3.	Sale of crap is shown in the Manufacturing Account.	Sale of scrap is not shown in the Trading Account.
4.	Stocks of raw materials and work-in-	Stocks of finished goods are shown

	progress are shown in the Manufacturing Account.	in the Trading Account.
5.	Manufacturing Account is a part of the Trading account.	Trading Account is a part of the Profit and Loss Account.

PROFIT AND LOSS ACCOUNT

Trading Account results in the gross profit/loss made by abusinessman on purchasing andselling of goods. It does not take intoconsideration the other operating expenses incurred by him during thecourse of running the business. Besides this, a businessman may haveother sources of income. In order to ascertain the true profit or losswhich the business has made during a particular period, it is necessarythat all such expenses and incomes should be considered. Profit andLoss Account considers all such expenses and incomes and gives the netprofit made or net loss suffered by a business during a particular period.

All the indirect revenue expenses and losses are shown on the debit sideof the Profit and Loss Account, where as all indirect revenue incomes areshown on the credit side of the Profit and Loss Account.

Profit and Loss Account measures net income by matchingrevenues and expenses according to the accounting principles. Netincome is the difference between total revenues and total expenses. Inthis connection, we must remember that all the expenses, for the periodare to be debited to this account - whether paid or not. If it is paid inadvance or outstanding, proper adjustments are to be made (Discussedlater). Likewise all revenues, whether received or not are to be credited.

Revenue if received in advance or accrued but not received, properadjustment is required.

A proforma of the Profit and Loss Account showing probable itemstherein is as follows:

PROFIT AND LOSS A/C
FOR THE YEAR ENDED ....

	Rs.		Rs.
To Gross Loss b/d		By Gross Profit b/d	
To *Selling and Distribution Expenses:*		By *Other Income:*	
Advertisement		Discount received	
Travellers' Salaries		Commission received	
Expenses & Commission		By Non-trading Interest:	
Godown Rent		Bank Interest	
Export Expenses		Rent of property let-out	
Carriage Outwards		Dividend from shares	
Bank Charges		By *Abnormal Gains:*	
Agent's Commission		Profit on sale of machinery	
Upkeep of Motor Lorries		Profit on sale of investment	
To *Management Expenses:*		By Net Loss transferred to Capital Account	
Rent, Rates and Taxes			
Heating and Lighting			
Office Salaries			
Printing & Stationary			
Postage & Telegrams			
Telephone Charges			
Legal Charges			
Audit Fees			
Insurance			
General Expenses			
To *Depreciation and Maintenance:*			
Depreciation			
Repairs & Maintenance			
To *Financial Expenses:*			
Discount Allowed			
Interest on Loans			
Discount on Bills			
To *Abnormal Losses:*			
Loss by fire (not covered by Insurance)			
Loss on Sale of Fixed Assets			
Loss on Sale of Investments			
To Net profit transferred to Capital A/c			

IMPORTANT POINTS IN PROFIT AND LOSS ACCOUNT

1. Selling and Distribution Expenses

These expenses are incurred for promoting sales and distributionof sold goods. Example of such expenses are go down rent, carriageoutwards, advertisement, cost of after sales service, selling agentscommission, etc.

2. Management Expenses

These are the expenses incurred for carrying out the day-to-dayadministration of a business. Expenses, under this head, include officesalaries, office rent and lighting, printing and stationery and telegrams,telephone charges, etc.

3. Maintenance Expenses

These expenses are incurred for maintaining the fixed assets of theadministrative office in a good condition. They include repairs andrenewals, etc.

4. Financial Expenses

These expenses are incurred for arranging finance necessary forrunning the business. These include interest on loans, discount on bills,etc.

5. Abnormal Losses

There are some abnormal losses that may occur during theaccounting period. All types of abnormal losses are treated as extraordinary expenses and debited to Profit and Loss Account. Examples arestock lost by fire and not covered by insurance, loss on sale of fixedassets, etc.

Following are the expenses not to appear in the Profit and LossAccount:

(i) Domestic and household expenses of proprietor or partners.

(ii) Drawings in the form of cash, goods by the proprietor orpartners.

(iii) Personal income tax and life insurance premium paid by thefirm on behalf of proprietor or partners.

6. Gross Profit

This is the balance of the Trading Account transferred to the Profitand Loss Account. If the Trading Account shows a gross loss, it willappear on the debit side.

7. Other Income

During the course of the business, other than income from the saleof goods, the business may have some other income of financial nature.The examples are discount or commission received.

8. Non-trading Income

Such incomes include interest on bank deposits, loans toemployees and investment indebentures of companies. Similarly,dividend on investment in shares of companies and units of mutualfunds are also known as non-trading incomes and shown in Profit andLoss Account.

9. Abnormal Gains

There may be capital gains arising during the course of the year,e.g., profit arising out of sale of a fixed asset. Such profit is shown as aseparate income on the credit side of the Profit and Loss Account.

Closing entries for Profit and Loss account

(i) For transfer of various expenses to Profit & Loss A/c

Profit and Loss A/c Dr.

To Various Expenses A/c

(Being various indirect expenses transferred to Profit andLoss Account)

(ii) For transfer of various incomes and gains to Profit & LossA/c

Various Incomes & Gains A/c Dr.

To Profit & Loss A/c

(Being various incomes & gains transferred to Profit and Loss Account)

(iii) (a) For Net Profit

Profit & Loss A/c Dr.

To Capital A/c

(Being Net Profit transferred to capital)

(b) For Net Loss

Capital A/c Dr

To Profit & Loss A/c

(Being Net Loss transferred to Capital Account)

Illustration II: From the following balances extracted at the close of year ended 31 March, 2006, prepare Profit and Loss Account as at that date:

	Rs.		Rs.
Gross Profit	51,000	Discount (Dr.)	500
Carriage Outward	2,500	Apprentice Premium (Cr.)	1,500
Salaries	5,500	Printing & Stationary	250
Rent	1,100	Rates & Taxes	350
Fire Insurance Premium	900	Travelling Expenses	200
Bad Debts	2,100	Sundry Trade Expenses	300
Commission Received	1,000	Discount allowed by Creditors	800

Solution

PROFIT & LOSS ACCOUNT OF M/S................................
FOR THE YEAR ENDED 31ST MARCH, 2006

Dr. Cr.

Particular	Rs.	Particular	Rs.
To Carriage Outward	2,500	By Gross Profit b/d	51,000
To Salaries	5,500	By Apprentice Premium	1,500
To Rent	1,100	By Discount by Creditors	800
To Fire Insurance Premium	900	By Commission	1,000
To Bad Debts	2,100		
To Discount	500		
To Printing & Stationary	250		
To Rent & Taxes	350		
To Travelling Expenses	200		
To Sundry Trade Expenses	300		
To Net Profit transferred to Capital A/c	40,600		
	54,300		54,300

Distinction between trading account and Profit and LossAccount

	Profit and Loss Account	Trading Account
1.	Profit and Loss Account is	Trading Account is prepared as a

	Profit and Loss Account	Trading Account
	prepared as a main account.	part or section of the Profit and Loss Account.
2.	Indirect expenses are taken in Profit and Loss Account.	Direct Expenses are taken in Trading Account.
3.	Net Profit or Net Loss is ascertained from the Profit and Loss Account.	Gross Profit or Gross Loss is ascertained from Trading Account.
4.	The balance of the Profit and Loss Account i.e. Net Profit or Net Loss is transferred to proprietor's Capital Account.	The Balance of the Trading Account i.e. Gross Profit or Gross Loss is transferred to the Profit and Loss Account.
5.	Items of accounts written in the Profit and Loss Account are much more as compared to the Trading Account.	Items of account written in the Trading Account are few as compared the Profit and Loss Account.

BALANCE SHEET

A Balance Sheet is a statement of financial position of a businessconcern at a given date. It is called a Balance Sheet because it is a sheetof balances of those ledger accounts which have not been closed till thepreparation of Trading and Profit and Loss Account. After the preparationof Trading and Profit and Loss Account the balances left in the trialbalance represent either personal or real accounts. In other words, theyeither represent assets or liabilities existing on a particular date. Excessof assets over liabilities represent the capital and is indicative of thefinancial soundness of a company.

A Balance Sheet is also described as a "Statement showing theSources and Application of Capital". It is a statement and not an accountand prepared from real and personal accounts. The left hand side of theBalance Sheet may be viewed as description of the sources from whichthe business has obtained the capital with which it currently operatesand the right hand side as a description of the form in which that capitalis invested on a specified date.

CHARACTERISTICS

The characteristics of a Balance Sheet are summarised as under:

(a) A Balance Sheet is only a statement and not an account. Ithas no debit side or credit side. The headings of the two sidesare 'Assets' and 'Liabilities'.

(b) A Balance Sheet is prepared at a particular point of time andnot for a particular period. The information contained in theBalance Sheet is true only at that particular point of time atwhich it is prepared.

(c) A Balance Sheet is a summary of balances of those ledgeraccounts which have not been closed by transfer to Tradingand Profit and Loss Account.

(d) A Balance Sheet shows the nature and value of assets andthe nature and the amount of liabilities at a given date.

Classification of assets and liabilities

Assets

Assets are the properties possessed by a business and the amountdue to it from others. The various types of assets are:

(a) Fixed Assets

All assets that are acquired for the purpose of using them in theconduct of business operations and not for reselling to earn profit arecalled fixed assets. These assets are not readily convertible into cash inthe normal course of business operations. Examples are land andbuilding, furniture, machinery, etc.

(b) Current Assets

All assets which are acquired for reselling during the course ofbusiness are to be treated as current assets. Examples are cash andbank balances, inventory, accounts receivables, etc.

(c) Tangible Assets

There are definite assets which can be seen, touched and havevolume such as machinery, cash, stock, etc.

(d) Intangible Assets

Those assets which cannot be seen, touched and have no volumebut have value are called intangible assets. Goodwill, patents and trademarks are examples of such assets.

(e) Fictitious Assets

Fictitious assets are not assets at all since they are not representedby any tangible possession. They appear on the asset side simply becauseof a debit balance in a particular account not yet written off e.g. provisionfor discount on creditors, discount on issue of shares etc.

(f) Wasting Assets

Such assets as mines, quarries etc. that become exhausted orreduce in value by their working are called wasting assets.

(g) Contingent Assets

Contingent assets come into existence upon the happening of acertain event or the expiry of a certain time. If that event happens, theasset becomes available otherwise not, for example, sale agreement toacquire some property, hire purchase contracts etc.

In practical no reference is made to contingent assets in theBalance Sheet. At the most, they may form part of notes to the BalanceSheet.

Liabilities

A liability is an amount which a business is legally bound to pay. Itis a claim by an outsider on the assets of a business. The liabilities of abusiness concern may be classified as:

(a) Long Term Liabilities

The liabilities or obligations of a business which are not payablewithin the next accounting period but will be payable within next five toten years are known as long term liabilities. Public deposits, debentures,bank loan are the examples of long term liabilities.

(b) Current Liabilities

All short term obligations generally due and payable within oneyear are current liabilities. This includes trade creditors, bills payable etc.

(c) Contingent Liabilities

A contingent liability is one which is not an actual liability. Theybecome actual on the happenings of some event which is uncertain. Inother words, they would become liabilities in the future provided thecontemplated event occurs. Since such a liability is not actual liability it

is not shown in the Balance Sheet. Usually it is mentioned in the form ofa footnote below the Balance Sheet.

Marshalling of assets and liabilities

The arrangement of assets and liabilities in a particular order iscalled marshalling of the Balance Sheet. Assets and liabilities can bearranged in the Balance Sheet into two ways:

(a) In order of liquidity.

(b) In order of permanence.

When assets and liabilities are arranged according to theirreliability and payment preferences, such an order is called liquidityorder. Such arrangement is given below in Balance Sheet (a). When theorder is reversed from that what is followed in liquidity, it is called orderof permanence. In other words, assets and liabilities are listed in order ofpermanence. This order of Balance Sheet is given below in BalanceSheet (B).

BALANCE SHEET (A)
(IN ORDER OF LIQUIDITY)

Liabilities	Rs.	Assets	Rs.
Bills payable		Cash in hand	
Loans		Cash at bank	
Sundry creditors		Investments	
Outstanding expenses		Sundry debtors	
Reserves		Bills receivable	
Capital		Stock-in-trade	
Add Net Profit		Loose tools	
Add Interest		Fixtures and fittings	
Less Drawings		Plant and machinery	
		Building	
		Land	
		Goodwill	

BALANCE SHEET (B)
(IN ORDER OF PERMANENCE)

Liabilities	Rs.	Assets	Rs.
Capital		Goodwill	
Add Net Profit		Land	
Add Interest		Building	
Less Drawings		Plant and machinery	
Reserves		Fixtures and fittings	
Outstanding expenses		Loose tools	
Sundry creditors		Stock-in-trade	
Loans		Bills receivable	
Bills payable		Sundry debtors	
		Investments	
		Cash at bank	
		Cash in hand	

Illustration III: The following balances are extracted from the booksof Kautilya & Co. on 31st March, 2006. You are required prepare theTrading and Profit and Loss Account and a Balance Sheet as on that date.

	Rs.		Rs.
Stock on April, 1	500	Commission (Cr.)	200
B/R	2,250	Returns Outwards	250
Purchases	19,500	Trade Expenses	100
Wages	1,400	Office Fixtures	500
Insurance	550	Cash in Hand	250
Sundry Debtors	15,000	Cash at Bank	2,375
Carriage Inwards	400	Rent & Taxes	550
Commission (Dr.)	400	Carriage Outwards	725
Interest on Capital	350	Sales	25,000
Stationary	225	Bills Payable	1,500
Returns Inwards	650	Creditors	9,825
		Capital	8,950

The closing stock was valued at Rs.12,500.

Solution

TRADING & PROFIT AND LOSS A/C OF MESSRS KAUTILYA & CO.

FOR THE YEAR ENDED 31ST MARCH, 2006

	Rs.	Rs.		Rs.	Rs.
To Opening stock		500	By Sales	25,000	
To Purchases	19,500		Less returns	650	24,350
Less returns	250	19,250	By Closing Stock		12,500
To Wages		1,400			
To Carriage Inwards		400			
To Gross Profit c/d		15,300			
		36,850			36,850
To Insurance		550	By Gross Profit b/d		15,300
To Commission		400	By Commission		200
To Interest on Capital		350			
To Stationary		225			
To Trade Expenses		100			
To Rent and Taxes		550			
To Carriage Outwards		725			
To Net Profit transferred to Capital A/c		12,600			
		15,500			15,500

BALANCE SHEET OF MESSERS KAUTILYA & CO
AS ON 31ST MARCH, 2006

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Creditors		9,825	Cash in Hand	250
Bills Payable		1,500	Cash at Bank	2,375
Capital	8,950		Bill Receivable	2,250
Add Net Profit	12,600	21,550	Stock	12,500
			Sundry Debtors	15,000
			Office Fixtures	500
		32,875		32,875

ADJUSTMENTS

While preparing trading and Profit and Loss account one point thatmust be kept in mind is that expenses and incomes for the full tradingperiod are to be taken into consideration. For example if an expense hasbeen incurred but not paid during that period, liability for the unpaidamount should be created before the accounts can be said to show theprofit or loss. All expenses and incomes should properly be adjustedthrough entries. These entries which are passed at the end of theaccounting period are called adjusting entries. Some importantadjustments which are to be made at the end of the accounting year arediscussed in the following pages.

1. Closing Stock

This is the stock which remained unsold at the end of theaccounting period. Unless it is considered while preparing the tradingaccount, the gross profit shall not be correct. Adjusting entry for closingstock is as under:

Closing stock Account Dr.

To Trading account

(Being closing stock brought in to books)

Treatment in final accounts

(i) Closing stock is shown on the credit side of Trading account.

(ii) At same value it will be shown as an asset in the balancesheet.

2. Outstanding Expenses

Those expenses which have become due and have not been paid atthe end of the accounting year, are called outstanding expenses. Forexample, the businessman has paid rent only for 4 months instead of oneyear. This means 8 months' rent is outstanding. In order to bring thisfact into books of accounts, the following adjustment entry will be passedat the end of the year:

Rent A/c Dr.

To outstanding Rent A/c

(Being rent outstanding for 8 months)

The two fold effect of the above adjustment will be (i) the amount ofoutstanding rent will be added to the rent on the debit side of Profit andLoss Account, and (ii) outstanding rent will be shown on the liability sideof the Balance Sheet.

3. Prepaid Expenses

There are certain expenses which have been paid in advance orpaid for the future period which is not yet over or not yet expired. Thebenefit of such expenses is to be enjoyed during the next accountingperiod. Since, such expenses have already been paid, they have alsorecorded in the books of account of that period for which they do notrelate. For example, insurance premium paid for one year Rs.3,600 on 1st July, 1996. The final accounts are prepared on 31st March, 1997. Thebenefit of the insurance premium for the period from 1st April to 30th June, 1997 is yet to expire. Therefore, the insurance premium paid forthe period from 1st April 1997 to 30th June, 1997, i.e. for 3 months, shallbe treated as "Prepaid Insurance Premium".

The adjustment entry for prepaid expenses is as under:

Prepaid Expenses Account Dr.

To Expenses Account

(Being the adjustment entry for prepaid expenses)

The amount of prepared expenses will appear as an asset in theBalance Sheet while amount of appropriate expense account will beshown in the Profit and Loss Account by way of deduction from the saidexpense.

4. Accrued Income

Accrued income means income which has been earned during thecurrent accounting year and has become due but not received by the endof the current accounting period. Examples of such income are incomefrom investments, dividend on shares etc. The adjustment entry foraccrued income is as under:

Accrued Income A/c Dr.

To Income A/c

(Being the adjustment entry for accrued income)

Treatment in final accounts

i) The amount of accrued income is added to the relevant itemof income on the credit side of the Profit and Loss Account toincrease the amount of income for the current year.

ii) The amount of accrued income is a debt due from a thirdparty to the business, so it is shown on the assets side of theBalance Sheet.

5. Income Received in Advance

Income received but not earned during the current accounting yearis called as income received in advance. For example, if building has beengiven to a tenant on Rs.2,400 p.a. but during the year Rs.3,000 has beenreceived, then Rs.600 will be income received in advance. In order tobring this into books of account, the following adjusting entry will bemade at the end of the accounting year:

Rent A/c Dr. Rs.600

To Rent Received in Advance A/c Rs.600The two-fold effect of this adjustment will be:

(i) It is shown on the credit side of Profit and Loss account byway of deduction from the income, and

(ii) It is shown on the liabilities side of the Balance Sheet asincome received in advance.

6. Depreciation

Depreciation is the reduction in the value of fixed asset due to itsuse, wear and tear or obsolescence. When an asset is used for earningpurposes, it is necessary that reduction due to its use, must be chargedto the Profit and Loss account of that year in order to show correct profitor loss and to show the asset at its correct value in the Balance Sheet.

There are various methods of charging depreciation on fixed assets.Suppose machinery for Rs.10,000 is purchased on 1.1.98, 20% p.a. isthe rate of depreciation. Then Rs.2,000 will be depreciation for the year1998 and will be brought into account by passing the following adjustingentry:

Depreciation A/c Dr. Rs. 2,000

To Machinery A/c Rs.2,000

The two-fold effect of depreciation will be:

(i) Depreciation is shown on the debit side of Profit and LossAccount, and

(ii) It is shown on the asset side of the balance sheet by way ofdeduction from the value of concerned asset.

7. Interest on Capital

The amount of capital invested by the trader in his business is justlike a loan by the firm. Charging interest on capital is based on theargument that if the same amount of capital were invested in somesecurities elsewhere, the businessman would have received interestthereon. Such interest on capital is not actually paid to the businessman.

Interest on capital is a gain to the businessman because it increases itscapital, but it is a loss to the business concern.

Calculation of Interest on Capital

Interest is calculated on the opening balance of the capital at thegiven rate for the full accounting period. If some additional amount ofcapital has been brought in the business during the course of accountingperiod, interest on such additional amount of capital is calculated fromthe date of introduction to the end of the accounting period. The followingadjustment entry is passed for allowing interest on capital:

Interest on Capital Account Dr.

To Capital Account

(Being the adjustment entry for interest on capital)

Treatment in final accounts

(i) Interest allowed on capital is an expense for the businessand is debited to Profit and Loss Account, i.e. it is shown onthe debit side of the Profit and Loss Account.

(ii) Such interest is not actually paid in cash to the businessmanbut added to his capital account. Hence, it is shown as anaddition to capital on the liabilities side of the Balance Sheet.

8. Interest of Drawings

It interest on capital is allowed, it is but natural that interest ondrawings should be charged from the proprietor, as drawings reducecapital. Suppose during an accounting year, drawings are Rs.10,000 andinterest on drawings is Rs.500. In order to bring this into account, thefollowing entry will be passed:

Drawings A/c Dr. Rs.500

To Interest on Drawings A/c Rs.500

The two-fold effect of interest on drawings will be:

(i) Interest on drawings will be shown on the credit side of Profitand Loss Account, and

(ii) Shown on the liabilities side of the Balance Sheet by way ofaddition to the drawings which are ultimately deducted fromthe capital.

9. Bad Debts

Debts which cannot be recovered or become irrecoverable arecalled bad debts. It is a loss for the business. Such a loss is recorded inthe books by making following adjustment entry:

Bad Debts A/c Dr.

To Sundry Debtors A/c

(Being the adjustment entry for bad debts)

Treatment in final accounts

The profit and Loss Account is debited with the amount of baddebts and in the Balance Sheet, the Sundry Debtors balance will bereduced by the same amount in the assets side.

10. Provisions for Doubtful Debts

In addition to the actual bad debts, a business unit may find onthe last day of the accounting period that certain debts are doubtful, i.e.,the amount to be received from debtors may or may not be received. Theamount of doubtful debts is calculated either by carefully examining theposition of each debtor individually and summing up the amount ofdoubtful debts from various debtors or it may be computed (as is usuallydone) on the basis of some percentage (say 5%) of debtors at the end ofthe accounting period. The percentage to be adopted is usually basedupon the past experience of the business. The reasons for makingprovision for doubtful debts are two as discussed below:

(i) Loss caused by likely bad debts must be charged to the Profitand Loss of the period for which credit sales have been madeto ascertain correct profit of the period.

(ii) For showing the true position of realizable amount of debtorsin the Balance Sheet, i.e., provision for doubtful debts will bededucted from the amount of debtors to be shown in thebalance sheet.

For example, sundry debtors on 31.12.1998 are Rs.55,200. Furtherbad debts are Rs.200. Provision for doubtful debts @ 5% is to be made ondebtors. In order to bring the provision for doubtful debts of Rs.2,750,

i.e., 5% on Rs.55,000 (55,200-200), the following entry will be made:

Profit and Loss A/c Dr. Rs.2,750

To Provision for Doubtful Debts A/c Rs.2,750

(Being Provision for Doubtful Debts provided)

It may be carefully noted that further bad debts (if any) will be firstdeducted from debtors and then a fixed percentage will be applied on theremaining debtors left after deducting further debts. It is so becausepercentage is for likely bad debts and not for bad debts which have beendecided to be written off.

Treatment in final accounts

(i) The amount of provision for doubtful debts is a provisionagainst a possible loss so it should be debited to Profit andLoss account.

(ii) The amount of provision for doubtful debts is deducted fromsundry debtors on the assets side of the balance sheet.

11. Provision for Discount on Debtors

It is a normal practice in business to allow discount to customersfor prompt payment and it constitutes a substantial sum. Some times thegoods are sold on credit to customers in one accounting period whereasthe payment of the same is received in the next accounting period and discount is to be allowed. It is a prudent policy to charge this expenditure(discount allowed) to the period in which sales have been made, so aprovision is created in the same manner, as in case of provision fordoubtful debts i.e.

Profit and loss account Dr.

To provision for discount on debtors account

(Being provision for discount on debtors provided)

TREATMENT IN FINAL ACCOUNTS

(i) Provision for discount on debtors is a probable loss, so itshould be shown on the debit side of Profit and Lossaccount.

(ii) Amount of provision for discount on debtors is deductedfrom sundry debtors on the assets side of the Balance Sheet.

Note: Such provision is made on debtors after deduction of furtherbad debts and provision for doubtful debts because discount is allowableto debtors who intend to make the payment.

12. Reserve for Discount on Creditors

Prompt payments to creditors enable a businessman to earndiscount from them. When a businessman receives cash discountregularly, he can make a provision for such discount since he is likely toreceive the discount from his creditors in the following years also. Thediscount received being a profit, the provision for discount on creditorsamounts to an addition to the profit.

Accounting treatment of Reserve for Discount on Creditors is justreverse of that in the case of Provision for Discount on Debtors. Theadjustment entries for Reserve for Discount on Creditors is as follows:

Reserve for Discount on Creditors Account Dr.

To Profit and Loss Account

(Being the adjustment entry for discount on creditors)

Treatment in final accounts

i) Reserve for discount on creditors is shown on the credit sideof Profit and Loss account.

ii) In the liabilities side of the Balance Sheet, the reserve fordiscount on creditors is shown by way of deductions fromSundry Creditors.

13. Loss of Stock by Fire

In business, the loss of stock may occur due to fire. The position ofthe stock may be:

(a) all the stock is fully insured.

(b) the stock is partly insured.

(c) the stock is not insured at all.

It the stock is fully insured, the whole loss will be claimed from theinsurance company. The following entry will be passed:

Insurance Co. A/c Dr.

To Trading A/c

(Being the adjustment entry for Loss of goods charged frominsurance Co.)

The value of goods lost by fire shall be shown on the credit side ofthe trading Account and this is shown as an asset in the Balance Sheet.

If the stock is not fully insured, the loss of stock covered byinsurance policy will be claimed from the insurance company and therest of the amount will be loss for the business which is chargeable toProfit and Loss Account. In this case, the following entry will be passed:

Insurance Co. A/c Dr.

Profit and Loss A/c Dr.

To Trading A/c

(Being the adjustment entry for Loss of goods)

The amount of goods lost by fire is credited to Trading Account, theamount of claim accepted by insurance company shall be treated as anasset in the Balance Sheet, while the amount of claim not accepted is aloss so it will be debited to Profit and Loss Account.

If the stock is not insured at all, the whole of the loss will be borneby the business and the adjusting entry shall be:

Profit and Loss A/c Dr.

To Trading A/c

(Being the adjustment entry for Loss of goods)

The double effect of this entry will be (a) it is shown on the creditside of the Trading Account (b) it is shown on the debit side of the Profitand Loss Account.

14. Manager's Commission

Sometimes, in order to increase the profits of the business,manager is given some commission on profits of the business. It can begiven at a certain percentage on the net profits but before charging suchcommission or on the net profits after charging such commission. In boththe cases, the adjustment entry will be:

Profit and Loss A/c Dr.

To Commission Payable A/c

(Being the adjustment entry for manager's commission)

Treatment in final accounts

(i) The amount of managers commission being a businessexpenditure is shown on the debit side of the Profit and Lossaccount.

(ii) As the commission to manager has not been paid so far,commission payable would be shown as liability on theliability side of balance sheet.

Illustration IV: The following adjustments are to be made in thefinal accounts being made as on 31st March, 2006.

i) Closing Stock in hand Rs.20,000.

ii) Salaries amounting to Rs.1,000 outstanding.

iii) Depreciate Plant and Machinery @10%. The value of Plant and Machinery on 31st March, 2006 was at Rs.40,000.

iv) Prepaid insurance Rs.150.

v) Accrued income from investment Rs.1,500.

You are required to pass adjustment entries.

Solution

JOURNAL

Date	Particulars		L.F.	Dr. Rs.	Cr. Rs.
2006					
Mar 31	Closing Stock Account	Dr.		20,000	
	To Trading Account			20,000	
	(Being the adjustment entry for closing stock)				
Mar 31	Salaries Account	Dr.			1,000
	To Outstanding Salaries Account				1,000
	(Being the adjustment entry for outstanding Salaries)				

Mar 31	Depreciation Account Dr. To Plant and Machinery Account (Being the adjustment entry for Depreciation)		4,000	4,000
Mar 31	Prepaid Insurance Account Dr. To Insurance Account (Being the adjustment entry for prepaid insurance)		150	150
Mar 31	Accrued Income Account To Income on Investment Account (Being the adjustment entry for accrued income)		1,500	1,500

Illustration V: From the following Trial Balance of Mr. Garg as on31st March, 2006, prepare Trading Account, Profit and Loss Account andBalance Sheet.

TRIAL BALANCE

Debit Balance	Rs.	Credit Balance	Rs.
Stock on 1st April, 2005	500	Capital	2,000
Purchases	1,500	Sales	3,500
Land and Building	2,000	Sunday Creditors	750
Bills Receivable	300	Commission	50
Wages	300	Bills payable	300
Machinery	800	Loan	600
Carriage Inward	100		
Carriage Outward	100		
Power	150		
Salaries	200		
Discount Allowed	30		
Drawings	100		
Insurance Premium	20		
Cash at Bank	500		
Cash in Hand	100		
Investments	500		
	7,200		7,200

Adjustments

1. Stock as on 31st

March 2006 is valued at Rs. 200.

2. Provide depreciation @ 10% on Machinery and @ 5% on Land and Building.

3. Outstanding salariesamounted to Rs.50.
4. Insurance premium is paid in advance to the extent of Rs.10.
5. Allow interest on Capital @ 6% per annum.
6. Interest on loan @ 12% per annum is due for one year.

Solution

TRADING & PROFIT ANDLOSS A/C

FOR THE YEAR ENDED 31STMARCH, 2006

Particulars		Rs.	Particulars	Rs.
To Opening stock		500	By Sales	3,500
To Purchases		1,500	By Closing Stock	200
To Wages		300		
To Carriage Inward		100		
To Power		150		
To Gross Profit c/d		1,150		
		3,700		3,700
To Salaries	200		By Gross profit b/d	1,150
Add Outstanding Salaries	50	250	By Commission	50
To Carriage Inward		100		
To Insurance Premium	20			
Less prepaid Ins.	10	10		
To Discount allowed		30		
To Depreciation on:				
Machinery	80			
Land and Building	100	180		
To Interest on Loan		72		
To Interest on Capital		120		
To Net Profit (Transferred to capital account)		435		
		1,200		1,200

BALANCE SHEET AS ON 31ST MARCH 2006

Liabilities		Rs.	Assets		Rs.
Capital	2,000		Land and Building	2,000	
Add Interest on Capital	120		Less Dep.	100	1,900
Add Net profit	438		Machinery	800	
	2,558		Less Dep.	80	720
Less Drawings Loan	100	2,458	Investments		500
	600		Closing stock		200
Add Interest O/S	72	672	Bills Receivable		300
Sundry Creditors		750	Cash at Bank		500
Bills payable		300	Cash in Hand		100
Outstanding Salaries		50	Prepaid Insurance		10
		4,230			4,230

Part A (ONE Mark)

Multiple Choice Questions

Online Examination

Part B

(2 Marks)

1. List three golden principles of accounting.
2. what do you meant by journal entry
3. write a short note on ledger entry
4. Journalize the following transactions:
 2015 June
 a. Balaji Commenced business with Rs. 50,000
 b. Bought goods for cash Rs. 10,500
 c. Paid rent by cheque Rs. 2,500
 d. Furniture purchased for cash Rs. 20, 000
5. Define final accounts.
6. Write a short note on trading account.
7.What do you mean by profit and loss account
8. Give journal entries for the following transactions

a. Vidhya started business with cash Rs. 5,000

b. Paid Salary Rs. 2,500
c. Sold goods to Kannan for cash Rs. 5,000
d. Purchase goods for cash Rs. 4,000

9..Ascertain the Gross Profit from the following figures:

	Rs.		Rs.
Opening Stock	8,550	`Purchases	13,816
Sales	15,284	Purchases Returns	516
Sales Return	584	Wages owing	200
Closing stock	15,000		

10. From the following information ascertain Net Profit :

	Rs.		Rs.
Gross Profit	95,000	Stationery	5,840
Commission Received	800	Advertisement	15,500
Interest	2,850	Carriages Outwards	185

Part C (8 Marks)

1. Elucidate the accounting principles with suitable examples?

2. Journalize the following transaction of Mohan& Co.:

July 2015	Rs.
1 Commenced business with cash	15, 00, 000
2 Purchased goods for cash	10, 000
4 Sold goods for cash	25, 000
6 Purchased goods from Mohan	5, 000
7 Sold goods to Rahul	35, 000
8 Rent paid	6, 500
9 Received cash from Rahul in full settlement	34, 950
and discount allowed	50
13 Paid cash to Mohan in full settlement	4, 950
and discount received	50
15 Commission paid	200
25 Interest received	500

3. From the following Trial balance, prepare Trading and Profit and Loss Account for the year ending 31.12.2013 and the balance sheet as on that date.

Particulars	Debit (Rs.)	Credit (Rs,)

Capital	-	6,40,000
Sales	-	4,00,000
Purchases	2,40,000	-
Salaries	32,000	-
Rent	24,000	-
Insurance	4,800	-
Drawings	80,000	-
Machinery	4,48,000	-
Cash and Bank	1,04,000	-
Stock (1.1.2013)	83,200	-
Debtors	40,000	-
Creditors	-	16,000
Total	**10,56,000**	**10,56,000**

Adjustments:

a. Stock on 31.12.2014 Rs. 78,400
b. Salaries outstanding Rs. 4,800
c. Rent paid in advance is Rs. 3,200
d. Prepaid Insurance Rs. 1,440

4. What is trading account? Explain with suitable example.

5. The following are the Balance Sheets of a concern for the years 2009 and 2010. Prepare a Comparative Balance Sheet and study the financial position of the concern.

Balance Sheet As on 31st December

Liabilities	2009 Rs.	2010 Rs.	Assets	2009 Rs.	2010 Rs.
Equity share capital	6,00,000	8,00,000	Land & Buildings	3,70,000	2,70,000
Reserves & surplus	3,30,000	2,22,000	Plant & Machinery	4,00,000	6,00,000
Debentures	2,00,000	3,00,000	Furniture & Fixtures	20,000	25,000
Long-term loans on Mortgage	1,50,000	2,00,000	Other fixed assets	25,000	30,000
Bills Payable	50,000	45,000	Cash in hand and at bank	20,000	80,000
Sundry Creditors	1,00,000	1,20,000	Bills Receivables	1,50,000	90,000

Other Current liabilities	5,000	10,000	Sundry Debtors	2,00,000	2,50,000
			Stock	2,50,000	3,50,000
			Prepaid Expenses		2,000
	14,35,000	16,97,000		14,35,000	16,97,000

6. Explain the procedure to prepare profit & loss account, Balance sheet.

Part D (11 Marks)

1. From the following Trial balance of Rajan & co., prepare Trading and Profit and loss account for the year ended 31.12.2013 and balance sheet as on that date:

Particulars	Debit (Rs.)	Credit (Rs,)
Capital	-	40,000
Sales	-	38,000
Loan	-	12, 000
Creditors	-	8, 500
Purchases	8,000	-
Salaries	3,000	-
Rent	1,500	-
Debtors	30,000	-
Cash	1, 500	-
Wages	2, 000	-
Bank Balance	3, 000	-
Stock on 1.1.12	2, 000	-
Machinery	15,000	-
Building	30, 000	-
Insurance	2,500	-
Total	**98, 500**	**98,500**

Adjustments

(i) The closing stock was Rs.18,000
(ii) Salary outstanding Rs.500
(iii) Insurance prepaid Rs.250
(iv) Depreciate machinery @ 10%
(v) Create a provision on Debtors @ 2% for bad debts.

UNIT 2

S.No	Questions	Opt 1	Opt 2	Opt 3	Opt 4	Answer
1	Provision is recorded in debit side of ____________	Trading	Profit & Loss account	Profit & Loss appropriation a/c	Profit statement	Profit & Loss account
2	Bad debts previously written off now recovered will be recorded in ________________	Debtors ledger	Creditors ledger	General ledger	Cash account	Creditors ledger
3	Reserves are shown _________________ side of the balance sheeet.	Liability	Asset	Credit	Debit	Debit
4	Single entry system is a ____________	Complete double entry system	Incomplete double entry system	Incomplete single entry system.	Complete single system.	Incomplete double entry system
5	In single entry system________ is ascertained by deducting the total liabilities from total assets	Profit	Loss	Capital	Assets	Capital
6	In ______ system , only personal and cash accounts are maintained	Single entry	Networth	Double entry	Self balancing	Single entry
7	The capital in the beginning of the accounting year is ascertained by preparing_______________	Cash a/c	Opening statement of affairs	Total creditors a/c	Statement of profit	Opening statement of affairs
8	-------- can be found by preparing a statement of	Opening capital	Closing capital	Drawings	Profit and loss account	Opening capital

	affairs at the beginning of the year					
9	Current liabilities are recorded in the balance sheet on________	Liability side	Asset Side	Profit and Loss account	Trading	Liability side
10	Opening stock is to be ____________	Debited in trading account	Credited in trading account	Debited in P/L a/c	Credited in P/L a/c	Debited in trading account
11	The capital of a business is ascertained by preparing ____________	Trading a/c	Statement of affairs	Statement of profit&loss a/c	Balance sheet	Statement of affairs
12	______ is suitable for all types of traders	Single entry	Double entry	Triple entry	Personal entry	Double entry
13	The amount of opening stock can be ascertained by preparing _______________	Memorandum trading a/c	Creditors a/c	Opening	Statement of profit	Memorandum trading a/c
14	An example for direct expenses is ________	Interest	Income tax	Depreciation	Wages	Wages
15	An example for indirect expenses is _________.	Wages	Carriage inward	Freight	Salaries	Salaries
16	Selling expenses like sales, commission, bad debts etc are apportioned on the basis of _________.	Sales ratio	Floor area	Light points	Purchase value	Sales ratio
17	Repairs to building, maintenance of building are apportioned on the basis of ________.	Turnover ratio	Floor area	Wages	Light points	Floor area

18	Opening stock + purchases – closing stock = ________.	Purchases	Sales	Stock	Debtor	Sales
19	Exchange of goods or services to gain profit or loss in a business activity is known as ______________	Business transaction	Banking transaction	Transaction	Entries	Business transaction
20	The amount which the proprietor has invested in the business is ____________	Capital	Liabilities	Assets	Fund	Capital
21	The closing stock at the end of the year is the _________for the subsequent year	Opening stock	Closing stock	Average Stock	Stock	Opening stock
22	The balance of unsold goods is known as _____________	Stock	Assets	Liabilities	Profit	Stock
23	____________enables the trader to find out Gross Profit or Loss	Trading account	Profit and loss account	Cash book	Balance Sheet	Trading account
24	_____________enables the trader to find out Net Profit or Loss	Profit or loss account	Trading account	Balance Sheet	Purchase book	Profit or loss account
25	____________shows the financial position of a trader	Balance sheet	Bank reconciliation statement	Cash book	Asset	Balance sheet

26	Outstanding expenses are shown on the ____________of the balance sheet.	Liability side	Asset side	Both Liability and Asset side	Trading account	Liability side
27	Income received in advance will be shown on the ___________side of the balance sheet.	Asset side	Both Liability and Asset side	Trading account	Liability side	Liability side
28	Opening stock is to be ___________	Debited in trading account	Credited in trading account	Debited in P/L a/c	Credited in P/L a/c	Debited in trading account
29	Balance sheet is a ___________	Statement	Account	Ledger	Transaction	Statement
30	Current liabilities are recorded in the balance sheet on_______	Liability side	Asset Side	Profit and Loss account	Trading	Liability side
31	Capital are recorded in the balance sheet on_______	Liability side	Asset Side	Both Liability and Asset side	May not appear in the balance sheet	Liability side
32	The Gross profit can be ascertained by preparing ______________	Trading a/c	Creditors a/c	Profit and Loss a/c	Debtors a/c	Trading a/c
33	Selling expenses like sales, commission, bad debts etc are apportioned on the basis of ________.	Sales ratio	Floor area	Light points	Purchase value	Sales ratio
34	Fixed assets are recorded in the balance sheet on_______	Liability side	Asset Side	Both Liability and Asset side	May not appear in the balance sheet	Asset Side

35	____________is a current asset	Plant	Machinery	Band Balance	Building	Band Balance
36	____________is a current liability	Plant	Machinery	Bills Payable	Building	Bills Payable
37	Fictituous assets are recorded in the balance sheet on________	Liability side	Asset Side	Both Liability and Asset side	May not appear in the balance sheet	Asset Side
38	____________is a current liability	Plant	Machinery	Sundry Creditors	Building	Sundry Creditors
39	Tangible assets are recorded in the balance sheet on________	Liability side	Asset Side	Both Liability and Asset side	May not appear in the balance sheet	Asset Side
40	Long term liabilities are recorded in the balance sheet on________	Liability side	Asset Side	Both Liability and Asset side	May not appear in the balance sheet	Liability side
41	An example for direct expenses is ________	Interest	Income tax	Depreciation	Freight	Freight
42	An example for indirect expenses is _________	Wages	Carriage inward	Freight	Printing and stationery	Printing and stationery
43	In _________ capital is added with net profit	Balance sheet	Bank reconciliation statement	Trading account	Statement of affairs	Balance sheet
44	Prepaid expenses are shown on the _____________of the balance sheet	Liability side	Asset side	Both Liability and Asset side	May not appear in the balance sheet	Asset side
45	An example for indirect expenses is _________	Wages	Carriage inward	Freight	Office expenses	Office expenses

46	___________is a fixed asset	Plant	Cash balance	Sundry Debtors	Bank balance	Plant
47	___________is a intangible asset	Goodwill	Machinery	Plant	Building	Goodwill
48	Unexpired expenses are shown on the ____________of the balance sheet	Liability side	Asset side	Both Liability and Asset side	May not appear in the balance sheet	Asset side
49	___________is a fixed asset	Cash balance	Machinery	Sundry Debtors	Bank balance	Machinery
50	___________ is a irecoverable debt from the customer	Bad debts	Reserves	Drawings	Capital	Bad debts
51	Discount allowed will be recorded in the __________	Trading account	Profit and loss account	Purchase account	Purchase return account	Profit and loss account
52	A comparative study of the financial statements of several year is called ______	Vertical analysis	Structural Analysis	Trend Analysis	Internal Analysis	Trend Analysis
53	Financial statement is outcome of ______ accounting	Cost	Management	Financial	corporate	Financial
54	A comparative study of the financial statements of several year is called ______	Vertical analysis	Structural Analysis	Trend Analysis	Internal Analysis	Trend Analysis
55	The networking capital can be ____	Positive	Negative	High	Low	Positive

56	As indicated ____ concepts of working capital have functional significance.	Net	Gross	Net or Gross	Assets	Net
57	_______ is the most important source for raising the permanent working capital.	Floating of debentures	Issue of share	Pouching back of profits	Loans	Issue of share
58	Companies have to follow the finacial year _____________	April 1^{st} to March 31^{st}	March 1^{st} to April 30^{th}	Jan1st to Dec 31^{st}	July 1^{st} to June 30^{th}	April 1^{st} to March 31^{st}
59	The statement which shows the periodical increase or decrease of funds is called _______	Fund flow statement	Cash flow statement	Working capital statement	Income statement	Working capital statement
60	Excess of current assets over current liabilities is called _______	Net working capital	Net current assets	Free current assets	Net current liability	Net working capital

UNIT-III-Financial Statement Analysis

SYLLABUS

Financial Statement Analysis - Objectives –Comparative Statements, Common-size statement, Trend Percentages, Ratio Analysis- Meaning, Nature, Uses, Limitations, Classification of Ratios-Liquidity, Solvency, Turnover ratios, Profitability ratios, Market ratios, Dupont Analysis, Interpretation of Ratios, Cash flow and Fund flow preparations.

MEANING OF FINANCIAL STATEMENTS

According to Himpton John, "A financial statement is an organized collection of data according to logical and consistent accounting procedures. Its purpose is to convey an understanding of some financial aspects of a business firm. It may show assets position at a moment of time as in the case of a balance sheet, or may reveal a series of activities over a given period of limes, as in the case of an income statement ".

On the basis of the information provided in the financial statements, management makes a review of the progress of the company and decides the future course of action.

DIFFERENT TYPES OF FINANCIAL STATEMENTS

- Income Statement
- Balance Sheet
- Statement of Retained earnings
- Funds flow statement
- Cash flow statement.
- Schedules.

FORMATS OF FINANCIAL STATEMENTS

The two main financial statements, viz the Income Statement and the Balance sheet, can either be presented in the horizontal form or the vertical form where statutory provisions are applicable, the statement has to be prepared in accordance with such provisions.

Income Statement:

There is no legal format for the profit and loss A/C. Therefore, it can be presented in the traditional T form, or vertically, in statement form. An example of the two formats is given as under.

(i) Horizontal, or "T" form:

Manufacturing, Trading and profit and loss A/C of ………........... for the year ending ....

Dr Cr

Particulars	Rs.	Particulars	Rs.
To opening stock		By cost of finished Goods c/d	xxxx
Raw materials	xxx	By closing stock	
Work in progress	xxx	Raw materials	xxx
		Work in progress	xxx
To purchases of raw materials	xxx		
To manufacturing wages	xxx		
To carriage inwards	xxx		
To other Factory Expenses	xxx		
	xxx		**xxx**
		By sales	xxx
To opening stock of finished	xxx	By closing stock of finished	xxx
goods		goods	
To cost of Finished goods b/d	xxx	By Gross Loss c/d	xxx
To Gross Profit c/d	xxx		
	xxx		**xxx**
To Gross Loss b/d	xxx	By Gross profit b/d	xxx
To office and Admn. Expense	xxx	By Miscellaneous Receipts	xxx
To Interest and financial expenses	xxx	By Net Loss c/d	xxx
To provision for Income-tax	xxx		
To Net Profit c/d	xxx		
	xxx		**xxx**
To net loss b/d	xxx	By Balance b/d	xxx

To general reserve	xxx	(from previous year)	
To Dividend	xxx	By Net profit b/d	xxx
To Balance c/f	xxx		
	xxx		**xxx**

(ii) Vertical Form

Income statement of ………… for the year ending ……………...

Particulars	**Rs.**	**Rs.**
Sales		xxxx
Less: Sales Returns	xxx	
Sales Tax/ Excise Duty	xxx	xxxx
Net sales (1)		xxxx
Cost of Goods Sold		
Materials Consumed		xxxx
Direct Labour		xxxx
Manufacturing Expenses		xxxx
Add / less Adjustment for change in stock (2)		xxxx
		xxxx
Gross Profit (1) – (2)		xxx
Less: Operating Expenses		
Office and Administration Expenses		
Selling and Distribution Expenses	xxx	
	xxx	xxx
Operating Profit		Xxxx
Add: Non-operating Income		Xxx
Less: Non-operating Expenses (including Interest)		xxxx
Profit before Tax		xxx
		xxxx
Less : Tax		xxx
Profit After Tax		**xxxx**

Appropriations		
Transfer to reserves		
Dividend declared /paid		xxxx
Surplus carried to Balance sheet		xxx
		xxx
		xxxx

Balance Sheet

The Companies Activities, 1956 stipulates that the Balance sheet of a joint stock company should be prepared as per part I of schedule VI of the Activities. However, the statement form has been emphasized upon by accountants for the purpose of analysis and Interpretation. The permission of the Centra! Government is necessary for adoption of the 'statement* form.

(i) Horizontal Form

Balance sheet of .... as on ....

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital	xxx	**Fixed Assets:**	
(with all paticulars of Authorized, Issued, Subscribed capital) Called up capital	xxx	1. Goodwill 2. Land & Building 3. Leasehold property 4. Plant and Machinery 5. Furniture and Fittings	xxx xxx xxx xxx xxx
Less: Calls in Arrears	xxx	6. Patents and Trademarks	xxx
Add: Forfeited Shares	xxx	7. Vehicles	xxx
Reserves and Surplus :		**Investments**	
1. Capital Reserve	xxx	**Current Assets, loans and**	
2. Capital Redemption		**Advances**	
reserve	xxx	**(A) Current Assets**	
3. Share premium	xxx	1. Interest accrued on	
4. Other premium	xxx	Investments	xxx
Less: debit balance of Profit	xxx	2. Loose tools	xxx

and loss A/C (if any)		3. Stock in trade	xxx
5. Profit and Loss	xxx	4. Sundry Debtors	xxx
Appropriation A/C		Less: Provision for doubtful	
6. Sinking Fund	xxx	Debts	
		5. cash in hand	xxx
		6. cash in Bank	xxx
Secured Loans		**(B) Loans and Advances**	
Debentures	xxx	7. Advances to subsidiaries	xxx
Add: Outstanding Interest	xxx	8. Bills Receivable	xxx
Loans from Banks	xxx	9. Prepaid Expenses	xxx
Unsecured Loans		**Miscellaneous** Expenditure (to the extent not written off or	
Fixed Deposits	xxx	adjusted)	xxx
Short-term loans and advances	xxx		
Current Liabilities and Provisions		1. Preliminary expenses 2. Discount on Issue of shares	xxx xxx
		and debentures	
A. Current Liabilities		3. Underwriting Commission	xxx
1. Bills Payable	xxx		
2. Sundry Creditors	xxx	Profit and Loss account (Loss),	
3. Income received in advance	xxx	if any	
4. unclaimed Dividends	xxx		
5. Other Liabilities	xxx		
B. Provisions			
6. Provisions for Taxation	xxx		
7. Proposed Dividends	xxx		
8. Proposed funds & pension	xxx		
fund contingent liabilities not			

Provided for			
	xxx		**xxx**

(ii) Vertical Form:

Balance sheet of ………………………. as on …………………

Particulars	Schedule No.	Current year	Previous Year
I. Source of funds			
1. Share holders funds			
a. capital		xxxx	xxxx
b. Reserves and surplus		xxxx	xxxx
2. Loans funds			
a. Secured Loans		xxxx	xxxx
b. Unsecured Loans		xxxx	xxxx
Total			
II. Application of funds			
1. Fixed Assets			
a. Gross Block		xxxx	xxxx
b. less Depreciation		xxxx	xxxx
c. Net block		xxxx	xxxx
d. Capital work in progress		xxxx	xxxx
2. Investments		xxxx	xxxx
3. Current Assets, Loans and Advances			
a. Inventions		xxxx	xxxx
b. Sundry Debtors		xxxx	xxxx
c. Cash and Bank balance		xxxx	xxxx
d. other current assets		xxxx	xxxx
e. Loans and Advances		xxxx	xxxx

Less : current Liabilities and Provisions		
a. Current Liabilities	xxxx	xxxx
b. Provisions	xxxx	xxxx
	xxxx	xxxx
Net Current Assets		
4. a. Miscellaneous Expenditure to	xxxx	xxxx
the extent not written off or adjusted		
b. Profit and Loss Account (debit)	xxxx	xxxx
Total	xxxx	xxxx

(ii) Vertical Form for analysis

Balance sheet of ……… as on …………….

Particulars	Rs.
ASSETS	
Current Assets	
Cash and Bank Balances	xxxx
Debtors	xxxx
Stock	xxxx
Other Current Assets	xxxx
(1)	xxxx
Fixed Assets	xxxx
Less: Depreciation	xxxx
Investments	xxxx
(2)	xxxx
Total (1) + (2)	xxxxx
LIABILITIES	
Current Liabilities :	
Bills Payable	xxxx

Creditors	
Other Current Liabilities	
(3)	xxxx
Long Term Debt	
Debentures	xxxx
Other Long-term Debts	xxxx
(4)	xxxx
Capital and Reserves	
Share Capital	xxxx
Reserves and surplus	xxxx
(5)	xxxx
Total Long term funds	
Total (3)+(4)+(5)	xxxxx

Statement of Retained Earnings:

Profit and Loss Appropriation Account

Particulars	**Rs.**	**Particulars**	**Rs.**
To transfer to Reserves	xxx	By Last year's balance	xxx
To Dividend	xxx	By Current Year's net profit (Transferred from profit and loss A/C)	xxx
To Dividend proposed	xxx		
To surplus carried to	xxx	By Excess provisions	xxx
Balance sheet		(which are no longer	
		required)	
		By Reserves withdrawn	
		(if any)	xxx
	xxx		xxxx

Illustration: 1

From the following information, prepare a vertical Income Statement.

Sales	2,00,000
Opening stock	10,000
Closing stock	15,000
Purchases	40,000
Operating Expenses	12,000

Rate of Tax 50%

Solution:

Income Statement

Particulars	Rs.	Rs.
Sales		2,00,000
Less : cost of goods sold:		
Opening stock	10,000	
Add: Purchases	40,000	
	50,000	
Less: closing Stock	15,000	
		35,000
Gross Profit		1,65,000
Less: operating expenses		12,000
Operating profit		1,53,000
Less: non-operating expenses		4,000
Profit before tax		1,49,000
Less: Income tax (50%)		74,500
Net profit after tax		74,500

Illustration: 2

From the following particulars, pertaining to Mohan Ltd., you are required to prepare a comparative Income Statement and interpret the changes.

Particulars	Rs.	Rs.
Sales	58,000	65,200
Cost of goods sold	47,600	49,200
Administration expenses	1,016	1,000
Selling expenses	1,840	1,920
Non -operating expenses	140	155
Non-operating expenses	96	644
Sales returns	2000	1,200
Tax rate	43.75%	43.75%

Solution:

Comparative Income Statement of Mohan Ltd., for the years 2000 and 2001.

Particulars	2000 Rs.	2001 Rs.
Sales	58,000	65,200
Less Returns	2,000	1,200
Net sales	56,000	64,000
Less: Cost of Goods sold	47,600	49,200
Gross Profit (A)	8,400	14,800
Less: Operating expenses		
Administration expenses	1,016	1,000
Selling expenses	1,840	1,920
Total operating expenses (B)	2,856	2,920
Operating profit (A)-(B)	5,544	11,880
Add: non - operating incomes	96	644
Less: non- operating expenses	5,640	12,524
	140	155
Net profit before tax	5,500	12,369
Less: Tax	2,406	5,411

Net profit after Tax	3094	6,958

Comparative Financial Statements

Comparative financial statements are statements of financial position of a business designed to provide time perspective to the consideration of various elements of financial position embodied in such statements. Comparative Statements reveal the following: .

i. Absolute data (money values or rupee amounts)
ii. Increase or reduction in absolute data (in terms of move values)
iii. Increase or reduction in absolute data (in terms of percentages)
iv. Comparison (in terms of ratios)
v. Percentage of totals.

a. Comparative Income Statement or Profit and Loss Account:

A comparative income statement shows the absolute figures for two or more periods and the absolute change from one period to another. Since the figures are shown side by side, the user can quickly understand the operational performance of the firm in different periods and draw conclusions.

b. Comparative Balance Sheet

Balance sheet as on two or more different dates are used for comparing the assets, liabilities and the net worth of the company Comparative balance sheet is useful for studying the trends of analysis undertaking.Financial Statements of two or more firms can also be compared for drawing inferences. This is called interfirm Comparison.

ADVANTAGES:

Comparative statements vindicate trends in sales, cost of production, profits etc., and help the analyst to evaluate the performance of the company.Comparative statements can also be used to compare the performance of the industry or inter-firm comparison. This helps in identification of the weaknesses of the firm and remedial measures can be taken; accordingly.

Weaknesses:

Inter-firm comparison can be misleading if the firms are not identical in size and age and when they follow different accounting procedures with regard to depreciation, inventory valuation etc.,Inter-period comparison may also be misleading if the period has witnessed changes in accounting policies, inflation, recession etc.

Illustration 3:

The following is the profit and loss account of Ashok Ltd., for the years 2009 and 2010. Prepare comparative Income Statement and comment on the profitability of the undertaking.

Particulars	2009	2010	Particulars	2009	2010
	Rs.	Rs.		Rs.	Rs.
To Cost of goods sold	2,31,625	2,41,950	By Sales	3,60,728	4,17,125
To Office expenses	23,266	27,068	Less Returns	5,794	6,952
To Interest expenses	45,912	57,816		3,54,934	4,10,173
To Loss on sale of fixed	627	1,750	By Other incomes :		
To Income Tax	21,519	40,195	By Discount on purchase	2,125	1,896
To Net Profit	35,371	44,425	By Profit on sale of land	1,500	
	3,60,457	4,13,379		3,60,457	4,13,379

Solution:

ASHOK LTD.

Comparative Income Statement for the years ending 2000 and 2001

Particulars	2009 Rs.	2010 Rs.	Increase (+) Decrease (-) Amount (Rs.)	Increase (+) Decrease (-) Percentages
Sales	3,60,728	4,17,125	+56,397	+15.63
Less: Sales returns	5,794	6,952	+1.158	+19.98

	3,54,934	4,10,173	+55,239	+15.56
Less: Cost of goods sold	2,31,625	2,41,950	+ 10,325	+4.46
Gross Profit	1,23,309	1,68,223	+44.914	+36.42
Operating Expenses:				
Office expenses	23,266	27,068	+3,802	+ 16.34
Selling expenses	45,912	57,816	+11,904	+25.93
Total operating expenses	69,178	84,884	+15,706	+22.70
Operating profit	54,131	83,339	+29,208	+53.96
Add: Other incomes	5,523	3,206	-2,317	-41.95
	59,654	86,545	+26.891	+45.08
Less: Other expenses	2,764	1,925	-839	-30.35
Profit before tax	56,890	84,620	+27,730	+48.74
Less: Income tax	21,519	40,195	+18,676	+86.79
Net Profit after tax	35,371	44,425	+9,054	+25.60

Interpretation:

The comparative Income statement reveals that while the net saleshas been increased by 15.5%, the cost of goods sold increased by 4.46%. So gross profit is increased by 36.4%. The total operating expenses has been increased by 22.7% and the gross profit is sufficient to compensate increase in operating expenses. Net profit after tax is 9,054 (i.e., 25.6%) increased. The overall profitability of the undertaking is satisfactory.

COMMON SIZE STATEMENTS

The figures shown in financial statements viz. Profit and Loss Account and Balance sheet are converted to percentages so as to establish each element to the total figure of the statement and these statement are called Common Size Statements. These statements are useful in analysis of the performance of the company by analyzing each individual element to the total figure of the statement. These statements will also assist in analyzing the performance over years and also with the figures of the competitive firm in the industry for making analysis of relative efficiency. The following statements show the method of presentation of the data.

Illustration: 4

Common Size Income Statement of XYZ Ltd., for the year ended 31st March, 2007.

Particulars	**Amount (Rs.)**	**% to Sales**
Sales (A)	14,00,000	100

Raw materials	5,40,000	16.4
Direct wages	2,30,000	16.4
Factory expenses	1,60,000	11.4
(B)	9,30,000	66.4
Gross Profit (A) - (B)	4,70,000	33.6
Less: Administrative expenses	1,10,000	7.9
Selling and distribution expenses	80,000	5.7
Operating Profit	2,80,000	20.0
Add: Non-operative income	40,000	2.9
	3,20,000	22.9
Less: Non-operating expenses	60,000	43
Profit before tax	2,60,000	18.6
Less: Income tax	80,000	5.7
Profit after tax	1,80,000	12.9

Common Size Balance Sheet of XYZ

Particulars	Amount (Rs.)	% to Total
ASSETS		
Fixed Assets		
Land	50,000	5.3
Buildings	1,10,000	11.7
Plant and Machinery	2,50,000	26.6
Current Assets :		
Inventory		
Raw materials	80,000	8.5
Work-in-progress	50,000	5.3

Finished goods	1,60,000	17.0
Sundry debtors	2,10,000	22.4
Cash at Bank	30,000	3.2
Total	9,40,000	100.0
Capital and Liabilities		
Equity Share capital	2,50,000	26.6
Preference Share Capital	1,00,000	10.6
General reserve	1,60,000	17.0
Debentures	80,000	8.5
Current Liabilities		
Sundry Creditors	2,20,000	23.4
Creditors for expenses	40,000	4.3
Bills payable	90,000	9.6
Total	9,40,000	100.0

Analysis of performance and position can be made from the above Common Size Statements.

llustration: 5

From the following P&L A/c prepare a Common Size Income Statement

Particulars	**2009**	**2010**	**Particulars**	**2009**	**2010**
	Rs.	**Rs.**		**Rs.**	**Rs.**
To Cost of goods Sold	12,000	1 5,000	By Net Sales	16,000	20,000
To Administrative	400	400			
Expenses					
To Selling expenses	600	800			
To Net Profit	3,000	3,800			
	16,000	20,000		16,000	20,000

Common Size Income Statement

Particulars	2009		2010	
	Rs.	%	Rs.	%
Net sales	16,000	100.00	20,000	100.00
Less: Cost of goods sold	12,000	75.00	15,000	7500
Gross Profit	**4,000**	**25.00**	**5,000**	**25.00**
Less: Operating expenses				
Administration expenses	400	2.50	400	2.00
Selling expenses	600	3.75	800	4.00
Total Operating expenses	1,000	6.25	1,200	6.00
Net Profit	**3,000**	**18.75**	**3,800**	**19.00**

TREND ANALYSIS

In trend analysis ratios of different items are calculated for various periods for comparison purpose. Trend analysis can be done by trend percentage, trend ratios and graphic and diagrammatic representation. The trend analysis is a simple technique and does not involve tedious calculations.

Illustration: 6

From the following data, calculate trend percentage taking 2006 as base.

Particulars	2006	2007	2008
	Rs.	Rs.	Rs.
Sales	50,000	75,000	1,00,000
Purchases	40,000	60,000	72,000
Expenses	5,000	8,000	15,000
Profit	5,000	7,000	13,000

Solution:

Particulars	2006	2007	2008	Trend Percentage Base 2006

	Rs.	Rs.	Rs.	2006	2007	2008
Purchases	40,000	60,000	72,000	100	150	180
Expenses	5,000	8,000	15,000	100	160	300
Profit	5,000	7,000	13,000	100	140	260
Sales	50,000	75,000	1,00,000	100	150	200

Illustration: 7

From the following data, calculate trend percentages (**2008** as base)

Particulars	**2008** Rs.	**2009** Rs.	**2010** Rs.
Cash	200	240	160
Debtors	400	500	650
Stock	600	800	700
Other Current Assets	450	600	750
Land	800	1,000	1,000
Buildings	1,600	2,000	2,400
Plant	2,000	2,000	2,400

Solution:

Particulars	**2008** Rs.	**2009** Rs.	**2010** Rs.	**(Base Year 2008)**		
				2008	2009	2010
Cash	200	240	160	100	120	80
Debtors	400	500	650	100	125	163
Other Current Assets	450	600	750	100	133	167
Total Current Assets	1,650	2,140	2,260	100	130	137
Fixed Assets:						
Land	800	1,000	1,000	100	125	125
Buildings	1,600	2,000	2,400	100	125	150

Plant	2,000	2,000	2,400	100	100	120
Total Fixed Assets	4,400	5,000	5,800	100	114	132

ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

Financial Statement are indicators of the two significant factors:

(i) Profitability, and (ii) Financial soundness

Analysis and interpretation of financial statements, therefore, refer to such a treatment of the information contained in the income statement and the Balance Sheet so as to afford full diagnosis of the profitability and financial soundless of the business.

TYPES OF FINANCIAL ANALYSIS

Financial Analysis can be classified into different categories depending upon
(i) The materials used and (ii) The modus operandi of analysis

ON THE BASIS OF MATERIAL USED: According to this basis financial analysis can be of two types.

(i) **External Analysis:**
This analysis is done by those who are outsiders for the business. The term outsiders includes investors, credit agencies, government and other creditors who have no access to the internal records of the company.

(ii) **Internal Analysis:**
This analysis is done by persons who have access to the books of account and other information related to the business. On the basis of modus operandi. According to this, financial analysis can also be two types.

(i)Horizontal analysis:

In case of this type of analysis, financial statements for a number of years are reviewed and analyzed. The current year's figures are compared with the standard or base year. The analysis statement usually contains figures for two or more years and the changes are shown recording each item from the base year usually in the from of percentage. Such an analysis gives the management considerable insight into levels and areas of strength and weakness. Since this type of analysis is based on the data from year to year rather than on the date, it is also termed as Dynamic Analysis.

(ii) Vertical analysis:

In case of this type of analysis a study is made of the quantitative relationship of the various terms in the financial statements on a particular date. For example, the ratios of different items of costs for a particular period may be calculated with the sales for that period such an analysis is useful in comparing the performance of several companies in the same group, or divisions or departments in the same company.

TECHNIQUES OF FINANCIAL ANALYSIS

A financial analyst can adopt one or more of the following techniques/tools of financial analysis.

1. **Comparative Financial Statements:**

   Comparative financial statements are those statements which have been designed in a way so as to provide time perspective to the consideration of various elements of financial position embodied in such statements. In these statements figures for two or more periods are placed side by side to facilitate comparison. Both the income statement and Balance Sheet can be prepared in the form of Comparative Financial Statements.

Comparative Income Statement:

The Income statement discloses net profit or Net Loss on account of operations. A comparative Income Statement will show the absolute figures for two or more periods, the absolute change from one period to another and if desired the change in terms of percentages. Since, the figures for two or more period are shown side by side, the reader can quickly ascertain whether sales have increased or decreased, whether cost of sales has increased or decreased etc. Thus, only a reading of data included in Comparative Income Statements will be helpful in deriving meaningful conclusions.

Comparative Balance Sheet: Comparative Balance Sheet as on two or more different dates can be used for comparing assets and liabilities and finding out any increase or decrease in those items. Thus, while in a single Balance Sheet the emphasis is on present position, it is on change in the comparative Balance Sheet. Such a Balance sheet is very useful in studying the trends in an enterprise.

The preparation of comparative financial statements can be well understood with the help of the following illustration.

ILLUSTRATION: From the following Profit and Loss Accounts and the Balance Sheet of Swadeshi polytex Ltd. For the year ended 31st December, 2009 and 2010, you are required to prepare a comparative Income Statement and Comparative Balance Sheet.

PROFIT AND LOSS ACCOUNT

(In Lakhs of Rs.)

Particular	2009	2010	*Assets	2009	2010
	Rs.	Rs.		Rs.	Rs.
To Cost of Goods sold	600	750	By Net Sales	800	1,000
To operating Expenses					
Administrative Expenses	20	20			
Selling Expenses	30	40			
To Net Profit	150	190			
	800	1,000		800	1,000

BALANCE SHEET AS ON 31ST DECEMBER

(In Lakhs of Rs.)

Liabilities	2009	2010	Assets	2009	2010
	Rs.	Rs.		Rs.	Rs.
Bills Payable	50	75	Cash	100	140
Sundry Creditors	150	200	Debtors	200	300
Tax Payable 6%	100	150	Stock	200	300
Debentures 6%	100	150	Land	100	100
Preference Capital	300	300	Building	300	270
Equity Capital	400	400	Plant	300	270
Reserves	200	245	Furniture	100	140
	1300	1520		1300	1520

SOLUTION:

Swadeshi Polytex Limited Comparative income statement

For the years ended 31st December and 2010 (In Lakhs of Rs.)

Particulars	2009	2010	Absolute increase or decrease in 2010	Percentage increase or decrease in 2010
Net Sales	800	1000	+200	+25
Cost of Goods Sold	600	750	+150	+25
Gross Profit	200	350	+50	+25
Operating Expenses Administration Expenses	20	20	-	-

Selling Expenses	30	40	+10	+33.33
Total Operating Expenses	50	60	10	+20
Operating Profit	150	190	+40	+26.67

Swadeshi Polytex Limited

COMPARATIVE BALANCE SHEET

AS ON 31ST DECEMBER, 1987, 1988

Figures in lakhs of rupees

Assets	2009	2010	Absolute increase or decrease during 1988	Percentage increase (+) or decrease (-) during 1988
Current Assets:				
Cash	100	140	40	+40
Debtors	200	300	100	+50
Stock	200	300	100	+50
Total Current Assets	500	740	240	+50
Fixed Assets:				
Land	100	100	-	-
Building	300	270	-30	-10%
Plant	300	270	-30	-10%
Furniture	100	140	+40	+40%
Total Fixed Assets	800	780	-20	-2.5%
Total Assets	1300	1520	220	+17%
Liabilities & Capital:				
Current Liabilities				
Bills Payable	50	75	+25	+50%

Sundry Creditors	150	200	+50	+33.33%
Tax Payable	100	150	+50	+50%
Total Current Liabilities	300	425	+125	+41.66%
Long-term Liabilities : 6% Debentures	100	150	+50	+50%
Total Liabilities	400	575	+175	+43.75%
Capital & Reserves				
6% Pre. Capital	300	300	-	-
Equity Capital	400	400	-	-
Reserves	200	245	45	22.5
Total Shareholders' Funds	900	945	45	5%
Total Liabilities and Capital	1300	1520	220	17%

2. Common – size Financial Statements:

Common – size Financial Statements are those in which figures reported are converted into percentages to some common base. In the Income Statement that sale figure is assumed to be 100 and all figures are expressed as a percentage of this total.

Illustration: Prepare a Common – size Income Statement & Common-size Balance Sheet of Swadeshi Polytex Ltd., for the years ended 31st December, 2009 & 2010

SOLUTION:

Swadeshi Polytex Limited

COMMON – SIZE INCOME STATEMENT

FOR THE YEARS ENDED 31ST DECEMBER 2009 AND 2010

(Figures in Percentage)

	2009	2010
Net Sales	100	100
Cost of Goods Sold	75	75
Gross Profit	25	25
Opening Expenses:		
Administration Expenses	2.50	2
Selling Expenses	3.75	4
Total Operating Expenses	6.25	6
Operating Profit	18.75	19

Interpretation:

The above statement shows that though in absolute terms, the cost of goods sold has gone up, the percentage of its cost to sales remains constant at 75%, this is the reason why the Gross Profit continues at 25% of sales. Similarly, in absolute terms the amount of administration expenses remains the same but as a percentage to sales it has come down by 5%. Selling expenses have increased by 25%. This all leads to net increase in net profit by 25% (i.e., from 18.75% to 19%)

3. Trend Percentage:

Trend Percentages are immensely helpful in making a comparative study of the Financial statements for several years. The method of calculating trend percentages involves the calculation of percentage relationship that each item bears to the same item in the base year. Any year may be taken as base year. It is usually the earliest year. Any intervening year may also be taken as the base year. Each item of base year is taken as 100 and on that basis the percentages for each of the years are calculated. These percentages can also be taken as Index Numbers showing relative changes in the financial data resulting with the passage of time.

The method of trend percentages is useful analytical device for the management since by substitution percentages for large amounts, the brevity and readability are achieved. However, trend percentages are not calculated for all of the items in the financial statements. They are usually calculated only for major items since the purpose is to highlight important changes.

Besides, Fund flow Analysis, Cash Flow Analysis and Ratio Analysis are the other tools of Financial Analysis which have been discussed in detail as separate chapters.

RATIO ANALYSIS

Meaning

A ratio expresses the relationship that exists between two numbers and in financial statement analysis a ratio shows the relationship between two interrelated accounting figures. Both the accounting figures may be taken from the balance sheet and the resulting ratio is called a balance sheet ratio or both the figures may be taken from profit and loss account when the resulting ratio is called as profit and loss account ratio and composite ratio is that ratio which is calculated by taking one figure from profit and loss account and the other figure from balance sheet.

Nature of ratio Analysis

To evaluate the financial performance of a company, the financial ratios are used as a very sophisticate tool. But, the type of analysis varies according to the specific interests of the party involved. Trade creditors are interested primarily in the liquidity of a firm. Their claims are short term, and the ability of a firm to pay these claims is best judged by means of a thorough analysis of its liquidity.

Investors in a company's common stock are concerned principally with present and expected future earnings and the stability of these earnings about a trend, as well as their covariance with the earnings of other companies. As a result, investors might concentrate their analysis on a company's profitability.

IMPORTANCE OF RATIO ANALYSIS

The inter relationship that exists among the current items appeared in the financial statements, are revealed by accounting ratios. Ratio analysis of a firm's financial statements is of interest to a number of parties, mainly, shareholders, creditors, financial executives etc. Shareholders are interested with earning capacity of the firm: creditors are interested in knowing the ability of firm to meet its financial obligations ; and financial executives are concerned with evolving analytical tools that will measure and compare costs, efficiency, liquidity and profitability with a view to making intelligent decisions.

The importance of ratio analysis are discussed below, in brief:

Aid to Measure General Efficiency

Ratios enable the mass of accounting data to be summarized and simplified. They act as an index of the efficiency of the enterprise. As such they serve as an instrument of management control.

Aid to Measure Financial Solvency

Ratios are useful tools in the hands of management and other concerned to evaluate the firms performance over a period of time by comparing the present ratio with the past ones. They point out firm's liquidity position to meet its short term obligations and long term solvency.

Aid in Forecasting and Planning

Ratio analysis is an invaluable aid to management in the discharge of its basic function such as planning, forecasting, control etc. The ratios that are derived after analyzing and scrutinizing the past result, help the management to prepare budgets to formulate policies and to prepare the future plan of action etc.

Facilitate Decision-making

It throws light on the degree of efficiency of the management and utilization of the assets and that is why it is called surveyor of efficiency. They help management in decision-making.

Aid in Corrective Action

Ratio analysis provides inter firm comparison. They highlight the factors associated with successful and unsuccessful firms. If comparison shows an unfavorable variance, corrective actions can be initiated. Thus, it helps the management to take corrective action.

Aid in Intra Firm Comparison

Intra firm comparisons are facilitated. It is an instrument for diagnosis of financial health of an enterprise. It facilitates the management to know whether the firm's financial position is improving or deteriorating by setting a trend with the help of ratios.

Acts as a Good Communication

Ratios are an effective means of communication and play a vital role in informing parties. The communications by the use of simplified and summarized ratios are more easy and understandable

Evaluation of Efficiency

Ratio analysis is an effective instrument which, when properly used, is useful to assess important characteristics of business – liquidity, solvency, profitability etc. A study of these aspects may enable conclusions to be drawn relating to capabilities of business.

Effective Tool

Ratio analysis helps in making effective control of the business – measuring performance, control of cost etc. Effective control is the keynote of better management. Ratio ensures secrecy..

Figures in the absolute forms, shown in the financial statements are neither significant nor able to be compared. In fact, they are dump. But ratios have power to speak.

USE OF FINANCIAL RATIOS

For analysing the financial condition and performance of a company, the financial analyst needs certain yardsticks. The yardstick frequently used is a ratio, or index, relating two pieces of financial data to each other. Analysis and interpretation of various ratios should give experienced, skilled analysts a better understanding of the financial condition and performance of the firm than they would obtain from analysis of the financial data alone.

The analysis of financial ratios involves two types of comparison. First, the analyst can compare a present ratio with past and expected future ratios for the same company. The current ratio (the ratio of current assets to current liabilities) for the present year end could be compared with the current ratio for the preceding year end. When financial ratios are arrayed on a spreadsheet over a period of years, the analyst can study the composition of change and determine whether there has been an improvement or deterioration in the financial condition and performance over time. The above is termed as trend analysis. Financial ratios also can be computed for projected, or pro forma, statements and compared with present and past ratios. In the comparison over time, it is best to compare not only financial ratios but also the few figures.

The second method of comparison involves comparing the ratios of one firm with those of similar firms or with industry averages at the same point in time. Such a comparison gives insight into the relative financial condition and performance of the firm. Sometimes a company will not fit neatly into an industry category. In such situations, one should try to develop a set, albeit usually small, of peer firms for comparison purposes.

TYPES OF RATIOS

CAPITAL STRUCTURE OR LEVERAGE RATIOS

Financial strength indicates the soundness of the financial resources of an organisation to perform its operations in the long run. The parties associated with the organisation are interested in knowing the financial strength of the organisation. Financial strength is directly associated with the operational ability of the organisation and its efficient management of resources. The financial strength analysis can be made with the help of the following ratios:

1. Debt-Equity Ratio
2. Capital Gearing Ratio
3. Financial Leverage
4. Proprietary Ratio and
5. Interest Coverage

1. Debt-Equity Ratio

The debt-equity ratio is determined to ascertain the soundness of the long-term financial policies of the company. This ratio indicates the proportion between the shareholders' funds (i.e. tangible net-worth) and the total borrowed funds. Ideal ratio is 1. In other words, the investor may take debt equity ratio as quite satisfactory if shareholders' funds are equal to borrowed funds. However, creditors would prefer a low debt-equity ratio as they are much concerned about the security of their investment. This ratio can be calculated by dividing the total debt by shareholders' equity. For the purpose of calculation of this ratio, the term shareholders' equity includes share capital, reserves and surplus and borrowed funds which includes both long-term funds and short-term funds.

Debt – Equity Ratio = Debt / Equity

A high ratio indicates that the claims of creditors are higher as compared to owners' funds and a low debt-equity ratio may result in a higher claim of equity.

2. Capital Gearing Ratio

This ratio establishes the relationship between the fixed interest-bearing securities and equity shares of a company.

It is calculated as follows:

$$\text{Capital Gearing Ratio} = \frac{\text{Fixed Interest-bearing securities}}{\text{Equity Shareholders' Funds}}$$

Fixed-interest bearing securities carry with them the fixed rate of dividend or interest and include preference share capital and debentures. A firm is said to be highly geared if the lion's share of the total capital is in the form of fixed interest-bearing securities or this ratio is more than one. If this ratio is less than one, it is said to be low geared. If it is exactly one, it is evenly geared. This ratio must be carefully planned as it affects the firm's capacity to maintain a uniform dividend policy during difficult trading periods that may occur. Too much capital should not be raised by way of debentures, because debentures do not share in business losses.

3. Financial Leverage Ratio

Financial leverage results from the presence of fixed financial charges in the firm's income stream. These fixed charges do not vary with the earnings before interest and tax (EBIT) or operating profits. They have to be paid regardless of the amount of earnings before interest and taxes available to pay them. After paying them, the operating profits (EBIT) belong to the ordinary shareholders. Financial leverage is concerned with the effects of changes in earnings before interest and taxes on the earnings available to equity holders. It is defined as the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on the firm's earning per share. Financial leverage and trading on equity are synonymous terms. The EBIT is calculated by adding back the interest (interest on loan capital + interest on long term loans + interest on other loans) and taxes to the amount of net profit. Financial leverage ratio is calculated by dividing EBIT by EBT (earnings before tax). Neither a very high leverage nor a very low leverage represents a sound picture. (EBIT ÷ EBT).

4.Proprietary Ratio

This ratio establishes the relationship between the proprietors' funds and the total tangible assets. The general financial strength of a firm can be understood from this ratio. The ratio is of particular importance to the creditors who can find out the proportion of shareholders' funds in the capital assets employed in the business. A high ratio shows that a concern is less dependent on outside funds for capital. A high ratio suggests sound financial strength of a firm due to greater margin of owners' funds against outside sources of finance and a greater margin of safety for the creditors. A low ratio indicates a small amount of owners' funds to finance total assets and more dependence on outside funds for working capital. In the form of formula this ratio can be expressed as:-

$$\text{Proprietary Ratio} = \frac{\text{Net Worth}}{\text{Total Assets}}$$

5. Interest CoverageRatio

This ratio measures the debt servicing capacity of a firm in so far as fixed interest on long-term loan is concerned. It is determined by dividing the operating profits or earnings before interest and taxes (EBIT) by the fixed interest charges on loans. Thus,

$$\text{Interest Coverage} = \frac{\text{EBIT}}{\text{Interest}}$$

It should be noted that this ratio uses the concept of net profits before taxes because interest is tax-deductible so that tax is calculated after paying interest on long-term loans. This ratio, as the name suggests, shows how many times the interest charges are covered by the EBIT out of which they will be paid. In other words, it indicates the extent to which a fall in EBIT is tolerable in the sense that the ability of the firm to service its debts would not be adversely affected. From the point of view of creditors, the larger the coverage, the greater the ability of the firm to handle fixed-charge liabilities and the more assured the payment of interest to the creditors. However, too high a ratio may imply unused debt capacity. In contrast, a low ratio is danger signal that the firm is using excessive debt and does not have the ability to offer assured payment of interest to the creditors.

FIXED ASSETS ANALYSIS

The successful operation of a business generally requires some assets of fixed character. These assets are used primarily in producing goods and in operating the business. With the help of these, raw materials are converted into finished products. Fixed assets are not meant for sale and are kept as a rule permanently in the business in order to carry on day-to-day operations.

Analysis of fixed assets is very important from investors' point of view because investors are more concerned with long term assets. Fixed assets are property of non-current nature which are acquired to provide facilities to carry on business. They include land, building, equipment, furniture, etc. They are generally shown in balance sheet by aggregating them into groups of gross block as reduced by the accumulated amount of depreciation till date. Investment in fixed assets is of a permanent nature and therefore should be financed by owners' funds (permanent sources of funds). The owners' funds should be sufficient to provide for fixed assets. Fixed assets are generally financed by owners' equity and long-term borrowings. The long-term borrowings are in the form of long-term loans and of almost permanent nature. Under such a situation it becomes more or less irrelevant to relate the fixed assets with only the owners' equity. Therefore, the analysis of the source of financing of fixed assets has been done with the help of the following ratios:-

1. Fixed Assets to Net Worth
2. Fixed Assets to Long-term Funds

1. Fixed Assets to Net Worth

In the words of Anil B.Roy Choudhary, "this ratio indicates the relationship between Net Worth (i.e. shareholders' funds) and investments in net fixed assets (i.e. Gross Block minus depreciation)".

The higher the ratio the lesser would be the protection to creditors. If the ratio is less than 1, it indicates that the net worth exceeds fixed assets. It will further indicate that the working capital is partly financed by shareholders' funds. If the ratio exceeds 1, it would mean that part of the fixed assets has been provided by creditors. The formula for derivation of this ratio is:-

$$\text{Fixed Assets to Net Worth Ratio} = \frac{\text{Net Fixed Assets}}{\text{Net Worth}}$$

2. Fixed Assets to Long-term Funds

This ratio establishes the relationship between the fixed assets and long-term funds and it is obtained by the formula:

Fixed Assets

$$\text{FIXED ASSET RATIO} = \frac{}{\text{Long-term Funds}}$$

The ratio should be less than one. If it is less than one, it shows that a part of the working capital has been financed through long-term funds. This is desirable because a part of working capital termed as "core working capital" is more or less of a fixed nature. The ideal ratio is 0.67.

If this ratio is more than one, it indicates that a part of current liability is invested in long-term assets. This is a dangerous position. Fixed assets include "net fixed assets" i.e. original cost less depreciation to date and trade investments including shares in subsidiaries. Long-term funds include share capital, reserves and long-term borrowings.

ANALYSIS OF TURNOVER (OR) ANALYSIS OF EFFICIENCY

Turnover ratios also referred to as Activity Ratios are concerned with measuring the efficiency in asset management. Sometimes, these ratios are also called as efficiency ratios or asset utilisation ratios. The efficiency with which the assets are used would be reflected in the speed and rapidity with which assets are converted into sales.

The greater the rate of turnover or conversion, the more efficient the utilisation/management, other things being equal. For this reason such ratios are also designated as turnover ratios. Turnover is the primary mode for measuring the extent of efficient employment of assets by relating the assets to sales. An activity ratio may, therefore, be defined as a test of the relationship between sales (more appropriately with cost of sales) and the various assets of a firm. Depending upon the various types of assets, there are various types of activity ratios. Some of the more widely used turnover ratios are:-

1. Fixed Assets Turnover Ratio
2. Current Assets Turnover Ratio
3. Working Assets Turnover Ratio
4. Inventory (or stock) Turnover Ratio
5. Debtors Turnover Ratio
6. Creditors Turnover Ratio

1. Fixed Assets Turnover Ratio

The Fixed Assets Turnover Ratio measures the efficiency with which the firm is utilising its investment in fixed assets, such as land, building, plant and machinery, furniture, etc. It also indicates the adequacy of sales in relation to investment in fixed assets. The fixed assets turnover ratio is sales divided by the net fixed assets (i.e., the depreciated value of fixed assets).

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Sales}}{\text{Net Fixed Assets}}$$

The turnover of fixed assets can provide a good indicator for judging the efficiency with which fixed assets are utilised in the firm. A high fixed assets turnover ratio indicates efficient utilisation of fixed assets in generating operating revenue. A low ratio signifies idle capacity, inefficient utilisation and management of fixed assets.

2. Current Assets Turnover Ratio

The current assets turnover ratio ascertains the efficiency with which current assets are used in a business. Professor Guthmann observes that "current assets turnover is to give an overall impression of how rapidly the total investment in current assets is being turned". This ratio is strongly associated with efficient utilisation of costs, receivables and inventory. A higher value of this ratio indicates greater circulation of current assets while a low ratio indicates a stagnation of the flow of current assets. The formula for the computation of current assets turnover ratio is:

$$\text{Current Assets Turnover Ratio} = \frac{\text{Sales}}{\text{Current Assets}}$$

3. Working Capital Turnover Ratio

This ratio shows the number of times working capital is turned-over in a stated period. Working capital turnover ratio reflects the extent to which a business is operating on a small amount of working capital in relation to sales. The ratio is calculated by the following formula:-

$$\text{Working Capital Turnover Ratio} = \frac{\text{Sales}}{\text{Net Working Capital}}$$

The higher the ratio, the lower is the investment in working capital and greater are the profits. However, a very high turnover of working capital is a sign of over trading and may put the firm into financial difficulties. On the other hand, a low working capital turnover ratio indicates that working capital is not efficiently utilised.

4. Inventory Turnover Ratio

The inventory turnover ratio, also known as stock turnover ratio normally establishes the relationship between cost of goods sold and average inventory. This ratio indicates whether investment in inventory is within proper limit or not. In the words of S.C.Kuchal, "this relationship expresses the frequency with which average level of inventory investment is turned over through operations". The formula for the computation of this ratio may be expressed thus:

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

In general, a high inventory turnover ratio is better than a low ratio. A high ratio implies good inventory management. A very high ratio indicates under-investment in, or very low level of inventory which results in the firm being out of stock and incurring high stock-out cost. A very low inventory turnover ratio is dangerous. It signifies excessive inventory or over-investment in inventory. A very low ratio may be the results of inferior quality goods, over-valuation of closing inventory, stock of unsaleable/obsolete goods.

5. Debtors Turnover Ratio and Collection Period

One of the major activity ratios is the receivables or debtors turnover ratio. Allied and closely related to this is the average collection period. It shows how quickly receivables or debtors are converted into cash. In other words, the debtors turnover ratio is a test of the liquidity of the debtors of a firm. The liquidity of a firm's receivables can be examined in two ways: (i) debtors/receivables turnover and (ii) average collection period. The debtors turnover shows the relationship between credit sales and debtors of a firm. Thus,

$$\text{Debtors Turnover Ratio} = \frac{\text{Net Credit Sales}}{\text{Average Debtors}}$$

Net credit sales consists of gross credit sales minus returns if any, from the customers. Average debtors is the simple average of debtors at the beginning and at the end of the year.

The second type of ratio measuring the liquidity of a firm's debtors is the average collection period. This ratio is, in fact, interrelated with and dependent upon, the receivables turnover ratio. It is calculated by dividing the days in a year by the debtors turnover. Thus,

$$\text{Average Collection Period} = \frac{\text{Days in year}}{\text{Debtors turnover}}$$

This ratio indicates the speed with which debtors/accounts receivables are being collected. The higher the turnover ratio and shorter the average collection period, the better the trade credit management and better the liquidity of debtors. On the other hand, low turnover ratio and long collection period reflects that payments by debtors are delayed. In general, short collection period (high turnover ratio) is preferable.

6. Creditors' Turnover Ratio and Debt Payment Period

Creditors' turnover ratio indicates the speed with which the payments for credit purchases are made to the creditors. This ratio can be computed as follows:-

$$\text{Creditors' Turnover Ratio} = \frac{\text{Average Accounts Payable}}{\text{Net Credit Purchases}}$$

The term accounts payable include trade creditors and bills payable. A high ratio indicates that creditors are not paid in time while a low ratio gives an idea that the business is not taking full advantage of credit period allowed by the creditors.

Sometimes, it is also required to calculate the average payment period or average age of payables or debt period enjoyed to indicate the speed with which payments for credit purchases are made to creditors. It is calculated as:

$$\text{Average age of payables} = \frac{\text{Days in a year}}{\text{Creditors' Turnover Ratio}}$$

Both the creditors' turnover ratio and the debt payment period enjoyed ratio indicate about the promptness or otherwise in making payment for credit purchases. A higher creditors' turnover ratio or lower credit period enjoyed ratio signifies that the creditors are being paid promptly.

ANALYSIS OF LIQUIDITY POSITION

The liquidity ratios measure the ability of a firm to meet its short-term obligations and reflect the short-term financial strength/solvency of a firm. The term liquidity is described as convertibility of assets ultimately into cash in the course of normal business operations and the maintenance of a regular cash flow. A sound liquid position is of primary concern to management from the point of view of meeting current liabilities as and when they mature as well as for assuring continuity of operations. Liquidity position of a firm depends upon the amount invested in current assets and the nature of current assets. The under mentioned ratios are used to measure the liquidity position:-

1. Current Ratio
2. Liquid (or) Quick Ratio
3. Cash to Working Capital Ratio

1. Current Ratio

The most widely used measure of liquid position of an enterprise is the current ratio, i.e., the ratio of the firm's current assets to current liabilities. It is calculated by dividing current assets by current liabilities:

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

The current assets of a firm represent those assets which can be in the ordinary course of business, converted into cash within a short period of time, normally not exceeding one year and include cash and bank balance, marketable securities, inventory of raw materials, semi-finished (work-in-progress) and finished goods, debtors net of provision for bad and doubtful debts, bills receivable and pre-paid expenses. The current liabilities defined as liabilities which are short-term maturing obligations to be met, as originally contemplated, within a year, consist of trade creditors, bills payable, bank credit, provision for taxation, dividends payable and outstanding expenses. N.L.Hingorani and others observe: "Current Ratio is a tool for measuring the short-term stability or ability of the company to carry on its day-to-day work and meet the short-term commitments earlier". Generally 2:1 is considered ideal for a concern i.e., current assets should be twice of the current liabilities. If the current assets are two times of the current liabilities, there will be no adverse effect on business operations when the payment of current liabilities is made. If the ratio is less than

2, difficulty may be experienced in the payment of current liabilities and day-to-day operations of the business may suffer. If the ratio is higher than 2, it is very comfortable for the creditors but, for the concern, it indicates idle funds and lack of enthusiasm for work.

2. Liquid (or) Quick Ratio

Liquid (or) Quick ratio is a measurement of a firm's ability to convert its current assets quickly into cash in order to meet its current liabilities. It is a measure of judging the immediate ability of the firm to pay-off its current obligations. It is calculated by dividing the quick assets by current liabilities:

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

The term quick assets refers to current assets which can be converted into cash immediately or at a short notice without diminution of value. Thus quick assets consists of cash, marketable securities and accounts receivable. Inventories are excluded from quick assets because they are slower to convert into cash and generally exhibit more uncertainty as to the conversion price.

This ratio provides a more stringent test of solvency. 1:1 ratio is considered ideal ratio for a firm because it is wise to keep the liquid assets atleast equal to the current liabilities at all times.

3. Cash to Working Capital Ratio: Efficient management of the inflow and outflow of cash plays a crucial role in the overall performance of a business. Cash is the most liquid form of assets which safeguards the security interest of a business. Cash including bank balances plays a vital role in the total net working capital. The ratio of cash to working capital signifies the proportion of cash to the total net working capital and can be calculated by dividing the cash including bank balance by the working capital. Thus,

$$\text{Cash to Working Capital Ratio} = \frac{\text{Cash}}{\text{Working Capital}}$$

Cash is not an end in itself, it is a means to achieve the end. Therefore, only a required amount of cash is necessary to meet day-today operations. A higher proportion of cash may lead to shrinkage of profits due to idleness of resources of a firm.

ANALYSIS OF PROFITABILITY

Profitability is a measure of efficiency and control. It indicates the efficiency or effectiveness with which the operations of the business are carried on. Poor operational performance may result in poor sales and therefore low profits. Low profitability may be due to lack of control over expenses resulting in low profits. Profitability ratios are employed by management in order to assess how efficiently they carry on business operations. Profitability is the main base for liquidity as well as solvency. Creditors, banks and financial institutions are interested in profitability ratios since they indicate liquidity or capacity of the business to meet interest obligations and regular and improved profits enhance the long term solvency position of the business. Owners are interested in profitability for they indicate the growth and also the rate of return on their investments. The importance of measuring profitability has been stressed by Hingorani, Ramanathan and Grewal in these words: "A measure of profitability is the overall measure of efficiency".

An appraisal of the financial position of any enterprise is incomplete unless its overall profitability is measured in relation to the sales, assets, capital employed, net worth and earnings per share. The following ratios are used to measure the profitability position from various angles:

1. Gross Profit Ratio
2. Net Profit Ratio
3. Return on Capital Employed
4. Operating Ratio
5. Operating Profit Ratio
6. Return on Owners' Equity
7. Earnings Per Share
8. Dividend Pay Out Ratio

1. Gross Profit Ratio

The Gross Profit Ratio or Gross Profit Margin Ratio expresses the relationship of gross profit on sales / net sales. B.R.Rao opines that "gross profit margin ratio indicates the gross margin of profits on the net sales and from this margin only, all expenses are met and finally net income emerges". The basic components for the computation of this ratio are gross profits and net sales. `Net Sales' means total sales minus sales returns and `gross profit' means the difference between net sales and cost of goods sold. The formula used to compute Gross Profit Ratio is:

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

Gross profit ratio indicates to what extent the selling prices of goods per unit may be reduced without incurring losses on operations. A low gross profit ratio will suggest decline in business which may be due to insufficient sales, higher cost of production with the existing or reduced selling price or the alround inefficient management. A high gross profit ratio is a sign of good and effective management.

2. Net Profit Ratio: Net profit is a good indicator of the efficiency of a firm. Net profit ratio or net profit margin ratio is determined by relating net income after taxes to net sales. Net profit here is the balance of profit and loss account which is arrived at after considering all non-operating incomes such as interest on investments, dividends received, etc. and non-operating expenses like loss on sale of investments, provisions for contingent liabilities, etc. This ratio indicates net margin earned on a sale of Rs.100. The formula for calculating the ratio is:

$$\text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Sales}} \times 100$$

This ratio is widely used as a measure of overall profitability and is very useful for proprietors. A higher ratio indicates better position.

3. Return on Capital Employed

The prime objective of making investments in any business is to obtain satisfactory return on capital invested. Hence, the return on capital employed is used as a measure of success of a business in realising this objective. Otherwise known as Return on Investments, this is the overall profitability ratio. It indicates the percentage of return on capital employed in the business and it can be used to show the efficiency of the business as a whole. The formula for calculating the ratio is:

$$\text{Return on Capital Employed} = \frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100$$

The term “Capital Employed” means [Share capital + Reserves and Surplus + Long Term Loans] minus [Non-business assets + Fictitious assets] and the term “Operating Profit” means profit before interest and tax. The term `interest’ means interest on long-term borrowings. Non-trading income should be excluded for the above purpose. A higher ratio indicates that the funds are invested profitably.

4. Operating Ratio

This ratio establishes the relationship between total operating expenses and sales. Total operating expenses includes cost of goods sold plus other operating expenses. A higher ratio indicates that operating expenses are high, as such profit margin is less and therefore lower the ratio better is the position. The operating ratio is an index of the efficiency of the conduct of business operations. An ideal norm for this ratio is between 75% to 85% in a manufacturing concern. The formula for calculating the operating ratio is thus:

$$\text{Operating Ratio} = \frac{\text{Cost of goods sold + Operating experience}}{\text{Sales}} \times 100$$

5. Operating Profit Ratio

This ratio indicates net-margin earned on a sale of Rs.100. It is calculated as follows:

$$\text{Operating Profit Ratio} = \frac{\text{Net Operating Profit}}{\text{Sales}} \times 100$$

The operating profit ratio helps in determining the efficiency with which affairs of the business are being managed. An increase in the ratio over the previous period indicates improvement in the operational efficiency of the business provided the gross profit ratio is constant. Operating profit is estimated without considering non-operating income such as profit on sale of fixed assets, interest on investments and nonoperating expenses such as loss on sale of fixed assets. This is thus, an effective tool to measure the profitability of a business concern.

6. Return on Owners' Equity (or) Shareholders' Fund (or) the Net Worth: The ratio of return on owners' equity is a valuable measure for judging the profitability of an organisation. This ratio helps the shareholders of a firm to know the return on investment in terms of profits.

Shareholders are always interested in knowing as to what return they earned on their invested capital since they bear all the risk, participate in management and are entitled to all the profits remaining after all outside claims including preference dividend are met in full. This ratio is computed as a percentage by using the formula:

$$\text{Return on Owners' Equity} = \frac{\text{Net Profit after interest and tax}}{\text{Owners' Equity (Net Worth)}} \times 100$$

This is the single most important ratio to judge whether the firm has earned a satisfactory return for its equity-shareholders or not. A higher ratio indicates the better utilisation of owners' fund and higher productivity. A low ratio may indicate that the business is not very successful because of inefficient and ineffective management and over investment in assets.

7. Earnings Per Share (EPS)

The profitability of a firm from the point of view of the ordinary shareholders is analysed through the ratio `EPS'. It measures the profit available to the equity shareholders on a per share basis, i.e. the amount that they can get on every share held. It is calculated by dividing the profits available to the shareholders by the number of the outstanding shares. The profits available to the ordinary shareholders are represented by net profit after taxes and preference dividend.

$$\text{Earnings Per Share} = \frac{\text{Net profit after tax – Preference Dividend}}{\text{Number of Equity Shares}}$$

This ratio is an important index because it indicates whether the wealth of each shareholder on a per-share basis has changed over the period. The performance and prospects of the firm are affected by EPS. If EPS increases, there is a possibility that the company may pay more dividend or issue bonus shares. In short, the market price of the share of a firm will be affected by all these factors.

8. Dividend Pay Out Ratio This ratio measures the relationship between the earnings belonging to the ordinary shareholders and the dividend paid to them. In other words, the dividend pay out ratio shows what percentage share of the net profits after taxes and preference dividend is paid out as dividend to the equity shareholders. It can be calculated by dividing the total dividend paid to the owners by the earnings available to them. The formula for computing this ratio is:

$$\text{Dividend payout ratio} = \frac{\text{Dividend per equity share}}{\text{Earnings per share}}$$

This ratio is very important from shareholder's point of view as its tells him that if a firm has used whole, or substantially the whole of its earnings for paying dividend and retained nothing for future growth and expansion purposes, then there will be very dim chances of capital appreciation in the price of shares of such firms. In other words, an investor who is more interested in capital appreciation must look for a firm having low payout ratio.

ANALYSIS OF OPERATIONAL EFFICIENCY

The operational efficiency of an organisation is its ability to utilise the available resources to the maximum extent. Success or failure of a business in the economic sense is judged in relation to expectations, returns on invested capital and objectives of the business concern. There are many techniques available for evaluating financial as well as operational performance of a firm. The two important techniques adopted in this study are:

1. Turnover to Capital Employed or Return on Investment (ROI)
2. Financial Operations Ratio

1. Turnover to Capital Employed

This is the ratio of operating revenue to capital employed. This is one of the important ratios to find out the efficiency with which the firms are utilising their capital. It signifies the number of times the total capital employed was turned into sales volumes. The term capital employed includes total assets minus current liabilities. The ratio for calculating turnover to capital employed (in percentage) is:

$$\text{Turnover to capital employed} = \frac{\text{Operating Revenue}}{\text{Capital Employed}} \times 100$$

The higher the ratio, the better is the position.

2. Financial Operations Ratio

The efficiency of the financial management of a firm is calculated through financial operations ratio. This ratio is a calculating device of the cost and the return of financial charges. This ratio signifies a relationship between net profit after tax and operating profit. The formula for the computation of this ratio is:

$$\text{Financial Operations Ratio} = \frac{\text{Net Profit after tax}}{\text{Operating Profit}} \times 100$$

Here, the term "operating profit" means sales minus operating expenses. A higher ratio indicates the better financial performance of the firm.

RATIOS FROM SHAREHOLDERS' POINT OF VIEW

1. Preference Dividend Cover

This ratio expresses Net Profit after tax as so many times of Preference Dividend Payable. This is calculated as:

$$\frac{\text{Net Profit after tax}}{\text{Preference Dividend}}$$

2. Equity Dividend Cover

This ratio gives information about net profit available to equity shareholders. This ratio expresses profit as number of times of equity dividend payable. This ratio is calculated using the following formula:

$$\frac{\text{Net Profit After Tax – Preference Dividend}}{\text{Equity Dividend}}$$

3. Dividend Yield on Equity Shares or Yield Ratio

This ratio interprets dividend as a percentage of Market Price Per Share. It is calculated at:

$$\frac{\text{Dividend Per Share}}{\text{Market Price Per Share}} \times 100$$

4. Price Earning Ratio

This ratio tells how many times of earnings per share is the market price of the share of a company. The formula to calculate this ratio is:

$$\frac{\text{Market Price Per Share}}{\text{Earnings Per Share}}$$

Illustration 1:

The following are the financial statements of Yesye Limited for the year 2005.

TRADING AND PROFIT AND LOSS ACCOUNT
for the year ended 31-12-2005

Particulars	Rs.	Particulars	Rs.
To Cost of goods sold	1,80,000	By Sales	3,00,000
To Gross profit c/d	1,20,000		

	3,00,000		**3,00,000**
To expenses	1,00,000	By Gross profit b/d	1,20,000
To Net Profit	20,000		
	1,20,000		**1,20,000**

BALANCE SHEET AS AT 31-12-2005

Liability	Rs.	Assets	Rs.
Equity Share capital	1,00,000	Fixed Assets	1,50,000
General Reserve	90,000	Stock	42,500
Profit & Loss Balance	7,500	Debtors	19,000
Sundry Creditors	35,000	Cash	61,000
6% Debentures	30,000	Proposed Dividends	10,000
	2,72,500		**2,72,500**

You are required to compute the following:

1. Current ratio
2. Acid Test ratio
3. Gross Profit ratio
4. Debtors' Turnover ratio
5. Fixed Assets to net tangible worth
6. Turnover to fixed assets

Solution

1) Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}}$

$= \dfrac{1,22,500}{45,000}$

= **2.7:1**.

2) Acid Test Ratio $= \dfrac{\text{Quick Assets}}{\text{Quick Liabilities}}$

$= \dfrac{80,000}{45,000}$

= **1.8:1.**

3) Gross Profit Ratio = $\dfrac{\text{Gross Profit}}{\text{Sales}} \times 100$

$= \dfrac{1,20,000}{3,00,000} \times 100$

= 40%

Net Sales

4) Debtors' Turnover Ratio = $\frac{}{\text{Average Debtors}}$

$= \frac{3,00,000}{19,000}$

= 15.78 times.

Collection Period = $\frac{\text{No. of days in the year}}{\text{Debtors' Turnover}}$

$= \frac{365}{15.78}$

= **23 days**

5) Fixed Asset to Net Tangible Worth = $\frac{\text{Fixed Assets}}{\text{Proprietor's Fund}} \times 100$

$= \frac{1,50,000}{1,97,500} \times 100$

= **76%**

6) Turnover to Fixed Assets = $\frac{\text{Net Sales}}{\text{Fixed Assets}}$

$= \frac{3,00,000}{1,50,000}$

= **2 times**

Illustration 2: From the following details prepare a statement of proprietary fund with as many details as possible.

1) Stock Velocity 6
2) Capital Turnover Ratio 2
3) Fixed Assets Turnover Ratio 4
4) Gross Profit Turnover Ratio 20%
5) Debtors' Velocity 2 months
6) Creditors' Velocity 73 days

Gross profit was Rs.60,000. Reserves and surplus amount to 20,000. Closing stock was Rs.5,000 in excess of opening stock.

Solution

1. **Calculation of Sales**

Gross Profit Ratio = $\frac{\text{Gross Profit}}{\text{Sales}}$

= 20%

$$\frac{\text{Rs.}60{,}000}{\text{Sales}} = \frac{20}{100}$$

$$= \frac{1}{5}$$

Sales: Rs.3,00,000

2. **Calculation of Sundry Debtors**

$$\text{Debtors' Velocity} = \frac{\text{Debtors}}{\text{Sales}} \times 12 \text{ months}$$

Let Debtors be x

$$2 = \frac{x}{3{,}00{,}000} \times 12$$

$$\frac{X}{3{,}00{,}000} = \frac{1}{6}$$

x = Rs.50,000

Debtors: Rs.50,000
It is assumed that all sales are credit sales.

3. **Calculation of Stock**

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of goods sold}}{\text{Average stock}}$$

= 6

Cost of goods sold = Sales – Gross Profit
= Rs.3,00,000 – Rs.60,000
= Rs.2,40,000

$$\frac{\text{Rs.}2{,}40{,}000}{\text{Average Stock}} = 6$$

$$\text{Average Stock} = \frac{\text{Rs.}2{,}40{,}000}{6}$$

= Rs.40,000

$$\text{Average Stock} = \frac{\text{Opening stock} + \text{Closing stock}}{2}$$

Let opening stock be Rs.x.
Then closing stock will be x + 5,000

$$\frac{x + x + 5,000}{2} = 40,000$$

$$\frac{2x + 5,000}{2} = 40,000$$

Cross multiplying

$$2x + 5,000 = 80,000$$
$$2x = 80,000 – 5,000$$
$$= 75,000$$
$$x = 37,500$$

Opening stock Rs.37,500
Closing stock Rs.42,500

4. **Calculation of Creditors**

$$\text{Creditors' velocity days} = \frac{\text{Total Creditors}}{\text{Credit Purchases}} \times 365$$
$$= 73 \text{ days}$$

Purchase = Cost of goods + Closing Stock – Opening stock
= Rs.2,40,000 + 42,500 – 37,500
= Rs.2,45,000

Let the creditors be x

$$\frac{x}{2,45,000} \times 365 = 73$$
$$365\,x = 2,45,000 \times 73$$
$$x = \frac{2,45,000 \times 73}{365}$$

Creditors = Rs.49,000

5. **Calculation of Fixed Assets**

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Costs of goods sold}}{\text{Fixed Assets}}$$
$$= 4$$

Let Fixed assets be x

$$\frac{2,40,000}{X} = 4$$
$$x = 60,000$$

Fixed Assets = Rs.60,000

6. Shareholders' Fund

Capital Turnover Ratio = Cost of goods sold / Proprietary Fund = 2

2,40,000 / Proprietary Fund = 2

Proprietary Fund = Rs.1,20,000

Shareholders' fund includes Share capital, Profit & Reserve.

Share Capital = Shareholders' Fund – (Profit + Reserve)
= Rs.1,20,000 – Rs.80,000
= **Rs.40,000**

7. Calculation of Bank Balance

Shareholders' Fund + Current Liabilities = Fixed Assets + Current Assets
Rs.1,20,000 + 49,000 = Rs.60,000 + Current Assets
Current Assets = Rs.1,09,000
Current Assets = Stock + Debtors + Bank Balance
Bank Balance = Current Assets – (Stock + Debtors)
= Rs.1,09,000 – (42,500 + 50,000)
= Rs.1,09,000 – 92,500
= Rs.16,500

Balance Sheet as on …

Liabilities	Rs.		Assets	Rs.
Share capital	40,000	Fixed Assets		60,000
Reserves & Surplus	20,000	Current Assets:		
Profit	60,000	Stock	42,500	
Current liabilities	49,000	Debtors	50,000	
		Bank	16,500	1,09,000
	1,69,000			**1,69,000**

Illustration 3: The following data is furnished:
a) Working capital Rs.45,000
b) Current ratio 2.5

c) Liquidity ratio 1.5
d) Proprietary ratio – (Fixed assets to proprietary funds) 0.75
e) Overdraft Rs.10,000
f) Retained earnings Rs.30,000
There are no long term loans and fictitious assets.
Find out:
1. Current assets
2. Current liabilities
3. Fixed assets
4. Quick assets
5. Quick liabilities
6. Stock Equity

Solution
Current Assets

Current assets	2.5
Current liability	1.0
Working capital	1.5

If working capital is 1.5, current asset will be 2.5.
If working capital is Rs.45,000, current assets will be Rs.75,000
Current Assets = Rs.75,000
Current Liability
Current Liability = Current assets – Working capital
= Rs.75,000 – Rs.45,000
= Rs.30,000

Fixed Assets
Shareholders' Fund+ Current Liabilities = Fixed Assets + Current Assets
Shareholders' Fund=Fixed assets + Current assets – Current Liabilities
= Fixed assets + Rs.75,000 – Rs.30,000
= Fixed assets + Rs.45,000
Let the shareholders' fund be x, fixed assets will be ¾ x
x = Rs. ¾ x + Rs.45,000
¼ x = Rs.45,000
x = Rs.1,80,000
¾ x = Rs.1,35,000
Fixed assets = Rs.1,35,000
 Shareholders Funds = Rs.1,35,000 + Rs.45,000
= Rs.1,80,000

Stock

$$\text{Liquid ratio} = \frac{\text{Quick assets}}{\text{Quick liabilities}}$$

Quick assets = Current assets – Stock

Quick liabilities = Current liabilities – Bank overdraft

Let the value of stock be x.

$$\frac{\text{Quick assets}}{\text{Quick liabilities}} = \frac{\text{Rs.}75{,}000 - x}{30{,}000 - 10{,}000}$$

$$= \frac{75{,}000 - x}{20{,}000} = 1.5$$

Cross multiplying

75,000 – x = 20,000 x 1.5

75,000 – x = 30,000

x = 45,000

Stock = Rs.45,000

Quick Assets = Rs.75,000 – Rs.45,000

= Rs.30,000

Quick Liabilities = Rs.20,000

Equity

Shareholders' Fund = Equity + Retained earnings

Shareholders' Fund = Rs.1,80,000 (as calculated)

Retained earnings = Rs.30,000 (as given)

Equity = Rs.1,50,000

Illustration 4: From the following balance sheet of Dinesh Limited calculate (i) Current ratio (ii) Liquid ratio (iii) Debt-equity ratio (iv) Proprietary ratio, and (v) Capital gearing ratio.

Balance Sheet of Dinesh Limited as on 31-12-2005

Liabilities	Rs.	Assets	Rs.
Equity share capital	10,00,000	Goodwill	5,00,000
6% preference capital	5,00,000	Plant & Machinery	6,00,000
Reserves	1,00,000	Land & Buildings	7,00,000
Profit & Loss a/c	4,00,000	Furniture	1,00,000
Tax provision	1,76,000	Stock	6,00,000
Bills payable	1,24,000	Bills receivables	30,000
Bank overdraft	20,000	Sundry debtors	1,50,000
Sundry creditors	80,000	Bank account	2,00,000
12% debentures	5,00,000	Short term investment	20,000
	29,00,000		**29,00,000**

Solution

$$\text{(i) Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$= \frac{\text{Stock + Bills receivables + Debtors + Bank + S.T. Investments}}{\text{S. Creditors + Bills Payable + Bank O.D. + Tax Provision}}$$

$$= \frac{10,00,000}{4,00,000} = 2.5 : 1.$$

Interpretation: The current ratio in the said firm is 2.5:1 against a standard ratio of 2:1. It is a good sign of liquidity. However, the stock is found occupying 60 percent of current assets which may not be easily realisable.

$$\text{(ii) Liquid ratio} = \frac{\text{Current Assets – Stocks}}{\text{Current Liabilities}}$$

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

$$= \frac{4,00,000}{4,00,000}$$

$$= 1:1.$$

Interpretation: The standard for quick ratio is 1:1. The calculated ratio in case of Dinesh Limited is also 1:1. The above two ratios show the safety in respect of liquidity in the said firm.

$$\text{(iii) Debt Equity ratio} = \frac{\text{Long term Debt}}{\text{Equity Shareholders' Fund}}$$

$$= \frac{\text{Debentures}}{\text{Equity capital + Preference capital + Reserves + Profit \& Loss a/c}}$$

$$= \frac{5,00,000}{10,00,000 + 5,00,000 + 1,00,000 + 4,00,000}$$

$$= 1:4.$$

Interpretation: Debt-equity ratio indicates the firm's long term solvency. It can be observed that the firm's long term loans are constituting 25 percent to that of the owners' fund. Although such a low ratio indicates better long term solvency, the less use of debt in capital structure may not enable the firm to gain from the full stream of leverage effects.

(iv) Proprietary ratio = $\dfrac{\text{Proprietors' Funds}}{\text{Total assets}}$

$\dfrac{20,00,000}{29,00,000} = \quad = \quad 20:29$

Interpretation: Out of total assets, seven-tenths are found financed by owners' funds. In other words a large majority of long term funds are well invested in various long term assets in the firm.

(v) Capital gearing ratio = $\dfrac{\text{Owners' resources}}{\text{Fixed-interest bearing resources}}$

$= \dfrac{\text{Equity Share Capital + Reserves + P\&L A/c}}{\text{Preference Capital + Debentures}}$

$= \dfrac{10,00,000 + 1,00,000 + 4,00,000}{5,00,000 + 5,00,000}$

$= \dfrac{15,00,000}{10,00,000} = 1.5:1.$

Interpretation: Keeping Rs.15 lakhs of equity funds as security, the firm is found to have mobilised Rs.10 lakhs from fixed interest bearing sources. It indicates that the capital structure is low geared.

Illustration 5: The following are the balance sheet and profit and loss account of Sundara Products Limited as on 31st December 2005.

Profit and Loss Account

Particulars	Rs.	Particulars	Rs.
To opening stock	1,00,000	By Sales	8,50,000
Purchases	5,50,000	Closing stock	1,50,000
Direct expenses	15,000		
Gross profit	3,35,000		
	10,00,000		**10,00,000**
To Admn. expenses	50,000	By Gross profit	3,35,000
Office establishment	1,50,000	Non-operating income	15,000
Financial expenses	50,000		
Non-Operating			
Expenses/losses	50,000		
Net profit	50,000		
	3,50,000		**3,50,000**

Balance Sheet

Liabilities	Rs.	Assets	Rs.

Equity share capital		Land & Buildings	1,50,000
(2000 @ 100)	2,00,000	Plant & Machinery	1,00,000
Reserves	1,50,000	Stock in trade	1,50,000
Current Liabilities	1,50,000	Sundry Debtors	1,00,000
P&L a/c Balance	50,000	Cash & Bank	50,000
	5,50,000		**5,50,000**

Calculate turnover ratios.

Solution

(i) Share capital to turnover ratio

$$= \frac{\text{Sales}}{\text{Total Capital Employed}}$$

$$= \frac{\text{Sales}}{\text{Equity + Reserve + P \& L a/c Balance}}$$

$$= \frac{8,50,000}{4,00,000}$$

$$= 2.13 \text{ times.}$$

Interpretation: This turnover ratio indicates that the firm has actually converted its share capital into sales for about 2.13 times. This ratio indicates the efficiency in use of capital resources and a high turnover ratio ensures good profitability on operations on an enterprise.

(ii) Fixed Asset's Turnover Ratio

$$= \frac{\text{Sales}}{\text{Total Fixed Assets}}$$

$$= \frac{\text{Sales}}{\text{Land + Plant \& Machinery}}$$

$$= \frac{8,50,000}{2,50,000}$$

$$= 3.4 \text{ times.}$$

Interpretation: Although fixed assets are not directly involved in the process of generating sales, these are said to back up the production process. A ratio of 3.4 times indicates the efficient utilisation of various fixed assets in this organisation.

(iii) Net Working Capital Turnover:

$$= \frac{\text{Sales}}{\text{Net Working Capital}}$$

Sales

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

$$= \frac{8,50,000}{3,00,000 – 1,50,000}$$

$$= 5.67 \text{ times.}$$

Interpretation: Net working capital indicates the excess of current assets financed by permanent sources of capital. An efficient utilisation of such funds is of prime importance to ensure sufficient profitability along with greater liquidity. A turnover ratio of 5.7 times is really appreciable.

(iv) **Average Collection Period:**

$$\text{Debtor's turnover} = \frac{\text{Credit Sales}}{\text{Average Debtors}}$$

Assuming that 80% of the sales of 8,50,000 as credit sales:

$$= \frac{6,80,000}{1,00,000}$$

$$= 6.8 \text{ times}$$

Average collection period

$$= \frac{\text{360 days}}{\text{Debtors' Turnover}}$$

$$= \frac{360}{6.8}$$

$$= 53 \text{ days}$$

Interpretation: Average collection period indicates the time taken by a firm in collecting its debts. The calculated ratio shows that the realisation of cash on credit sales is taking an average period of 53 days. A period of roughly two months indicate that the credit policy is liberal and needs a correction.

(v) **Stock Turnover Ratio**

$$= \frac{\text{Cost of goods sold}}{\text{Average stock}}$$

$$= \frac{\text{Sales – Gross Profit}}{\text{(Opening stock + Closing stock) + 2}}$$

$$= \frac{5,15,000}{1,25,000}$$

$$= 4.12 \text{ times.}$$

Interpretation: Stock velocity indicates the firm's efficiency and profitability. The stock turnover ratio shows that on an average inventory balances are cleared once in 3 months. Since there is no standard for this ratio, the period of operating cycle of this firm is to be compared with the industry average for better interpretation.

Illustration 6: Comment on the performance of Arasu Limited from the ratios given below:

S.No.	Particulars	Industry Average Ratios	Ratios of Arasu Ltd.
1.	Current ratio	2:1	2.5:1
2.	Debt-equity ratio	2:1	1:1
3.	Stock turnover ratio	9.5	3.5
4.	Net profit margin ratio	23.5%	15.1%

Solution

(i) Current ratio: The ratio indicates the liquidity position of a firm. The ability of a firm in meeting its current liabilities could be understood by this ratio. The calculated results show that the liquidity in Arasu Limited is even greater than industry average, showing the safety. However, excess liquidity locks up the capital in unnecessary current assets.

(ii) Debt-equity ratio: It is an indicator of a firm's solvency in terms of its ability to repay long term loans in time. The calculated ratio shows better solvency of 1:1 indicating that for every one rupee of debt capital, to repay one rupee of equity base exists in Arasu Ltd. However, this ratio is not likely to ensure the leverage benefits that a firm gains by using higher dose of debt.

(iii) Stock turnover ratio: Stock velocity is an indicator of a firm's activeness. It directly influences the profitability of a firm. The calculated ratio for Arasu Ltd. is very poor when compared to industry average. This poor ratio indicates the inefficient use of capacities, consequently, the likely low profitability.

(iv) Net Profit margin ratio: Although the firms in a particular industry could sell the product more or less at same price, the net profits differ among firms due to their cost of production, excessive administrative and establishment expenses etc. This picture is found true in case of Arasu Ltd. A poor profitability of 15.1% compared to an industry average of 23.5% may be due to low stock turnover, inefficiency in management, excess overhead cost and excessive interest burdens.

LIMITATION OF RATIO ANALYSIS

Ratio analysis is, as already mentioned, a widely-used tool of financial analysis. It is because ratios are simple and easy to understand. But they must be used very carefully. They suffer from various limitations. For instance, financial statements suffer from number of limitations and may therefore, affect the quality of ratio analysis. If due care is not taken, they might confuse rather then clarify the situation. Different firms may use these terms in different senses or the same firm may use them to mean different things at different times. Some of the limitations of the ratio analysis are given below:

Differences in Definitions

Comparisons are made difficult due to differences in definitions of various financial terms. Lack of standard formula for working out ratios makes it difficult to compare them. They are worked out on the basis of different items in different industries.

Limitations of Accounting Records

Ratio analysis is based on financial statements which are themselves subject to limitations. Thus, ratios calculated on the figures given in the financial statements, also suffers from similar limitations.

Lack of Proper Standards

It is very difficult to ascertain the standard ratio in order to make proper comparison. Because, it differs from firm to firm, industry to industry. Apart from this, it may also have happened that in one firm, a current ratio of 2:1 is found to be quite satisfactory, whereas in another firm 2.5:1 may be unsatisfactory. Again, a high current ratio may not necessarily mean sound liquid position when current assets include large inventory or inventory consisting of obsolete items.

No Allowances for Price Level Changes

Due to changes in price level of various years, comparison of ratios of such years cannot give correct conclusions. A change in the price level can seriously affect the validity of comparisons of ratios computed for different time periods. For instance, a firm which has purchased an asset at a lower price, will show a higher return, than the firm which has purchased the asset at a higher price.

Changes in Accounting Procedure

Comparison between two variables prove worth provided their basis of valuation is identical. But in reality, it is not possible, such as methods of valuation of stock (FIFO or LIFO) or charging different methods of depreciation on fixed assets etc. Thus, if different methods are followed by different firms for their valuation, then comparison will practically be of no use.

Qualitative Factors are Ignored

Ratios are tools of quantitative analysis only and normally qualitative factors which may generally influence the conclusions derived, are ignored while computing ratios. For instance, a high current ratio may not necessarily mean sound liquid position when current assets include a large inventory consisting of mostly obsolete items. Therefore, it is very difficult to generalize whether a particular ratio is good or bad.

Limited Use of Single Ratio

A single ratio would not be able to convey anything. Ratios can be useful only when they are computed in a sufficient large number. If too many ratios are calculated, they are likely to confuse instead of revealing meaningful conclusions.

Background is overlooked

When inter-firm comparison is made, they differ substantially in age, size, nature of product etc. When an inter-firm comparison is made, these factors are not considered. Therefore, ratio analysis cannot give satisfactory results.

MEANING OF FUND FLOW STATEMENT ANALYSIS

The term flow denotes the change. Flow of funds means the change in funds or in working capital. The change on the working capital leads to the net changes taken place on the working capital i.e., especially due to either increase or decrease in the working capital. The change in the volume of the working capital due to numerous transactions. Some of the transactions may lead to increase or decrease the volume of working capital. Some other transactions neither registers an increase nor decrease in the volume of working capital.

Meaning of Funds: The term funds have been defined in number of ways in a narrow sense it means cash only. In a broader sense funds means all financial resources used in business whether in the form of men, materials, money, machinery and others. In Popular sense It means the working capita, it may be increased or decreased.

Funds Flow Statement :

The Funds Flow Statement is a Statement which shows the movement of funds is a report of the financial operations of the business undertaking. It indicates various means by which funds were obtained during a particular period and the ways in which these funds were employed. In simple words it is a statement of sources and applications of funds.

According Foulke "A statement of source and application of funds is a technical device designed to analyse the changes to the financial condition of a business enterprise in between two dates"

VariousFacetsofFundflowstatementareasfollows

- Statementofsourcesandapplicationoffunds
- Statementchangesinfinancialposition
- Analysis of working capital changes and
- Movementoffundsstatement

OBJECTIVESOFFUNDFLOWSTATEMENTANALYSIS

- It pinpoints the mobilization of resources and the further utilization of resources
- It highlights the financing of the general expansion of the business firms

- It exemplifies the utilization of debt finance in the structure of financing
- It portrays the relationship between the financing, investment, liquidity and dividend decision of the firm during the given point of time.

METHODS OF PREPARING FUND FLOW STATEMENT

Steps in the preparation of Fund Flow Statement:

- First and fore most method is to prepare the statement of changes in working capital i.e., to identify the flow of fund / movement of fund through the detection of changes in the volume of working capital.
- Second step is the preparation of Non- Current A/c items-Changes in the volume of Non current a/cs have to be prepared only in order to quantify the flow fund i-e either sources or application of fund.
- Third step is the preparation Adjusted Profit& Loss A/c, which already elaborately discussed in the early part of the chapter.
- Last step is the preparation of fund flow statement.

ADVANTAGES OF PREPARING FUND FLOW STATEMENT

Illustrative Statement of Financing

It is a statement which highlights the role of various kinds of financing not only in the dimension of project development and expansion but also growth rate of the organization.

To fulfil the Primary Objective of the Financial Management

It not only elucidates the mode of financing but also the application of resources after raising. It answers to the following queries viz:

- How the outsider's liabilities are redeemed?
- What is the role of the fund from operation generated?
- How the raised funds applied into business?
- How the decrease in working capital was applied?
- What is the mode of raising of financial resources for an increase in the working capital?

LIMITATIONS

- Itis an extension of financial statements but it cannot be leveled with the emphasis of them
- It is not a resultant of the transaction instead it is an arrangement of among the available information
- Projected fund flow statement ever only to the tune of financial statements which are historic in feature

PREPARATION OF FUNDS FLOW STATEMENT

Two statements are involved in Funds Flow Analysis.

- Statement or Schedule of Changes in Working Capital
- Statement of Funds Flow

Statement of Changes in Working Capital

This statement when prepared shows whether the working capital has increased or decreased during two Balance Sheet dates. But this does not give the reasons for increase or decrease in working capital. This statement is prepared by comparing the current assets and the current liabilities of two periods. It may be shown in the following form:

Schedule of Changes in Working Capital (Proforma)

Items	As on	As on	Change	
			Increase	Decrease
Current Assets				
Cash Balances				
Bank Balances				
Marketable Securities				
Stock in Trade				
Pre-paid Expenses				
Current Liabilities				
Bank Overdraft				

Outstanding Expenses

Accounts Payable

Provision for Tax

Dividend

Increase / Decrease in

Working Capital

Any increase in current assets will result in increase in Working Capital and any decrease in Current Assets will result in decrease in Working Capital. Any increase in current liability will result in decrease in working capital and any decrease in current liability will result in increase in working capital.

Funds Flow Statement

Funds Flow Statement is also called as Statement of Changes in Financial Position or Statement of Sources and Applications of Funds or where got, where gone statement. The purpose of the funds flow statement is to provide information about the enterprise's investing and financing activities. The activities that the funds flow statement describes can be classified into two categories:

- activities that generate funds, called Sources, and
- activities that involve spending of funds, called Uses

When the funds generated are more than funds used, we get an increase in working capital and when funds generated are lesser than the funds used, we get decrease in working capital. The increase or decrease in working capital disclosed by the schedule of changes in working capital should tally with the increase or decrease disclosed by the Funds Flow Statement.

The Funds Flow Statement may be prepared either in the form of a statement or in `T' shape form. When prepared in the form of the statement it would appear as follows:

Funds Flow Statement

Sources of Funds

Issues of Shares	x	x	x
Issue of Debentures	x	x	x
Long term borrowings	x	x	x
Sale of Fixed Assets	x	x	x
*Operating Profit (Funds from Operations)	x	x	x
Total Sources	x	x	x
Application of Funds			
Redemption of Redeemable Preference shares	x	x	x
Redemption of Debentures	x	x	x
Payments for other long-term loans	x	x	x
Purchase of fixed assets	x	x	x
* Operation loss (Funds lost from Operations)	x	x	x
Total uses	x	x	x

Net increase / decrease in working capital (Total Sources – Total uses)

When prepared in `T' shape form, the Funds Flow Statement would appear as follows:

Funds Flow Statement

Sources of Funds		Application of Funds	
* Funds from operation	x x x	*Funds lost in operations	x x x
Issue of shares	x x x	Redemption of Preference Shares	x x x

Issue of Debentures	x x x	Redemption of Debentures	x x x
Long-term borrowings	x x x	Payment of other long-term Loans	x x x
Sale of fixed assets	x x x	Purchase of fixed assets	x x x
* Decrease in working capital	x x x	Payment of dividend, tax, etc.	x x x
		Increase in working capital	x x x

*Only one figure will be there.

It may be seen from the proforma that in the Funds Flow Statement preparation, current assets and current liabilities are ignored. Attention is given only to change in fixed assets and fixed liabilities.

In this connection an important point about provision for taxation and proposed dividend is worth mentioning. These two may either be treated as current liability or long-term liability. When treated as current liabilities they will be taken to `schedule of changes in working capital' and thereafter no adjustment is required anywhere. If they are treated as long-term liabilities there is no place for them in the schedule of changes in working capital. The amount of tax provided and dividend proposed during the current year will be added to net profits to find the funds from operations. The amount of actual tax and dividend paid will be shown as application of funds in the Funds Flow Statement. In this lesson, we have taken them as Current Liabilities.

Illustration 1: The mechanism of preparation of Funds Flow Statement is proposed to be explained with the help of Annual Reports for the years 2003-04 and 2004-05 pertaining to Arasu Limited.

ARASU LIMITED
Balance Sheet as at 31st March 2005

	2004-05	2003-04
I. Source of Funds		
1. Share Capital	1,40,00	1,40,00
2. Reserves and Surplus	2,77,84	2,30,62
	4,17,84	3,70,62

II. Application of Funds

1. Fixed Assets	4,83,15		4,61,23	
Less: Dep. Provision	2,57,85	2,25,30	2,27,36	2,33,87
2. Investments		20,25		20,30
3. **Current Assets, Loans and Advances**				
Inventories	1,52,83		1,92,54	
Debtors	51,41		64,29	
Cash and Bank	1,40,80		18,46	
Loans & Advances	17,82		14,73	
	3,62,86		2,90,02	
Less: **Current Liabilities & Provisions**				
Liabilities	89,81		76,70	
Provisions		100,76	96,87	
		1,90,57	1,73,57	
Net Current Assets		1,72,29		1,16,45
(Working Capital)		4,17,84		3,70,62

Profit and Loss Account
for the year ended 31st March 2005

	2004-05	**2003-04**
Income		
Sales	4,94,19	5,36,63
Other income	2,35,73	2,57,64
	7,29,92	**7,94,27**
Expenditure		
Opening Stock	20,45	25,59
Raw materials consumed	87,35	95,67
Packing materials consumed	2,87,78	3,29,04
Excise Duty	23,90	27,26
Expenses	1,65,38	1,29,94
Directors' Fees	11	10
Interest	94	5,69

Depreciation	30,49	39,98
	6,16,40	**6,53,27**
Less: Closing Stock	19,06	20,45
	5,97,34	**6,32,82**
Profit before Taxation	1,32,58	1,61,45
Provision for Income-tax	(64,36)	(82,40)
	68,22	**79,05**
Profit brought forward from Previous year	12	1
Balance	**68,34**	**79,06**
Provision for Taxation Relating to Earlier Year		(46,27)
Miscellaneous Expenditure Written off		(15,67)
Balance available for Appropriation	**68,34**	**17,12**
Appropriations		
General Reserve	47,25	3,00
Proposed Reserve for Appropriation	21,00	14,00
	68,25	**17,00**
Balance carried over to next year	9	12

For the above financial statements, Funds Flow Statement is prepared as follows with necessary workings:

I. Calculation of Funds from Operations for the year 2004-05

		(Rs.`000)
Balance of Profit carried over to next year		9
Add:	Provision for Depreciation	30,49
	Transfer to General Reserves	47,25
		77,83
Less:	Balance of Profit brought forward from previous year	12
Funds from operations		77,71

Note: Provision for income-tax and proposed dividend are taken as current liabilities. Hence they are not added here. They will be taken to Schedule of Changes in Working Capital.

II. Fixed Assets: From a perusal of schedule relating to `Fixed Assets' in the annual report, it is ascertained that there was a sale of fixed assets amounting to Rs.16,62,000 and purchase of fixed assets to the tune of Rs.38,54,000. These will be shown as source and application of funds respectively. (In examination problems information about, sale and purchase of assets can be ascertained by preparing respective Asset Accounts).

III. Investments: A similar perusal of schedule relating to `investments' gives information that there was a redemption of investment amounting to Rs.5,000 which is a source of fund. Now the Schedule of Changes in Working Capital and Funds Flow Statement are prepared.

ARASU LIMITED
Schedule of Changes in Working Capital 2004-05
(Rs. '000)

	2003-04	2004-05	Increase	Decrease
Current Assets				
Inventories	1,92,54	1,52,83	-	39,71
Debtors	64,29	51,41	-	12,88
Cash and Bank	18,46	1,40,80	1,22,34	-
Loans and Advances	14,73	17,82	3,09	-
(A) Total of Current Assets	2,90,02	3,62,86		
Current Liabilities				
Creditors	75,43	88,81	-	13,38
Unpaid Dividend	1,27	1,00	27	-
Provision for Tax	82,87	79,76	3,11	-
Proposed Dividend	14,00	21,00	-	7,00
(B) Total of Current Liabilities	1,73,57	1,90,57		
Working Capital (A)-(B)	1,16,45	1,72,29	-	-
Increase in Working Capital	55,84			55,84

1,72,29 1,72,29 1,28,81 1,28,81

ARASU LIMITED Funds Flow Statement 2004-04

Sources	Rs.	Applications	Rs.
Funds from Operations	7771	Purchase of Fixed Assets	3854
Sale of Fixed Assets	1662	Increase in Working Capital	5584
Redemption of Investment	5		
	9438		**9438**

It may be seen from the above statement that Sources amount to Rs.94,38,000 and Applications amount to Rs.38,54,000, thereby resulting in an increase in Working Capital amounting to Rs.55,84,000. This figure tallies with the increase in working capital as shown by the Schedule of Changes in Working Capital.

Illustration 2: The Balance Sheet of Mathi Limited for two years were as follows:

Liabilities	2004	2005	Assets	2004	2005
Share Capital	40,000	60,000	Land & Buildings	27,700	56,600
Share Premium	4,000	6,000	Plant & Machinery	17,800	25,650
General Reserve	3,000	4,500	Furniture	1,200	750
Profit & Loss A/c	9,750	10,400	Stock	11,050	13,000
5% Debentures		13,000	Debtors	18,250	19,550
Creditors	16,750	18,200	Bank	2,400	2,000
Provision for Taxation	4,900	5,450			
	78,400	**1,17,550**		**78,400**	**1,17,550**

Additional Information

Depreciation written off during the year was:

Plant and Machinery Rs.6,400

Furniture Rs.200

Prepare: A Schedule of Changes in Working Capital and A Statement of Sources and Application of Funds.

Schedule of Changes in Working Capital

	2004 Rs.	2005 Rs.	Working Capital Increase Rs.	Working Capital Decrease Rs.
Current Assets				
Stock	11,050	13,000	1,950	-
Debtors	18,250	19,550	1,300	-
Bank	2,400	2,000		400
(A)	31,700	34,550		
Current Liabilities				
Creditors	16,750	18,200	-	1,450
Provision for Taxation	4,900	5,450	-	550
(B)	21,650	23,650		
Working Capital (A) – (B)	10,050	10,900		
Increase in Working Capital	850			850
	10,900	10,900	3,250	3,250

Calculation of Funds from Operations

Profit and Loss a/c as on 31-12-2005		10,400
Add:	Transfer to Reserve	1,500
	Depreciation – Plant & Machinery	6,400

	Furniture	200

		18,500

Less:	P&L a/c as on 1-1-2005	9,750

	Funds from Operations	8,750

Land & Building A/c

To Balance b/d	27,700	By Balance c/d	56,600
To Bank Purchase (Balancing figure)	28,900		
	56,600		56,600

Plant & Machinery A/c

To Balance b/d	17,800	By Depreciation	6,400
To Bank Purchase (Balancing figure)	14,250	By Balance c/d	25,650
	32,050		32,050

Furniture A/c

To Balance b/d	1,200	By Depreciation	200
		By Bank – Sale (Balancing figure)	250
		By Balance c/d	750
	1,200		**1,200**

Statement of Sources and Application of Funds

Sources	Rs.	Applications	Rs.
Funds from Operations	8,750	Purchase of Land &	
Share Capital	20,000	Buildings	28,900
Share Premium	2,000	Purchase of Plant &	14,250
Debentures	13,000	Increase in working	850
Sale of Furniture	250	capital	
	44,000		**44,000**

Illustration 3: Following are Balance Sheet of a Limited Co. as on 31stDec.2003and 2004.

Liabilities	2003	2004	Assets	2003	2004
ShareCapital	61,000	74,000	Plant	45,000	43,000
Reserves	13,000	15,500	Building	50,950	48,000
Creditors	28,000	24,000	Stock	20,500	18,800
Bank Overdraft	18,000	-	Debtors	20,000	16,200
Provision for Taxation	8,000	8,500	Cash	150	180
Profit & Loss A/c.	8,600	8,800	Cash at Bank		2,100
			Goodwill		2,520
	136600	**130800**		**1,36,600**	**1,30,800**

Takingintoaccountthefollowinginformation, calculate funds fromoperations:

1) InterimDividend was paid Rs.2,000.
2) Dividend proposed for Rs. 4,000.
3) Provision ofRs.9,000 was made for Income Tax.
4) Rs. 2000 was written off as depreciation on Plant and Rs.2,950 on Building.
5) Profit on Sale of Fixed Investment Rs. 1,500.

Solution

Calculationofnetprofitfor2003

	Rs.	Rs.
Creditbalance of P & L A/c on 31Dec. 2003		8,800
Less:CreditBalanceofP&LA/con31Dec.2002		8,600

		200

Add:		
InterimDividend	2,000	
ProposedDividend	4,000	
Provisionmade for Income Tax	9,000	
ProvisionMade for Reserve	2,500	17,500

NetProfit During the Year		17,700

Particulars	Rs.	Rs.
NetProfit During the Year		17,700
Add:		
DepreciationonBuilding	2,950	

Particulars	Rs.	Rs.
DepreciationonPlant	2,000	4,950

		22,650
Less:		
Profiton sale of FixedInvestment		1,500

Profitfrom BusinessOperations		21,150

Thealternative method forcalculation of Funds fromoperations is as follows:

Particulars	Rs.	Particulars	Rs.
ToInterim Dividend	2,000	By Opening Balance	8,600
ToDividendProposed	4,000	By Profit on Sale of Investment	1,500
ToProvision for Income Tax	9,000	By Profit from Business Operations (B/f)	21,150
ToProvision for Reserve	2,500		
ToPlantA/c(Depreciation)	2,000		
ToBuildingA/c (Depreciation)	2,950		
To Closing Balance	8,800		
	31,250		**31,250**

CASH FLOW STATEMENT

A cash flow statement is a statement depicting changes in cash position from one period to another i.e. the result of cash flow analysis is given in the cash flow statement. For example if the cash balance of a concern as per its Balance Sheet as on 31st March 2004 is Rs.90,000 and the cash balance as per its Balance Sheet as on 31st March 2005 is Rs.1,20,000, there has been an inflow of cash of Rs.30,000 in the year 2004-05 as compared to the year 2003-04. The cash flow statement explain the reasons for such inflows or outflows of cash as the case may be.

Normally the following are principal sources of inflows of cash:

a) Issue of shares and debentures for cash

b) Sale of fixed assets and investments for cash

c) Borrowings from banks and other financial institution

d) Cash from operations

Outflows of cash generally include:

a) Redemption of shares and debentures by cash

b) Purchase of fixed assets and investments by cash

c) Repayment of loans

d) Cash lost in operations

The following is the format of a cash flow statement:

Cash Flow Statement for the year ending say 31st March 2005

Balance as on 1-4-2004		**Balance as on 1-4-2004**	
Cash in hand	x x x	Bank overdraft (if any)	x x x
Cash at Bank	x x x		
Add: Cash Inflows:		**Cash Outflows**:	
Here the items mentioned as sources of cash inflows above will be recorded		Here the items mentioned as outflows of cash above will be recorded	
Balance as on 31-3-2005		**Balance as on 31-3-2005**	
Bank overdraft (if any)	x x x	Cash in hand	x x x
		Cash at Bank	x x x
	-----------		-----------
	x x x		x x x
	-----------		-----------

The Accounting Standard 3 issued by the Institute of Chartered Accountants of India requires the companies to prepare Cash Flow Statement and present them as part of their Annual Reports.

CALCULATION OF CASH FROM OPERATIONS

The important step in the preparation of cash flow statement is the calculation of cash from operations. It is calculated as follows:

The first step in the calculation of cash from operations is the calculation of funds from operations (which is already explained in the lesson on Funds Flow Analysis). To the funds from operations the decrease in current assets and increase in current liabilities will be added (except cash, Bank and Bank O.D.). From the added total increase in current assets and decrease in current liabilities will be deducted (except cash, Bank and Bank O.D.). The resultant figure is cash from operations (Refer Illustration 3).

Performa of Cash from Operations Statement

Funds from Operations or Funds lost from operations			x x x x
Add:	Decrease in current assets		x x x x
	Increase in current liabilities		x x x x
			---------
			x x x x
Less:	Inecrease in current assets	x x x	
	Decrease in current liabilities	x x x	
		---------	x x x x

Cash from operations or cash lost from operations			x x x x

As in the case of Fund Flow Analysis here also we assume **Provision for Taxation** and **Proposed Dividend** as current liabilities.

UTILITY OF CASH FLOW ANALYSIS

Cash flow analysis yields the following advantages:

a) It is very helpful in understanding the cash position of the firm. This would enable the management to plan and coordinate the financial operations properly.

b) Since it provides information about cash which would be available from operations the management would be in a position to plan repayment of loans, replacement of assets, etc.

c) It throws light on the factors contributing to the reduction of cash balance in spite of increase in income and vice versa.

d) A comparison of the cash flow statement with the cash budget for the same period helps in comparing and controlling cash inflows and cash outflows.

However cash flow analysis is not without limitations. The cash balance as disclosed by the cash flow statement may not represent the real liquid position of the business since it can be easily influenced by postponing purchases and other payments. Further cash flow statement cannot replace the income statement or funds flow statement. Each of them has a separate function to perform.

CASH FLOW ANALYSIS Vs FUNDS FLOW ANALYSIS

a) A cash flow statement is concerned only with the changes in cash position while funds flow analysis is concerned with changes in working capital position between two balance sheet dates.

b) Cash flow analysis is a tool of short-term financial analysis while the funds flow analysis is comparatively a long-term one.

c) Cash position results in improvement in the funds position but not vice versa. In other words "inflows of cash" results in "inflow of funds" but inflow of funds may not necessarily result in "inflow of cash".

d) In funds flow analysis, the changes in various current assets and current liabilities are shown in a separate statement called schedule of changes in working capital in order to ascertain the net increase or decrease in working capital. But in cash flow analysis, such changes are adjusted to funds from operations in order to ascertain cash from operations.

Illustration 3:

From the following balances calculate cash from operations:

Particulars	December 31	
	2004	2005
Profit and Loss A/c Balance	75,000	1,55,000
Debtors	45,000	42,000
Creditors	20,000	26,000
Bills Receivable	12,000	15,000
Cash in hand	2,500	3,000
Prepaid expenses	1,600	1,400
Bills Payable	18,000	16,000
Cash at Bank	8,000	10,000
Outstanding expenses	1,200	1,600
Income received in advance	250	300
Outstanding Income	800	900

Additional Information

a) Depreciation written off during the year Rs.10,000
b) Transfer to General Reserve Rs.10,000

Calculation of Funds from Operations

		Rs.
Profit & Loss A/c as on 31st December 2005		1,55,000
Add:	Depreciation	10,000
	Transfer to General Reserve	10,000

		1,75,000
Less:	P & L a/c as on 1st January 2005	75,000

	Funds from Operations	1,00,000

Calculation of Cash from Operations

	Funds from Operations		1,00,000
Add:	**Decrease in Current Assets**		
	Decrease in Debtors		3,000
	Decrease in Prepaid Expenses		200
	Increase in Current Liabilities		
	Increase in Creditors		6,000
	Increase in Outstanding Expenses		400
	Increase in Income Received in Advance		50

			1,09,650
Less:	**Increase in Current Assets**		
	Increase in Bills Receivables	3,000	
	Increase in Outstanding Income	100	
	Decrease in Current Liabilities		
	Decrease in Bills Payable	2,000	
		----------	5,100

	Cash from Operations		1.04,550

Note: Decrease in current assets means current assets are converted into cash and increase in current liabilities results in further generation of cash. Hence they are added. Increase in current assets and decrease in current liabilities result in outflow of cash. Hence they are deducted.

Illustration 4: Balance Sheets of Somy Thomas as on 1-1-2005 and 31-12-2005 were as follows:

Liabilities	2004	2005	Assets	2004	2005

	Rs.	Rs.		Rs.	Rs.
Credits	40,000	44,000	Cash	10,000	7,000
Bills payable	25,000	----	Debtors	30,000	50,000
Loans from Bank	40,000	50,000	Stock	35,000	25,000
Capital	1,25,000	1,53,000	Machinery	80,000	55,000
			Land	40,000	50,000
			Building	35,000	60,000
	2,30,000	**2,47,000**		**2,30,000**	**2,47,000**

During the year, a machine costing Rs.10,000 (accumulated depreciation Rs.3,000) was sold for Rs.5,000. The provision for depreciation against machinery as on 1-1-2005 was Rs.25,000 and 31-12-2005 it was Rs.40,000. Net profit for the year 2005 amounted to Rs.45,000. Prepare Cash Flow Statement.

Calculation of Cash from Operations

			Rs.
Net Profit for the year 2005			45,000
Add:	Addition to Provision for Depreciation		18,000
	Loss of Sale of Machinery		2,000
	Funds from Operations		65,000
Add:	Decrease in Stock		10,000
	Increase in Creditors		4,000
			79,000
Less:	Increase in Debtors	20,000	
	Decrease in Bills Payable	25,000	45,000
	Cash from Operations		34,000

Capital A/c

To Drawings (b/f)	17,000	By Balance b/d	1,25,000
To Balance c/d	1,53,000	By Net Profit for the year	45,000
	1,70,000		1,70,000

Machinery A/c

To Balance b/d (80000 + 25000)	1,05,000	By Bank Sale	5,000
		By Provision for Dep.	3,000
		By P&L a/c – Loss	2,000
		By Balance c/d (55000 + 40000)	95,000

	1,05,000		1,05,000

Provision for Depreciation A/c

To Machinery a/c (Dep. on machinery sold)	3,000	By Balance b/d	25,000
To Balance c/d	40,000	By P&L a/c Dep. for the current year	18,000
	43,000		43,000

Cash Flow Statement

Cash as on 1-1-2005 10,000			
Add: Inflows		Cash Outflows:	
Cash from Operations 34,000		Drawings	17,000
Loan from Bank	10,000	Purchase of Land	10,000
Sale of Machinery	5,000	Purchase of Building	25,000
		Cash as on 31-12-2005	7,000
	59,000		59,000

Part A (ONE Mark)

Multiple Choice Questions

Online Examination

Part B

(2 Marks)

1. Bring out any five limitations of ratio analysis?

2.Define the term Financial Statement Analysis?

3. From the following particulars you are required to find out cash from operations:

Liabilities	2007	2008	Asset	2007	2008
Share capital	8,000	8,500	Land	5,000	5,000
Profit & Loss A/C	1,450	2,450	Plant	2,400	3,400
Creditors	900	500	Debtors	1,650	1,950
Mortgage Loan		500	Stock	900	700
			Cash at Bank	400	900
	10,350	**11,950**		**10,350**	**11,950**

4. Bring out the merits of financial statement?

5.Fromthefollowinginformationcalculatecashfromoperations:

Particulars	Rs.
NetProfitfortheyear	30,000
TotalSales	60,000
DebtorsOutstandinginthebeginningoftheyear	20,000
Debtors outstandingattheendoftheyear	15,000

6. Write a brief note on Trend analysis

7. M/s. Asoka Ltd., has submitted the following Balance Sheet for the year ending 31st December 1984.

Liability	Amount (Rs.)	Asset	Amount (Rs.)
Equity Capital	1, 50, 000	Fixed Assets	1, 62, 000
Revenue reserves	30, 000	**Current Assets:**	
8% Debentures	20, 000	Stock	22, 000
		Debtors	51, 000
		Bills Receivable	2, 000
		Bank	12, 000
	2,49,000		**2,49,000**

Find the current ratio and liquidity ratio and comment on the financial condition of the company.

8. Define the term Cash Flow

Part C (8 Marks)

1.Elucidate the various classification of accounting ratios and explain its importance?

2. The following is the Balance sheet of Rajan Limited as on December 31, 2010

Liability	Amount (Rs.)	Asset	Amount (Rs.)
Equity shares capital	1,00, 000	Fixed Assets	2, 60, 000
7% Preference shares capital	20, 000	**Current Assets:**	
Reserves and surplus	80, 000	Cash	10, 000
6% Mortgage debenture	1,40,000	Investments (Govt. Securities @ 10% interest)	30, 000
Current Liabilities:		Sundry Debtors	40, 000
Creditors	12,000	Stock	60, 000
Bills Payable	20, 000		
Outstanding Expenses	2, 000		
Taxation Provision	26, 000		
	4, 00, 000		**4, 00, 000**

Other Information:

i) Net sales Rs. 6, 00, 000
ii) Cost of Goods Sold Rs. 5, 16, 000
iii) Net Income before tax Rs. 40, 000
iv) Net Income after tax Rs. 20, 000

Calculate a) Short term solvency ratio (Current ratio and Liquidity ratio) b) Profitability ratios (Gross profit ratio , Net profit ratio)

3. Thefollowingdetailsareavailablefromacompany.

Liabilities	31-12-98 Rs.	31-12-99 Rs.	Assets	31-12-98 Rs.	31-12-99 Rs.
ShareCapital	70,000	74,000	Cash	9,000	7,800
Debentures	12,000	6,000	Debtors	14,900	17,700
Reservefordoubtfuldebts	700	800	Stock	49,200	42,700
TradeCreditors	10,360	11,840	Land	20,000	30,000
P&LA/c	10,040	10,560	Goodwill	10,000	5,000
	1,03,100	**1,03,200**		**1,03,100**	**1,03,200**

AdditionalInformation

(i)DividendpaidtotalRs.3,500(ii)Landwas purchasedfarRs.10,000.AmountprovidedfaramortizationofgoodwillRs. 5,000and(iii)DebenturespaidoffRs.6,000. Prepare Cash Flow Statement.

4. Elaborate the purpose of preparing a cash flow statement with suitable illustration?

The following details are available from a company.

	31-12-09 Rs.	31-12-10 Rs.		31-12-09 Rs.	31-12-10 Rs.
Share capital	70,000	74,000	Cash	9,000	7,800
Debentures	12,000	6,000	Debtors	14,900	17,700
Reserve for doubtful debts	700	800	Stock	49,200	42,700
Trade Creditors	10,360	11,840	Land	20,000	30,000
P/L A/c	10,040	10,560	Goodwill	10,000	5,000
	1,03,100	1,03,200		1,03,100	1,03,200

In addition, you are given:
Dividend paid total Rs. 3,500.
Land was purchased for Rs.10,000.
Amount provided for amortization of goodwill Rs.5,000.
Debentures paid off Rs.6,000.
Prepare Fund Flow Statement.

5. Describe the various types of accounting ratios?

6. From the following particulars pertaining to assets and liabilities of a company calculate i) Current ratio ii) Liquid ratio iii) Proprietary ratio iv) Debt equity ration v) Gearing ratio

Liability	Amount (Rs.)	Asset	Amount (Rs.)
5000 Equity shares of Rs. 100 each	6,00, 000	Land and Building	6, 00, 000
2000 8% Preference shares of Rs. 100 each	2,00, 000	Plant and Machinery	5, 00, 000
40000 9% Debentures of Rs. 100 each	4,00, 000	Stock	2, 40, 000
Reserves	3,00,000	Debtors	3, 00, 000
Creditors	1,50,000	Cash and bank	55, 000
Bank Overdraft	50,000	Prepaid expenses	5, 000
	17, 00, 000		**17, 00, 000**

7. Ratio analysis is a tool of management for measuring efficiency and guiding business policies – Discuss.

8. Thefollowingdetailsareavailablefromacompany.

Liabilities	31-12-98 Rs.	31-12-99 Rs.	Assets	31-12-98 Rs.	31-12-99 Rs.
ShareCapital	70,000	74,000	Cash	9,000	7,800
Debentures	12,000	6,000	Debtors	14,900	17,700
Reservefordoubtfuldebts	700	800	Stock	49,200	42,700
TradeCreditors	10,360	11,840	Land	20,000	30,000
P&LA/c	10,040	10,560	Goodwill	10,000	5,000
	1,03,100	**1,03,200**		**1,03,100**	**1,03,200**

AdditionalInformation

(i)DividendpaidtotalRs.3,500(ii)Landwas purchasedfarRs.10,000.AmountprovidedfaramortizationofgoodwillRs. 5,000and(iii)DebenturespaidoffRs.6,000. Prepare Cash Flow Statement.

Part D (11 Marks)

The following is the Balance sheet of Rajan Limited as on December 31, 2010

Liability	Amount (Rs.)	Asset	Amount (Rs.)
Equity shares capital	1,00, 000	Fixed Assets	2, 60, 000
7% Preference shares capital	20, 000	**Current Assets:**	
Reserves and surplus	80, 000	Cash	10, 000
6% Mortgage debenture	1,40,000	Investments (Govt. Securities @ 10% interest)	30, 000
Current Liabilities:		Sundry Debtors	40, 000
Creditors	12,000	Stock	60, 000
Bills Payable	20, 000		
Outstanding Expenses	2, 000		
Taxation Provision	26, 000		
	4, 00, 000		**4, 00, 000**

Other Information:

i) Net sales Rs. 6, 00, 000
ii) Cost of Goods Sold Rs. 5, 16, 000
iii) Net Income before tax Rs. 40, 000
iv) Net Income after tax Rs. 20, 000

Calculate a) Short term solvency ratio (Current ratio and Liquidity ratio) b) Profitability ratios (Gross profit ratio, Net profit ratio)

UNIT 3

S.No	Questions	Opt 1	Opt 2	Opt 3	Opt 4	Answer
1	The word 'fund' means the difference between ____________	Current Assets	Current Liabilities	Current Assets and Current Liabilities	No Assets	Current Assets, Current Liabilities
2	The indicated quotient of two mathematical expression is known as ____________	Ratio	Analysis	Working capital	Profit	Ratio
3	Issue of capital will mean________in working capital	increase	decrease	Liquidity	current	increase
4	Goodwil is a __________ transaction	Fund	Non-Fund	current	Non-Current	Non-Fund
5	Depreciation of Machinery is ___________	Source of Funds	Application of Funds	No flow of funds	Flow of funds	No flow of funds
6	Which of the following are non-current iterm____________	Share premium	sundry creditors	bank balance	payment of wages	Share premium
7	Which of the following will result into application of funds___________	Purchase of plant	Issue of share capital	payment of dividend	payment of creditors	Purchase of plant
8	Operating cost/ net sales X 100=	Gross profit ratio	Net profit ratio	Operating ratio	Current ratio	Operating ratio

	_______					
9	Cash flow statement is useful for __________term financial anaysis	Long	Short	Medium	Short and Long	Short
10	Cash comprises cash on hand and ______ deposit with banks	Current	fixed	Demand	Saving	Saving
11	Cash flows are ___________of cash and Cash equivalents	inflow	outflow	inflow and out flow	sources	inflow and out flow
12	Cash payments to suppliers for goods and services are classified as cash flow from __________activities	investing	operating	Non-operating	Non-investing	operating
13	Decrease in creditors is _______of cash	inflow	outflow	inflow and out flow	source	inflow
14	The term 'Fund' refers to __________	Reserves	Working capital	Profits	Loss	Working Capital
15	Gross working Capital is the __________	Total value of current assets	Total value of fixed assets	Total value of current liabilities	Total value of permanent liabilities	Total value of current assets
16	Fund from operation is _________	Gross profit	Net profit	operating profit	non-operating profit	Operating profit
17	Depreciation is __________	An external source of funds	Application of Funds	A non fund item	A non-operating item	A non-fund item
18	Proposed dividend,	added back to Net	to be reduced from	ignored while	nill effect	added back to

	if already reduced while ascertaining net profit, is ________	profit to find fund from operations	net profit	ascertaining fund from operations		Net profit to find fund from operations
19	Sale of fixed asset is ________	an item of funds from operation	an external source of fund	an application of fund	a flow of fund	an external source of fund
20	Short term investment is ____________	a current asset	a current liability	an application of fund	a source of fund	a current asset
21	Payment of dividend is _____________	An application of fund	a source of fund	Fixed expenses	operating expenses	An application of funds
22	A tool that is used for measuring short term stability of the company	Liquid Ratio	Current Ratio	Debt Turnover Raio	Inventory Ration	Current Ratio
23	Funds inflow from operation is	an internal source of funds	an application of funds	an external source of funds	net profit	An internal source of funds
24	Purchase of fixed assets by issue of shares is _________	Source of Funds	Application of Funds	An item to be ignored in Funds flow analysis	An item to be added in fund flow	An item to be ignored in fund flow analysis
25	Issue of bonus shares out of reserves _________	increase in working capital	decrease in working capital	does not affect working capital	flow of funds	does not affect working capital
26	Difference between current assets and current liabilities is _________	permanent capital	working capital	additional capital	debt capital	working Capital
27	___________ in current assets increases working capital	increase	decrease	constant	permanent	increase
28	The primary	Gross profit	Net profit	Current	Inventory	Current

	objective of _____ ratio is to measure the liquidity.					
29	_____ ratio is also known as rate of dividend to net profit	Payout	Price to earnings	Gross profit	Net profit	Payout
30	_____ ratio establishes the relationship between total operating expenses and sales.	Operating	Current	Liquidity	Turn over	Operating
31	Issue of debenture for cash is ______ item	Source of Funds	Application of Funds	flow of funds	no flow of funds	Source of funds
32	Redemption of preference shares is an ________ item	Source of Funds	Application of Funds	flow of funds	no flow of funds	Application of funds
33	_____ ratio gives an idea about adequate investments or over investment or under investment in fixed assets.	Fixed assets turn over ratio	Fixed assets to current assets ratio	Fixed assets to capital ratio	Fixed assets to profit ratio	Fixed assets to capital ratio
34	If current ratio is 1:5:1 and current liability is 50,000 then the current assets could be_____	Rs. 20,000	Rs. 75,000	Rs. 50,000	Rs. 1,00,000	Rs. 75,000
35	Cash from	profit from	cash from business	sale of fixed assets	borrowing from	cash from

	operation is the result of ________	business activities	activities and changes in current assets and liabilities		outside source	business activities and changes in current assets and liabilities
36	Income from long term investment is ___________	Source of cash	application of cash	cash inflow from operations	cash out flow from operations	Source of cash
37	Premium on redemption of debentures is _______	cash inflow	cash outflow	an income	an asset	Cash outflow
38	Dividend paid is usually treated as __________	an application of cash	source of cash	loss	gain	an application of cash
39	Cashflow includes cash inflows and cash ____	outflows	movements	changes	transactions	outflows
40	Cash from operation is a _____ of cash	source	application	external	fundamental	source
41	Cash outflow on account of operation is an ________ of cash	source	application	income or loss	expenditure	application
42	Increase in current assets __________ in cash	increase in cash	decrease in cash	no change in cash	loss in cash	decrease in cash
43	Increase in current liability ________ in cash	increase in cash	decrease in cash	no change in cash	loss in cash	increase in cash
44	Tax paid usually shown as an	application	finance	source	loss	application

	__________ of cash					
45	Issue of shares result in ________ in flow	cash	Credit	debit	loss	cash
46	Current ratio is an example for _________ ratio.	Balance Sheet	Income Statement	Profit and Loss Account	Inter Statement	Balance Sheet
47	_______ ratio is an example for long term solvency ratio.	Gross Profit	Net Profit	Debt Equity	Current	Debt equity
48	Liquid ratio is also known as _________ ratio.	Current	Acid test	Velocity	Profitability	Acid test
49	Cash from oepration reveals ________	fund generated from routine and normal business operations	cash generated from routine or normal business operations	cash generated from non operating business activities	fund generated from non operating business activities	cash generated from routine or normal business operations
50	Cash flow statement is prepared on the basis of ___________	income statement	balance sheet	fund flow statement	income statement, balance sheet and additional data	income statement, balance sheet and additional data
51	Decrease in current assets ___________ in working capital	increase	decrease	constant	permanent	decrease
52	Redemption of debentures by converting them into shares is __________	source of cash	application of cash	to be ignored	to be included	to be ignored
53	Cash received from sale of long term investments is __________	source of cash	application of cash	loss of cash	gain of cash	source of cash

54	Premium charged on issue of shares is also ______________	Source of funds	application of funds	non fund item	non operatng expenses	Source of funds
55	Goodwill written off should be ___________ while ascertaining fund from operations	to be added back to net profit	deducted from net profit	ignored	considered	to be added bacl to net profit
56	The fund flow analysis is of primary importance to __________	Personnel management	Quality control management	Financial management	Auditing	Financial management
57	A statement prepared to show the sources and application of cash is known as ___________	Funds flow statement	Working capital statement	Cash flow statement	Cash from operation	Cash flow statement
58	The cash flow statement is prepared for ___________	A particular period	One year	Two years	Five year	One year
59	Issue of bonus shares is a _________ of funds	sources	application	No flow of funds	inflow of funds	no flow of funds
60	Cash flow includes _________	Cash receipts only	cash payments only	cash receipts and payments	cash and non cash incomes and expenses	cash receipts and payments

UNIT-IV-Introduction to Costing
SYLLABUS

Costing –Types of costing- Job costing, Batch Costing, Process costing, Activity Based Costing, Target costing. Elements of Costs (a) Materials Costs: - Materials purchasing, receiving, storing and issuing including pricing of issues. (b) Labour Costs and Labour Turnover. (c) Overheads-Identifying the overheads with cost centre. Allocation, Apportionment and Absorption – Accounting treatment of Under and Over Absorption. (d) Preparation of Cost Sheet, items to be excluded while preparing cost sheet.

DEFINITION:

According to Horngren Charles. T. "Cost accounting is quantitative method that accumulates, Classifies, Summaries and interprets information for 3 major purposes.
i) Operational planning and control. ii) Special decisions. iii) Product decisions."

According to WJ Morse, "Cost accounting is the processing and evaluation of monetary and non-monetary data to provide information for external reporting, internal planning and control of business operations and special analysis and decisions."

SCOPE OF COSTING:

The scope of cost accounting is very wide. There are lots of techniques, tools, procedures, processes, programs are used in cost accounting for calculating cost and its control. But basically, we divide its scope within three major parts namely a) Cost ascertainment b)Cost accounting c)Cost control .

1. Cost Ascertainment

In this region of cost accounting, cost accounting collects product's material, labor and overhead cost and try to calculate total and per unit cost of product. This total cost calculation will be based on historical or standard or estimated basis. After this, cost accountant will use any method of costing like specific order costing, operation costing, and direct costing technique. These techniques and methods may be used for calculating different nature products in same organization.

2.Cost Records (Cost Accounting)

In this part of cost accounting, cost accountant maintains cost books, vouchers, ledgers, reports and other cost related documents for future comparison and reference. It will also be under the scope of cost accounting.

3. Cost Control:

This is the end boundary of cost accounting scope. In this division, cost accountant used different techniques and methods for controlling the cost. Save One Rupees in the cost of product means we have earned one rupees in the production of goods. So, Cost accountant uses budgetary control, standard costing, break even point analysis and many other techniques for controlling the cost.

OBJECTIVES OF COSTING:

Cost

Cost may be define as the price of any asset when one company purchases it or it may the expenses for getting services . So , we can say that cost is total amount which is sacrificed for getting the goods , services and assets .In general , cost is calculated on production of goods . Total cost represents cost of raw material , cost of labour and cost of overheads after adding above we can find total cost and if we divide total numbers of units, then we can find cost per unit.

Costing

Costing is technique to determine the cost. It involves the process and method to classify and analysis of different expenditures.

Cost Accounting

Cost accounting is science of recording , classify , analyzing and allocation of cost to cost centers or cost unit . It also include cost control .

Cost accounting = Accounting used → **{ [** determine the cost + control the cost**] }**

ELEMENTS OF COST

- Material (Material is a very important part of business)
  - Direct material
- Labor
  - Direct labor
- Overhead (Variable/Fixed)
  - Indirect material
  - Indirect labor
  - Maintenance & Repair
  - Supplies
  - Utilities
  - Other Variable Expenses
  - Salaries
  - Occupancy (Rent)
  - Depreciation
  - Other Fixed Expenses

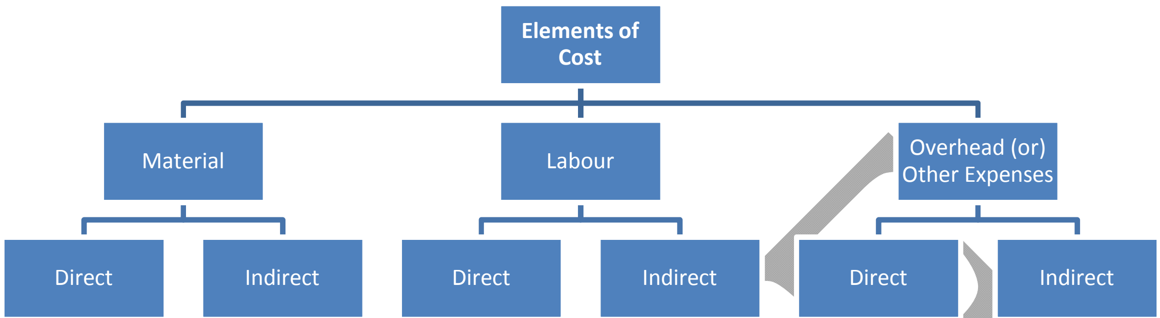
(In some companies, machine cost is segregated from overhead and reported as a separate element)

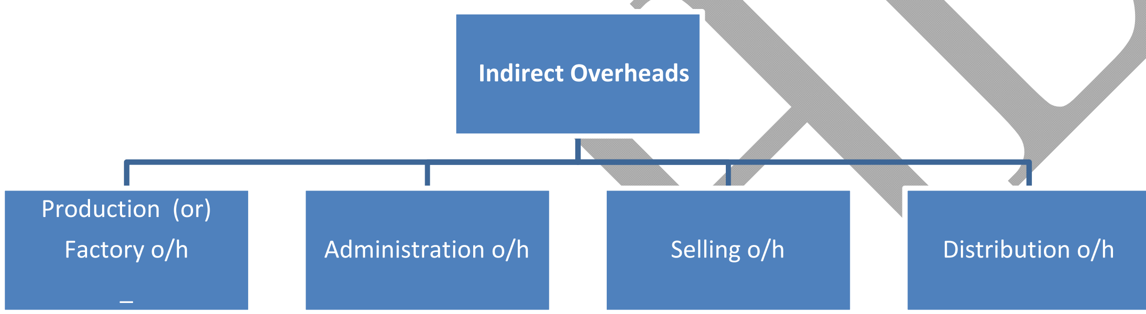
They are grouped further based on their functions as,

- Production or works overheads
- Administration overheads
- Selling overheads
- Distribution overheads

- Financial Expenses

Elements of Cost





Cost Classification:

- By Nature (materials, labor, expenses)
- By Function (production, selling, distribution, administration, R&D, development etc)
- By Degree of traceability to the product.(direct and indirect)
- By Changes in activity (fixed, variable, semi-variable)
- By Controllability (controllable, uncontrollable)
- By Normality (normal, abnormal)
- By Relationship with accounting Period
- By Time
- By Planning and Control
- By Association with the product
- By Management decisions.

Cost Object

Costs are assigned to objects for a variety of purposes including pricing, profitability studies, and control of spending. A cost object is anything for which cost data are desired including products, product lines, customers, jobs, and organizational subunits. For the purpose of assigning costs to cost objects, costs are classified as direct cost and indirect cost.

Direct Cost:

A direct cost is a cost that can be easily and conveniently traced to the particular cost object under consideration. A cost object is anything for which cost data is required including products, customer's jobs and organizational subunits. For example, if a company is assigning costs to its various regional and national sales offices, then the salary of the sales manager in its Tokyo office would be a direct cost of that office.

Indirect Cost:

An indirect cost is a cost that cannot be easily and conveniently traced to the particular cost object under consideration. For example a soup factory may produce dozens of verities of canned soups. The factory manager's salary would be an indirect cost of a particular verity such as chicken noodle soup. The reason is that the factory manager's salary is not caused by any one variety of soup. To be traced to a cost object such as a particular product, the cost must be caused by the cost object. This salary of manger is called common cost of producing the various products of the factory. A common cost is a cost that is incurred to support a number of costing objects but cannot be traced to them individually. A common cost is a particular type of indirect cost.

A particular cost may be direct or indirect, depending on the cost object. While, in the above example, the soup factory manager's salary is an indirect cost of manufacturing chicken noodle soup, it is a direct cost of the manufacturing division. In the first case, the cost object is the chicken noodle soup product. In the second case, the cost object is the entire manufacturing division.

Cost Classification as Manufacturing and Non-manufacturing:

Manufacturing firms are involved in acquiring raw materials producing finished goods and then administrative, marketing and selling activities. All these activities require costs to be incurred. These costs are normally classified by manufacturing companies as manufacturing and non-manufacturing costs. In the following paragraphs we will see how these costs are classified as manufacturing and non-manufacturing.

Manufacturing Costs:

Manufacturing costs are those costs that are directly involved in manufacturing of products and services. Examples of manufacturing costs include raw materials costs and salary of labor workers. Manufacturing cost is divided into three broad categories by most companies.

- Direct materials cost
- Direct labor cost
- Manufacturing overhead cost.

Direct Materials Cost:

The materials that go into final product are called raw materials. This term is somewhat misleading, since it seems to imply unprocessed natural resources like wood pulp or iron ore. Actually raw materials refer to any materials that are used in the final product; and the finished product of one company can become raw material of another company. For example, plastic produced by manufacturers of plastic is a finished product for them but is a raw material for Compaq Computers for its personal computers.

Direct Materials are those material that become an integral part of the finished product and that can be physically and conveniently traced to it. Examples include tiny electric motor that Panasonic uses in its CD players to make the CD spin. According to a study of 37 manufacturing industries material costs averaged about 55% of sales revenue.

Sometimes it is not worth the effort to trace the costs of relatively insignificant materials to the end products. Such minor items would include the solder used to make electrical connection in a Sony TV or the glue used to assemble a chair. Materials such as solder or glue are called indirect materials and are included as part of manufacturing overhead, which is discussed later on this page.

Direct Labor Cost:

The term direct labor is reserved for those labor costs that can be essentially traced to individual units of products. Direct labor is sometime called touch labor, since direct labor workers typically touch the product while it is being made. The labor cost of assembly line workers, for example, is a direct labor cost, as would the labor cost of carpenter, bricklayer and machine operator

Labor costs that cannot be physically traced to the creation of products, or that can be traced only at a great cost and inconvenience, are termed indirect labor and treated as part of manufacturing overhead, along with indirect materials. Indirect labor includes the labor costs of janitors, supervisors, materials handlers, and night security guards. Although the efforts of these workers are essential to production, it would be either impractical or impossible to accurately trace their costs to specific units of product. Hence, such labor costs are treated as indirect labor.

In some industries, major shifts are taking place in the structure of labor costs. Sophisticated automated equipment, run and maintained by skilled workers, is increasingly replacing direct labor. In a few companies, direct labor has become such a minor element of cost that it has disappeared altogether as a separate cost category. However the vast majority of manufacturing and service companies throughout the world continue to recognize direct labor as a separate cost category.

Direct Materials cost combined with direct labor cost is called prime cost**.**

In equation form:

Prime Cost = Direct Materials Cost + Direct Labor Cost

For example total direct materials cost incurred by the company is Rs.4,500 and direct labor cost is Rs.3,000 then prime cost is Rs.7,500 (Rs.4,500 + Rs.3,000).

Fixed Cost

A fixed cost is a cost that remains constant, in total, regardless of changes in the level of activity. Unlike variable costs, fixed costs are not affected by changes in activity. Consequently, as the activity level rises and falls, the fixed costs remain constant in total amount unless influenced by some outside forces, such as price changes. Rent is a good example of fixed cost. Fixed cost can create confusion if they are expressed on per unit basis. This is because average fixed cost per unit increases and decreases inversely with changes in activity. Examples of fixed cost include straight line depreciation, insurance property taxes, rent, supervisory salary etc.

Manufacturing Overhead Cost:

Manufacturing overhead, the third element of manufacturing cost, includes all costs of manufacturing except direct material and direct labor. Examples of manufacturing overhead include items such as indirect material, indirect labor, maintenance and repairs on production equipment and heat and light, property taxes, depreciation, and insurance on manufacturing facilities. Indirect materials are minor items such as solder and glue in manufacturing industries. These are not included in direct materials costs. Indirect labor is a labor cost that cannot be trace to the creation of products or that can be traced only at great cost and inconvenience. Indirect labor includes the labor cost of janitors, supervisors, materials handlers and night security guards. Costs incurred for heat and light, property taxes, insurance, depreciation and so forth associated with selling and administrative functions are not included in manufacturing overhead. Studies have found that manufacturing overhead averages about 16% of sales revenue. Manufacturing overhead is known by various names, such as indirect manufacturing cost, factory overhead, and factory burden. All of these terms are synonymous with manufacturing overhead.

Manufacturing overhead cost combined with direct labor is called conversion cost.

Formula:

- Prime cost = Direct Materials + Direct Labour + Direct Expenses
- Works cost (or) Factory Cost = Prime Cost + Factory Overhead
- Cost of Production = Works cost + Administration overhead
- Total Cost (or) Cost of Sales = Cost of production + Selling and distribution overhead.

In equation form:

Conversion Cost = Direct Labor Cost + Manufacturing Overhead Cost

For example if total direct labor cost is Rs. 3,000 and total manufacturing overhead cost is Rs. 2,000 then conversion cost is Rs. 5,000 (Rs. 3,000 + Rs. 2,000).

Non-manufacturing Costs:

Non-manufacturing costs are those costs that are not incurred to manufacture a product. Examples of such costs are salary of sales person and advertising expenses. Generally non-manufacturing costs are further classified into two categories.

1. Marketing and Selling Costs
2. Administrative Costs

Marketing or Selling Costs:

Marketing or selling costs include all costs necessary to secure customer orders and get the finished product into the hands of the customers. These costs are often called order getting or order filling costs. Examples of marketing or selling **costs** include advertising costs, shipping costs, sales commission and sales salary.

Administrative Costs:

Administrative costs include all executive, organizational, and clerical costs associated with general management of an organization rather than with manufacturing, marketing, or selling. Examples of administrative costs include executive compensation, general accounting, secretarial, public relations, and similar costs involved in the overall, general administration of the organization as a whole.

Cost Concepts:

- Cost
- Cost Centre
- Profit Centre
- Conversion Cost
- Contribution margin
- Carrying cost
- Out of stock cost
- Ordering cost
- Development cost
- Policy cost
- Idle facilities cost
- Expired cost
- Incremental revenue
- Added Value cost

COST STATEMENT

Running a factory which manufactures electronic toys. You incur expenses on raw material, labour and other expenses which can be directly attributed to cost and which cannot be directly attributed but are incurred up to their sales. You need to know the composition of cost at different stages. This will help you in the analysis of cost of a product so that same can be used for its proper management. In this lesson you will learn about cost sheet and its various components.

COST SHEET : MEANING AND ITS IMPORTANCE

Cost sheet is a statement, which shows various components of total cost of a product. It classifies and analyses the components of cost of a product. Previous periods data is given in the cost sheet for comparative study. It is a statement which shows per unit cost in addition to Total Cost. Selling price is ascertained with the help of cost sheet. The details of total cost presented in the form of a statement is termed as Cost sheet. Cost sheet is prepared on the basis of :

1. Historical Cost 2. Estimated Cost

Historical Cost

Historical Cost sheet is prepared on the basis of actual cost incurred. A statement of cost prepared after incurring the actual cost is called Historical Cost Sheet.

Estimated Cost

Estimated cost sheet is prepared on the basis of estimated cost. The statement prepared before the commencement of production is called estimated cost sheet. Such cost sheet is useful in quoting the tender price of a job or a contract.

IMPORTANCE OF COST SHEET

The importance of cost sheet is as follows:

- **Cost ascertainment**
  - The main objective of the cost sheet is to ascertain the cost of a product. Cost sheet helps in ascertainment of cost for the purpose of determining cost after they are incurred. It also helps to ascertain the actual cost or estimated cost of a Job.
- **Fixation of selling price**
  - To fix the selling price of a product or service, it is essential to prepare the cost sheet. It helps in fixing selling price of a product or service by providing detailed information of the cost.

- **Help in cost control**
  - For controlling the cost of a product it is necessary for every manufacturing unit to prepare a cost sheet. Estimated cost sheet helps in the control of material cost, labour cost and overheads cost at every point of production.

- **Facilitates managerial decisions**
  - It helps in taking important decisions by the management such as: whether to produce or buy a component, what prices of goods are to be quoted in the tender, whether to retain or replace an existing machine etc.

COMPONENTS OF TOTAL COST

The Components of cost are shown in the classified and analytical form in the cost sheet. Components of total cost are as follows:

Prime Cost

It consists of direct material, direct wages and direct expenses. In other words "Prime cost represents the aggregate of cost of material consumed, productive wages, and direct expenses". It is also known as basic, first, flat or direct cost of a product. **Prime Cost = Direct material + Direct Wages + Direct expenses**

Direct material means cost of raw material used or consumed in production. It is not necessary that all the material purchased in a particular period is used in production. There is some stock of raw material in balance at opening and closing of the period. Hence, it is necessary that the cost of opening and closing stock of material is adjusted in the material purchased.

Opening stock of material is added and closing stock of raw material is deducted in the material purchased and we get material consumed or used in production of a product. It is calculated as :

Material Consumed = Material purchased + Opening stock of material – Closing stock of material.

Specimen of Cost Sheet (or) Statement of Cost:

Particulars	**Total cost**	**Cost /Unit**
Direct Materials	xxxx	

Direct Labour	xxxx	
Direct Expenses	xxxx	
Prime Cost	**xxxx**	
Add: Factory Overhead	**xxxx**	
Factory Cost Or Works Cost	xxxx	
Add: Administration Overhead	xxxx	
Cost of production	**Xxxx**	
Add: Selling &distribution o/h	Xxxx	
Cost of Sales Or Total Sales	**Xxxx**	

Illustration 1

Calculate prime cost from the following particulars for a production unit:

	Rs.
Cost of material purchased	30,000
Opening stock of material	6,000
Closing stock of material	4,000
Wages paid	3,000
Rent of hire of a special machine for production	5,000

Solution:

Statement showing Prime Cost

Particulars		**Total cost (Rs.)**
Direct Material: Material Consumed		
Opening stock of material	6,000	
Add : Material Purchased	30,000	
Material available for consumption	36,000	
Less : Closing stock of material	4,000	

Material consumed	32,000
Direct Labour : Wages Direct Expenses: Rent of hire a special machine	3,000 5,000
Prime Cost	**40,000**

Factory Cost

In addition to prime cost it includes works or factory overheads. Factory overheads consist of cost of indirect material, indirect wages, and indirect expenses incurred in the factory. Factory cost is also known as works cost, production or manufacturing cost.

Factory Cost = Prime cost + Factory overheads

Illustration 2

Calculate factory cost from the following particulars:

	Rs.	
Material consumed	60,000	
Productive wages	20,000	
Direct Expenses	5,000	
Consumable stores		2,000
Oil grease/Lubricating		500
Salary of a factory manager		6,000
Unproductive wages		1,000
Factory rent		2,000
Repair and Depreciation on Machine		600

Solution:

Statement showing Factory cost

Particulars	**Total cost (Rs.)**
Direct Material: Material Consumed 60,000 Direct Labour: Productive wages 20,000	60,000 20,000

Direct Expenses		5,000
Prime Cost		**85,000**
Add : Factory overheads		
Indirect Material:		
Consumable stores	2,000	
Oil grease/lubricants	500	2,500
Indirect Labour:		
Unproductive wages	1,000	
Salary of a factory Manager	6,000	7,000
Indirect Expenses:		
Factory rent	2,000	
Repair and Depreciation on Machine	600	2,600
Factory cost		**97,100**

Adjustment for stock of work-in-progress

In the process of production, some units remain to be completed at the end of a period. These incomplete units are known as work-in-progress. Normally, the cost of incomplete units include direct material, direct Labour, direct expenses, and average factory overheads. Hence, at the time of computing factory cost, it is necessary to make adjustment of opening and closing stock of work in progress to arrive at the net Factory cost/works cost.

Illustration 3

From the following information calculate the works cost.

		Rs.
Direct material		80,000
Direct Labour	22,000	
Direct Expenses		5,000
Factory overheads		12,000
Work-in-progress: Opening stock		13,000
Closing stock		7,000

Solution:

Statement showing Factory cost

Particulars	**Total cost (Rs.)**
Direct Material: Material Consumed	80,000
Direct Labour: Productive wages	22,000
Direct Expenses	5,000
Prime Cost	**1,07,000**
Add : Factory overheads	12,000
Factory Costs	**1,19,000**
Add: Opening stock of work-in-progress	13,000
	1,32,000
Less: Closing stock of work-in-progress	7,000
Works or Factory cost (Net)	**1,25,000**

TOTAL COST AND COST SHEET

If office and administrative overheads are added to factory or works cost, total cost of production is arrived at. Hence the total cost of production is calculated as:

Total Cost of production = Factory Cost + office and administration overhe

Illustration 4

From the following information calculate the total cost of production

	Rs.
Direct material	90,000
Direct Labour	32,000
Direct Expenses	9,000
Factory overheads	25,000
Office and administration overheads	18,000

Solution

Statement showing total cost of production

It is not necessary, that all the goods produced in a period are sold in the same period. There is stock of finished goods in the opening and at the end of the period. The cost of opening stock of finished goods is added in the total cost of production in the current period and cost of closing stock of finished goods is deducted. The cost of goods sold is calculated as:

Cost of goods sold = Total cost of production + Opening stock of Finished goods – Closing stock of finished goods

Illustration 5

From the following information calculate the cost of goods sold.

	Rs.
Total Cost of Production	1,22,000
Opening stock of finished goods	12,000
Closing stock of finished goods	16,000

Solution:

Cost of goods sold = Cost of Production + Opening stock of Finished goods - closing stock of Finished goods

Cost of goods sold = Rs.1,22,000 + 12,000 – 16,000 = Rs.1,18,000

Total Cost i.e, Cost of Sales

If selling and distribution overheads are added to the total cost of production, total cost is arrived at. This cost is also termed as cost of Sales. Hence the total cost is calculated as:

Total Cost = Cost of Goods sold + Selling and distribution overheads

Illustration 6

From the following information calculate the total cost.

	Rs.
Direct material	1,60,000
Direct Labour	52,000
Direct Expenses	19,000
Factory overheads	45,000
Office and administration overheads	28,000
Selling and distribution overheads	33,000

Solution:

Statement showing Factory cost

Particulars	**Total cost (Rs.)**
Direct Material: Direct Labour Direct Expenses	1,60,000 52,000 19,000
Prime Cost Add : Factory overheads	**2,31,000** 45,000
Factory Costs Add: Office and administration overheads	**2,76,000** 28 ,000
Total Cost of Production **Add :** Selling and distribution overheads	3,04,000 33,000
Total Cost = cost of sales	**3,27,000**

Sales

If the profit margin is added to the total cost, sales are arrived at. Excess of sales over total cost is termed as profit. When total cost exceeds sales, it is termed as Loss.

Sales = Total Cost + Profit

Sometimes profit is calculated on the basis of given information in percentage of cost or sales. In such a situation, the amount is assumed 100 in which the percentage is calculated. Then the Profit is calculated in the following ways:

Case 1

If Cost is Rs.10,000 and profit on cost 10%. Assume the cost is Rs.100 and profit on cost is Rs.10. Hence Profit on cost of Rs.10,000 is

10,000 × 10/100 = Rs.1,000

Thus the sales value is Rs 11000 (10,000 + 1000)

Case 2

If Cost is Rs.10,800 and profit on sales price is 10%. Assume sales price is Rs.100. cost price is Rs.90 [i.e. Rs.100 – Rs.10]. When profit on cost of Rs.90 is Rs.10. Hence profit on cost of Rs.10,800 is

10,800 × 10/90 = Rs.1,200

10,800 + 1200 = 12,000 sales value

Case 3

If sales price is Rs.12,100 and profit on cost is 10%. Assume Cost price is Rs.100. Sales price is Rs.110 [i.e.100 + 10]. If sales price is Rs.110, profit is Rs.10. Profit on sales price of Rs.12,100 is

12,100 × 10/110 = Rs.1,100 profit

Illustration 7

From the following information, calculate the value of goods sold.

	Rs.
Total Cost of Production	1,45,000
Opening stock of finished goods	22,000
Closing stock of finished goods	6,000
Selling and distribution overheads	25,000
Profit	22,000

Solution

Statement showing Sales

Particulars	**Total cost (Rs.)**
Total cost of production Add : Opening stock of finished goods	1,45,000 22,000
 Less Closing stock of finished goods	1,67,000 6,000
Cost of Goods sold	1,61,000
Add: Selling and distribution overheads	25,000
Total Cost	1,86,000
Profit	22,000
Sales	**2,08,000**

PREPARATION OF COST SHEET

The various components of cost explained above are presented in the form of a statement. Such a statement of cost consists of prime cost, works cost, cost of production of goods, cost of goods sold, total cost and sales and is termed as cost sheet. The Preparation of a cost sheet can be understood with the help of following illustration:

Illustration 8

From the following information, prepare a cost sheet for period ended on 31st March 2006.

	Rs.
Opening stock of raw material	12,500
Purchases of raw material	1,36,000
Closing stock of raw material	8,500
Direct wages	54,000

Direct expenses 12,000

Factory overheads 100% of direct wages

Office and administrative overheads 20% of works cost

Selling and distribution overheads 26,000

Cost of opening stock of finished goods 12,000

Cost of Closing stock of finished goods 15,000

Profit on cost 20%

Solution:

Cost sheet

Details Amount		(Rs.)		
Direct Material : Material consumed	12,500			
Opening 'stock of raw material		1,36,000		
Add: Purchases		1,48,500		
Less: Closing stock of raw material	8,500		1,40,000	
Direct wages				54,000
Direct expenses				12,000
Prime cost				2,06,000
Factory overheads: 100% of direct wages				54,000
(i.e. 100x 54000/100				
Works Cost				2,60,000
Office and administrative overheads				
20% of works cost, (2,60,000 × 20/100				52,000

Total cost of production		3,12 000
Add : opening stock of finished goods		12,000
Cost of Goods available for sale		3,24,000
Less : Closing stock of finished goods		15,000
Cost of goods sold		3,09,000
Selling and distribution overheads	26,000	
Total Cost = cost of sales		3,35,000
Profit (20% On Cost i.e. 3,35,00 × 20/100)	67,000	
Sales		4,02,000

Techniques of Material Cost:

1. Level Setting

   Re-ordering Level

   Minimum Level

   Maximum Level

   Danger Level

   Average Stock Level
2. EOQ (Economic Order Quantity)
3. JIT (Just In Time)
4. ABC Analysis (Activity Based Costing)
5. VED Analysis (Vital, Essential, & Desirable)
6. Perpetual Inventory Analysis System

7. MTR Analysis (Material Turnover Ratio)
8. FNSD Analysis (Fast, Normal, Slow and Dead)

Formula:

- Ordering Level = Minimum Level + Consumption during + time required to get fresh delivery
- Re – Ordering Level = Maximum Consumption X Maximum Re – Ordering Period
- Minimum Stock Level = Re – Ordering Level - (Normal Consumption X Normal Re – Ordering Period)
- Maximum Stock Level = Re – Ordering Level + Re – Ordering Quantity - (Minimum Consumption X Minimum Re – Ordering Period)
- Danger Stock Level = Average Consumption X Maximum re – order period for emergency purchases.
- Average Stock Level = Minimum Stock Level + ½ of Re – Order Quantity

  (or)

  ½ of (Minimum Stock Level + Maximum Stock Level)

Job-Order Costing

Job-Order Costing is the development of a list of expenses you will incur to complete a specific job. Example: You want to build a deck onto the back of your house. This is a "one-time" project - i.e. you're not planning to go into business manufacturing decks.

Process Costing

Process Costing is when you begin manufacturing the same deck over and over. Each deck is identical, and they pop out of the end of your production process at regular intervals. Process Costing is an in depth look at the expenses incurred in producing one deck off of your production line.

Activity Based Costing

Activity Based Costing is used to manage Key Indicator activities throughout your company. There are various levels of Activity Based Costing:

- Per Unit Activities would be used to measure costing for individual aspects of a unit of output. Example: reducing cost while improving the process used to measure a product's impact resistance.
- Batch Activities are costs you might measure across a multitude of products you've manufactured. Example: The activity of producing 10,000 widgets, then racking (storage) them, retrieving them, and getting them packaged for shipment. This activity measures how well are you organized? How much time and expense can be found in storing your products? How easily are they found again? How can we reduce expenses while reducing process time?
- Product Activities are grouped expenses you might incur no matter how many products roll off the production line. Example: Sales or Marketing expenses by product.
- Customer Activity Costing reveals expenses across departments and/or departmental level outputs. Example: Customer Service Department expenses, Social Media Management, Development of Sales Catalogs, etc.

Under/Over-Absorption of Overheads (Accounting Treatment)!

- Where the actual overhead of a period is absorbed at an absorption rate based on actual production during that period, the overhead absorbed must, if all calculations have been correctly made, exactly equal the overhead incurred. This is not so, however, when a predetermined rate is used. The amount absorbed in cost accounts may not be equal to actual overhead relating to an accounting period.

- The use of a predetermined rate may, therefore, result in under-absorption or over-absorption. When the amount absorbed is less than the actual overhead, there is under-absorption. Over absorption arises when the amount absorbed is more than the actual overhead.

Methods for the Treatment of Under/Over Absorption:

Since actual overheads are not recorded in cost accounts, under-absorption and over-absorption can be treated in any one of the following ways:

(1) In a seasonal business firm, the balance (due to under – or over-absorption) may be carried forward to the subsequent period with the expectation that it will be counterbalanced at the end of accounting period.

This is clear from the following example:

Months	*Production units*	*Overhead absorbed @ ₹ 2 per unit*	*Actual overhead*	*Under-or over-absorption*
July	1000	2000	3,000	–1,000
August	1500	3000	4,200	–1,200
September	3000	6000	3,800	+2,200

(2) A supplementary rate can be used to adjust the amount of under-or over-absorption. The supplementary rate is determined by dividing the amount of under – or over-absorption by

the actual absorption base. Under-absorption is adjusted by using a plus supplementary rate while a minus supplementary rate in used to correct over-absorption.

For instance, in the above example, a plus supplementary rate of Re. 1 per unit Rs. 1, 000/1, 000 units can be used to increase the recorded overhead by Rs 1,000 for the month of July. Similarly, a minus supplementary rate of Re. 0.733 x (2, 200/3, 000) can be used to decrease the recorded overhead by Rs 2,200 for the month of September.

(3) The amount of under-or over-absorption can be transferred to the costing profit and loss account to arrive at the accurate net profit for an accounting period. When over-or under absorption has been due to abnormal factors, the amount of under- or over-absorption is necessarily transferred to the costing profit and loss account.

Example:

In a manufacturing company, overhead was recovered at predetermined rate of Rs 25 per man-day. The total factory expenses incurred and the man-days actually worked were Rs 41.50 lakhs and 1.50 lakh days respectively.

Out of the 40,000 units produced during a period, 30,000 were sold.

On analysing the reasons, it was found that 60% of the unabsorbed over-heads were due to defective planning and the rest were attributable to increases in overhead costs.

How would unabsorbed overheads be treated in cost accounts?

Solution:

Recovered Overheads = Actual mandays × Rate

= 1.50 lakhs × ₹ 25 = ₹ 37.50 lakhs

Actual Overheads = ₹ 41.50 lakhs

Under-recovery of overhead = 41.50 – 37.50 = 4 lakhs

Reasons for under-absorption:

(*i*) Defective Planning $= \frac{4 \text{ lakhs} \times 60}{100}$

= ₹ 2.40 lakhs

(*ii*) Increase in Overhead cost $= \frac{4 \text{ lakhs} \times 40}{100}$

= 1.60 lakhs

Treatment of under-absorption in cost account:

(*i*) ₹ 2.40 lakhs should be transferred to the costing profit and loss account as under absorption has arisen because of abnormal factors.

(*ii*) The under-absorption due to increases in overhead costs should be charged to units produced in the company. The amount of ₹ 1.60 lakhs will be distributed in the following manner:

Cost of sales A/c = 1.60 lakhs × $\frac{3}{4}$ = ₹ 1.20 lakhs

Finished goods stock A/c = $\frac{1.60 \text{ lakhs} \times 1}{4}$ = ₹ 0.40 lakhs

Example:

Your company uses a historical cost system and applied overheads on the basis of "predetermined" rates. The following are the figures from the Trial Balance as on 31st March 2012.

Manufacturing Overheads	₹ 4,26,544 Dr.
Manufacturing Overheads applied	₹ 3,65,904 Cr.
Work-in-Progress	₹ 1,41,480 Dr.
Finished goods stock	₹ 2,30,732 Dr.
Cost of goods sold	₹ 8,40,588 Dr.

Give two methods for the disposal of the under-absorbed overheads and show the profit implications of each method.

Solution:

Actual Overheads	₹ 4,26,544
Overheads recovered	₹ 3,65,904
Under-absorbed Overheads	₹ 60,640

Methods for the Treatment of Under Absorbed Overheads:

The under absorbed overheads may be treated by following any one of the following methods:

1. Transferring to the costing profit and loss account.

2. Using a supplementary rate to recover the under-absorbed overhead.

According to first method, the total unabsorbed overhead amount of Rs 60,640 will be written off to the costing profit and loss account. The use of this method will reduce the profits of the concern by Rs 60,640 for the period.

According to second method, a supplementary rate may be used to adjust the overhead cost of each unit. The under-absorbed amount in total may, at the end of the accounting period, be apportioned on a ratio basis to the three control accounts, viz., work-in-progress, finished goods stock and cost of goods sold account.

Prorated figures of under-absorbed overhead for work-in-progress, finished goods stock and cost of goods sold in this question on the basis of values of the balances in each of these accounts are as follows:

Additional Overhead (under-absorbed)

	₹	₹	*Total* ₹
Work-in-progress	1,41,480	7,074 *	1,48,554
Finished goods stock	2,30,732	11,537 **	2,42,269
Cost of goods sold	8,40,588	42,029 ***	8,82,617
	12,12,800	60,640	12,73,440

By using this method, the profit for the period will be reduced by Rs 42,029 and the value of stock will increase by Rs 18,611 (Rs 7074 + Rs 11,537). The later will affect the profit of the subsequent period.

Part A (ONE Mark)

Multiple Choice Questions

Online Examination

Part B

(2 Marks)

1. Define Costing
2. List out the techniques of costing?
3. From the following information you are asked to prepare the cost sheet and find out the Profit .

Direct Materials	Rs. 15,000	Direct Labour	Rs. 10,000
Direct Expenses	Rs. 11,500	Factory Overhead	Rs. 15,200
Administration Overhead	Rs. 5,300	Selling Expenses	Rs. 1,300

4. List out the methods of costing?
5. What do you mean by marginal costing?
6. What are the types of costing
7. Define job costing

8 List out the elements of costing

9. Write a short note on Activity Based Costing
10. What do you mean by target costing

Part C (8 Marks)

1. Elaborate the various basis of classification of cost and various types of cost?
2. From the following particulars of a manufacturing firm, prepare a statement of cost

Stock of materials on January 1, 1996	20,000

Purchases of raw materials in January, 2016	5,50,000
Stock of finished goods on January, 1 2016	25,000
Productive wages	2,50,000
Finished goods sold	12,00,000
Works overhead charges	75,000
Office and general expenses	50,000
Stock of materials on 31st January, 2016	70,000
Stock of finished goods on 31st January, 2016	30,000

3. Elaborate the steps to followed in Preparation of Cost Sheet?

4. Describe the different methods of costing and state the particular industries to which they can be applied?

5. Describe the concept of accounting treatment of under and over absorption

6. Explain the elements of costing with suitable examples.

7. From the following particulars of a manufacturing firm, prepare a statement of cost

	Rs.
Stock of materials on January 1, 1996	20,000
Purchases of raw materials in January, 2016	5,50,000
Stock of finished goods on January, 1 2016	25,000
Productive wages	2,50,000
Finished goods sold	12,00,000
Works overhead charges	75,000
Office and general expenses	50,000
Stock of materials on 31st January, 2016	70,000
Stock of finished goods on 31st January, 2016	30,000

8. Explain the cost Accounting Systems with suitable examples?
9. Identifying the overheads with cost center to allocation of expenses.
10. Explain the concept of Activity Based Costing

Part D (11 Marks)

Mr. X furnishes the following data relating to the manufacture of a standard product during the month of April 2016

Raw materials consumed	60, 000
Direct labour charges	36,000

Machine hours worked	3,600
Machine hour rate	Rs. 5.00
Administrative overheads	20% on works cost
Selling Overheads	Re.1.00 per unit
Units produced	10,000
Unit sold	9,000 at Rs. 20 per unit

Prepare a cost sheet from the above information

a) Cost per unit
b) Profit per unit sold and profit for the period

UNIT 4

S.No	Questions	Opt 1	Opt 2	Opt 3	Opt 4	Answer
1	Costing is a technique of _________________	Ascertainment of cost	analyzing of cost	utilization of cost	cost reduction	Ascertainment of cost
2	Cost accounting provide data for managerial_________________	Planning	Organizing	Decision making	Decision Making and cost controlling	Decision Making and cost controlling
3	Cost accounting is a separate _____________of accounting.	No branch	Branch	Batch	No Batch	Branch
4	Cost accounting serves the information needs of _____________	Management	Financial	Marketing	Owners	Management
5	Cost accounting has been developed because of ____________ of financial accounting	Advantages	Limitations	Importance	Cost	Limitations
6	Management accounting is concerned with accounting information that is useful to -----	Financial	Cost	Management	Auditing	Management
7	__________accounting deals with monetary as well as non-monetary information	Cost	Financial	Management	Auditing	Management
8	Historical costing is also known as ___________	Uniform costing	Standard costing	Traditional costing	Job costing	Traditional costing
9	_______ is a technique / process of ascertaining cost	Costing	Cost	Cost accounting	Management accounting	Costing
10	________ is ascertainment of cost after they have been	Marginal costing	Historical costing	Direct costing	Indirect costing	Historical costing

	incurred.					
11	________ is used of same costing principle or practices by several undertaking for common control or comparison of costs	Uniform costing	Marginal costing	Standard costing	Job Costing	Uniform costing
12	__________ methods has been dropped from the latest CIMA terminology	Multiple costing	Farm costing	Operating costing	Job Costing	Farm costing
13	Cost accounting can be used only by ________ concerns	Big	Small	Big and Small	Trading	Big and Small
14	Many theories can be proved or disproved in the light of basic principles of __________	Cost accounting	Management accounting	Financial accounting.	Financial management	Financial accounting.
15	________ cost are those costs incurred to maintain the earning capacity of the firm	Capital	Revenue	Direct	Indirect	Capital
16	The chief objective of management accounting is to serve ---------	Public	Employees	Management	Government	Management
17	The term management accounting was first coined by the British team of accountants they visited the -----------	USA	China	India	Japan	USA
18	Management accounting involves---------	Recording of costs	Recording of transaction	Preparation of accounts	Analysis and interpretation of data	Analysis and interpretation of data
19	Management accounting is also known as ----	Cost accounting	Financial accounting	Corporate accounting	Decision accounting.	Decision accounting.
20	Management accounting functions are ------	Complementary in nature	Contradictory in nature	Neutral effect	Opposite effect	Complementary in nature
21	Management accounting provides valuable services to	Planning functions	Controlling functions	Co-ordinating functions	All managerial	All managerial functions.

	management in performing. -----				functions.	
22	Management accounting is ----------	An extension of financial accounting.	An extension of cost accounting.	An extension of auditing	An extension of cost accounting and Management accounting	An extension of cost accounting and Management accounting
23	Management accounting is concerned with formulation of _______ to meet enterprise objectives.	Plans	Cost	Purchase	Sales	Plans
24	Installation of management accounting is purely -------	Compulsory	Optional	Optimum	Fixed	Optional
25	The term of appointment of financial controller may be fixed by the ------------	Board of Directors	Articles of association	Memorandum of Association	Chairman	Board of Directors and Articles of Association
26	Financial accounting deals with -----------	Determination of costs	Determination of profits	Determination of prices	Determination of production	Determination of profits
27	The term management accounting was first used in the year -------------	1910	1939	1950	1970	1950
28	Preparation of financial accounts is compulsory for -------------	Sole trader business	Partnership firm	Joint stock companies	Co-operative socities	Joint stock companies
29	______is the oldest branch of accounting.	Management accounting	Cost accounting	Financial accounting	Corporate accounting.	Financial accounting
30	Management accounting also comprises the preparation of financial reports for non-management groups such as -----------	Shareholders	Creditors	Tax authorities	Tax authorities, Shareholders and Creditors	Tax authorities, Shareholders and Creditors
31	Management accounting and	Supplementary to	Complementary	Independent to	Opposite to	Complementary to

	cost accounting are ----------------	each other	to each other	each other	each other	each other
32	____ is also known as Management oriented accounting.	Management accounting	Cost accounting	Financial accounting	Corporate accounting	Management accounting
33	_____is concerned with accounting information which is useful to management in maximizing profits or minimizing losses.	Management accounting	Cost accounting	Financial accounting	Corporate accounting	Management accounting
34	The difference between the time booked to different jobs and delivery is called _______	Idle time	Cycle time	Gate time	Labour time	Idle time
35	_____ is the process and techniques of ascertaining costs.	Management accounting	Financial accounting	Cost accounting	Budgeting	Cost accounting
36	___________ is an important part of management accounting	Budgeting	Fixing standards	Inventory control	Interpretation of data	Interpretation of data
37	The primary objective of ________ is to enable the management to maximize or minimize losses	Cost accounting	Financial accounting	Management accounting	Auditing	Management accounting
38	The main objective of management accounting is to present _______ information to the management	Cost	Financial	Auditing	Sales	Financial
39	Management accounting makes ______ process more modern and scientific by providing significant information relating to various alternatives in terms of cost	Forecasting	Planning	Decision making	Budgeting	Decision making

	and Revenue					
40	Management accounting is a useful advice of managerial ____________	Planning	Control	Motivation	Forecasting	Control
41	Return on capital employed is one of the tools of _________	Financial accounting	Cost accounting	Corporate accounting	Management accounting	Management accounting
42	_____ of data are considered as back bone of management accounting	Modification of data	Analysis and interpretation	Communication	Co-ordination	Analysis and interpretation
43	Management accounting is an important medium of ______	Motivation	Co-ordination	Communication	Delegation	Communication
44	_____ supplies analytical information regarding various alternatives and the choice of management is made easy.	Financial accounting	Management accounting	Cost accounting	Corporate accounting	Management accounting
45	____ is the essence of managerial activity	Co-ordination	Control	Motivation	Decision making	Co-ordination
46	Incremental cost is a type of ____________	Differential cost	Out-of-pocket cost	Conversion cost	Factory	Differential cost
47	Fixed cost per unit increases when ___________	Production volume decreases	Production volume increases	Variable cost per unit decreases	Sales Increases	Production volume decreases
48	Opportunity cost helps in __________	Ascertainment of cost	Controlling cost	Making managerial decisions	Sales Decisions	Making managerial decisions
49	Closing stock are valued at cost price or market price whichever is less in ____________	Financial accounting	Cost accounting	Management accounting	Corporate Accounting	Financial accounting
50	Direct material+ Direct labour+ Direct expenses = __________	Fixed cost	Prime cost	Factory cost	Total cost	Prime cost
51	Salary of general manager is	Factory overhead	Administrative	Selling overhead	Distribution	Administrative

	generally treated as __________		overhead		overhead	overhead
52	________of any product comprises of all direct cost	Work cost	Prime cost	Total cost	Factory Cost	Prime cost
53	_________means and represents the factory cost plus administrative expenses	Prime cost	Work cost	Cost of production	Cost of sales	Cost of production
54	Indirect material + Indirect labour +___________ = Overhead	Indirect expenses	Direct labour	Direct expenses	Factory overhead	Indirect expenses
55	An example of sales overhead is _______	Office salaries	Advertisement expenses	Factory rent	Indirect material	Advertisement expenses
56	Prime cost = _____________	Direct material+direct labour+direct expenses	Direct material+labour direct expenses	Inmaterials +direct expenses	Inmaterials +Indirect expenses	Direct material+direct labour+direct expenses
57	Works cost = ________________	Prime cost+factory cost	Prime cost+Selling overhead	Prime cost+administrative overhead	Prime cost+ Selling overhead	Prime cost+factory cost
58	Cost of production = __________________	Work cost + factory cost	Work cost + prime cost	Work cost x prime cost	Work cost + administrative overhead	Work cost + administrative overhead
59	Total Cost = __________________	Cost of production+Selling and distribution expenses	Cost of sales+ distribution overhead	Cost of production + administrative overhead	Cost of sales	Cost of production+Selling and distribution expenses
60	The work cost is also known __________	factory cost	prime Cost	cost of production	cost of sales	factory cost

UNIT- V - Managerial Decision Making Techniques
SYLLABUS

Managerial Decision Making Techniques like

(a) Marginal costing – Cost volume profit analysis, BEP

(b) Budgetary control, Operating and Financial Budgets, Flexible Budgets.

(c) Standard Costing – Materials Cost and Labour cost variances only.

Marginal costing is a technique where only the variable costs are considered while computing the cost of a product. The fixed costs are met against the total fund arising out the excess of selling price over total variable cost. This fund is known as 'contribution' in marginal costing. According to the Chartered Institute of Management Accountants, London, marginal costing is a technique where 'only the variable costs are charged to cost units, the fixed costs attributable being written off in full against the contribution for that period'.

Marginal cost means change in cost which will be observed when Production is increased or decreased by one unit up to a certain level of Production. As fixed cost is fixed, change in cost will be equal to variable cost per unit. Thus from practical point of view, marginal cost is just equal to overall variable cost per unit. Where overall variable cost per unit is sum total of the followings1 :- (1) Prime cost per unit. (2) Variable overhead per unit (3) Variable Part of semi-variable overhead

Cost-Volume-Profit (CVP) Analysis is also known as Break–Even Analysis. Every business organization works to maximize its profits. With the help of CVP analysis, the management studies the co-relation of profit and the level of production.

CVP analysis is concerned with the level of activity where total sales equals the total cost and it is called as the break-even point. In other words, we study the sales value, cost and profit at different levels of production. CVP analysis highlights the relationship between the cost, the sales value, and the profit.

Assumptions

Let us go through the assumptions for CVP analysis:

- Variable costs remain variable and fixed costs remain static at every level of production.

- Sales volume does not affect the selling price of the product. We can assume the selling price as constant.
- At all level of sales, the volume, material, and labor costs remain constant.
- Efficiency and productivity remains unchanged at all the levels of sales volume.
- The sales-mix at all level of sales remains constant in a multi-product situation.
- The relevant factor which affects the cost and revenue is volume only.
- The volume of sales is equal to the volume of production.

Marginal Cost Equation

Equations for elements of cost are as follows:

Sales = Variable costs + Fixed Expenses ± Profit /Loss

Or

Sales – Variable Cost = Fixed Expenses ± Profit /Loss

Or

Sales – Variable Cost = Contribution

It is necessary to understand the following four concepts, their calculations, and applications to know the mathematical relation between cost, volume, and profit:

- Contribution
- Profit Volume Ratio (P/V Ratio or Contribution/Sales (C/S))
- Break-Even Point
- Margin of Safety

Contribution

Contribution = Sales – Marginal Cost

We have already discussed contribution in Marginal Costing topic above.

Profit-Volume Ratio

Profit / Volume (P/V) ratio is calculated while studying the profitability of operations of a business and to establish a relation between Sales and Contribution. It is one of the most important ratios, calculated as under:

$$P/V \text{ Ratio} = \frac{\text{Contribution}}{\text{Sales}}$$

$$= \frac{\text{Fixed Expenses+Profit}}{\text{Sales}}$$

$$= \frac{\text{Sales}-\text{Variable Cost}}{\text{Sales}}$$

$$= \frac{\text{Change in profits of Contributions}}{\text{Change in Sales}}$$

The P/V Ratio shares a direct relation with profits. Higher the P/V ratio, more the profit and vice-a-versa.

Break-Even Point

When the total cost of executing business equals to the total sales, it is called break-even point. Contribution equals to the fixed cost at this point. Here is a formula to calculate break-even point:

$$\text{B.E.P (in units)} = \frac{\text{Total Fixed Expenses}}{\text{Selling Price per Unit} - \text{Marginal Cost per Unit}}$$

$$= \frac{\text{Total Fixed Expenses}}{\text{Contribution per Unit}}$$

Break-even point based on total sales:

$$= \frac{\text{Fixed Cost}}{P/V \text{ Ratio}}$$

Calculation of output or sales value at which a desired profit is earned:

$$= \frac{\text{Fixed Expenses + Desired Profit}}{\text{Selling Price per Unit} - \text{Marginal Cost per Unit}}$$

$$= \frac{\text{Fixed Expenses + Desired Profit}}{\text{Contribution per Unit}}$$

COMPOSITE BREAK EVEN POINT

A company may have different production units, where they may produce the same product. In this case, the combined fixed cost of each productions unit and the combined total sales are taken into consideration to find out BEP.

- **Constant Product** - Mix Approach In this approach, the ratio is constant for the products of all production units.
- **Variable Product** - Mix Approach In this approach, the preference of products is based on bigger ratio.

Margin of Safety

Excess of sale at BEP is known as margin of safety. Therefore,

Margin of safety = Actual Sales − Sales at BEP

Margin of safety may be calculated with the help of the following formula:

Margin of Safety =

$$\frac{\text{Profit}}{\text{P/V Ratio}}$$

=

$$\frac{\text{Profit}}{\text{Contribution per Unit}}$$

Break-Even Chart

Break-Even Chart is the most useful graphical representation of marginal costing. It converts accounting data to a useful readable report. Estimated profits, losses, and costs can be determined at different levels of production. Let us take an example.

Example

Calculate break-even point and draw the break-even chart from the following data:

Fixed Cost = Rs 2,50,000
Variable Cost = Rs 15 per unit
Selling Price = Rs 25 per unit
Production level in units 12,000, 15,000, 20,000, 25,000, 30,000, and 40,000.

Solution:

B.E.P =

$$\frac{\text{Fixed Cost}}{\text{Contribution per unit}}$$

=

$$\frac{\text{Rs } 2{,}50{,}000}{\text{Rs } 10 \times (\text{Rs } 25 - \text{Rs } 15)}$$

= 25,000 units

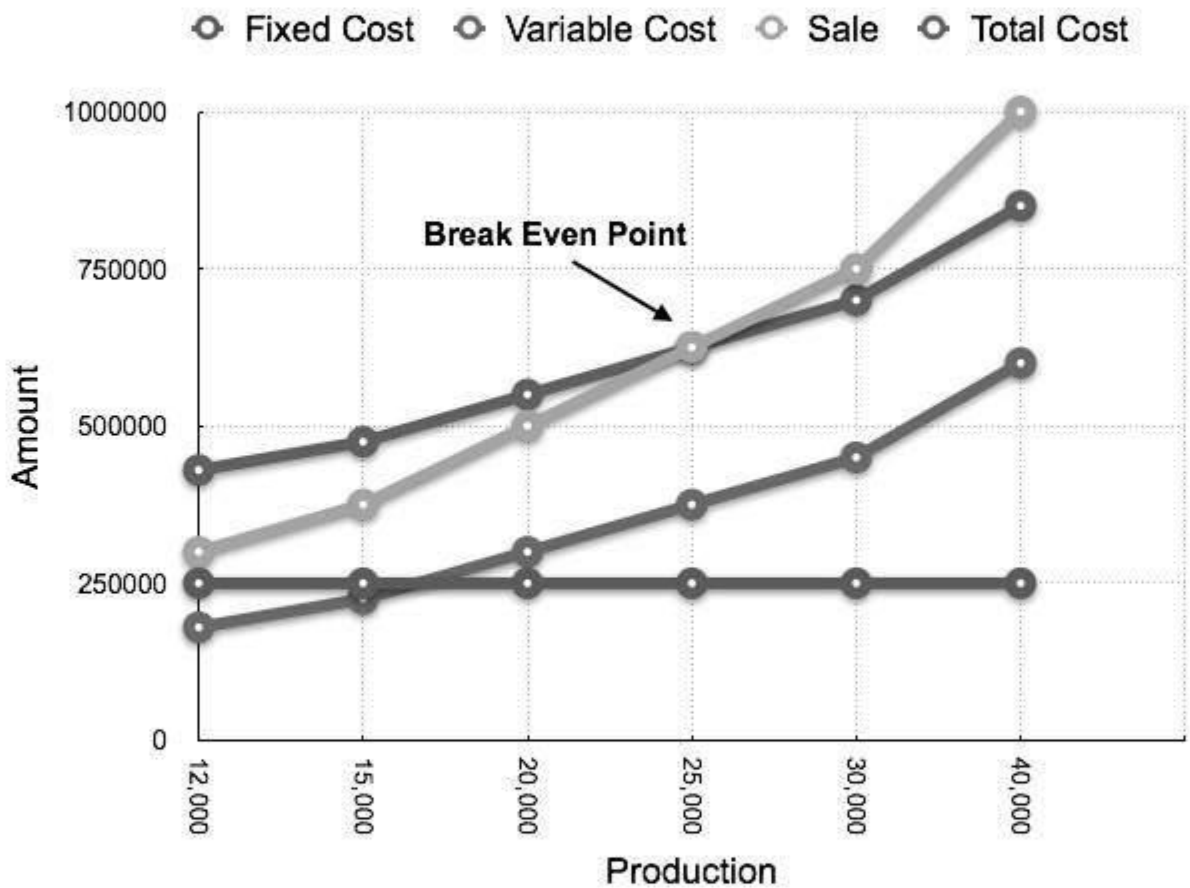
At production level of 25,000 units, the total cost will be Rs 6,25,000.

(Calculated as (25000 × 14) + 2,50000)

Statement showing Profit & Margin of safety at different level of production Break Even Sale = Rs 6,25,000 (25,000 x 25)

Production (In Units)	**Total Sale** (In Rs)	**Total Cost** (In Rs)	**Profit (Sales - Cost)** (In Rs)	**Margin of safety (Profit/Contribution per unit)** (In Units)
12000	3,00,000	4,30,000	-1,30,000	
15000	3,75,000	4,75,000	-1,00,000	
20000	5,00,000	5,50,000	-50,000	
25000	6,25,000	6,25,000	(B.E.P)	(B.E.P)
30000	7,50,000	7,00,000	50,000	5,000
40000	10,00,000	8,50,000	1,50,000	15,000

The corresponding chart plotted as production against amount appears as follows:



Budgetary control methods

a) **Budget:**

A formal statement of the financial resources set aside for carrying out specific activities in a given period of time.

It helps to co-ordinate the activities of the organisation.

An example would be an advertising budget or sales force budget.

b) Budgetary control:

A control technique whereby actual results are compared with budgets.

Any differences (variances) are made the responsibility of key individuals who can either exercise control action or revise the original budgets.

Budgetary control and responsibility centres;

These enable managers to monitor organisational functions.

A responsibility centre can be defined as any functional unit headed by a manager who is responsible for the activities of that unit.

There are four types of responsibility centres:

a) *Revenue centers*

Organisational units in which outputs are measured in monetary terms but are not directly compared to input costs.

b) *Expense centres*

Units where inputs are measured in monetary terms but outputs are not.

c) *Profit centres*

Where performance is measured by the difference between revenues (outputs) and expenditure (inputs). Inter-departmental sales are often made using "transfer prices".

d) *Investment centres*

Where outputs are compared with the assets employed in producing them, i.e. ROI.

Advantages of budgeting and budgetary control

There are a number of advantages to budgeting and budgetary control:

Compels management to think about the future, which is probably the most important feature of a budgetary planning and control system. Forces management to look ahead, to set out detailed plans for achieving the targets for each department, operation and (ideally) each manager, to anticipate and give the organisation purpose and direction.

Promotes coordination and communication.

Clearly defines areas of responsibility. Requires managers of budget centres to be made responsible for the achievement of budget targets for the operations under their personal control.

Provides a basis for performance appraisal (variance analysis). A budget is basically a yardstick against which actual performance is measured and assessed. Control is provided by comparisons of actual results against budget plan. Departures from budget can then be investigated and the reasons for the differences can be divided into controllable and non-controllable factors.

Enables remedial action to be taken as variances emerge.

Motivates employees by participating in the setting of budgets.

Improves the allocation of scarce resources.

Economises management time by using the management by exception principle.

Problems in budgeting

Whilst budgets may be an essential part of any marketing activity they do have a number of disadvantages, particularly in perception terms.

Budgets can be seen as pressure devices imposed by management, thus resulting in:
a) bad labour relations
b) inaccurate record-keeping.

Departmental conflict arises due to:

a) disputes over resource allocation
b) departments blaming each other if targets are not attained.

It is difficult to reconcile personal/individual and corporate goals.

Waste may arise as managers adopt the view, "we had better spend it or we will lose it". This is often coupled with "empire building" in order to enhance the prestige of a department.

Responsibility versus controlling, i.e. some costs are under the influence of more than one person, e.g. power costs.

Managers may overestimate costs so that they will not be blamed in the future should they overspend.

Characteristics of a budget

A good budget is characterised by the following:

Participation: involve as many people as possible in drawing up a budget.
Comprehensiveness: embrace the whole organisation.
Standards: base it on established standards of performance.
Flexibility: allow for changing circumstances.

Feedback: constantly monitor performance.
Analysis of costs and revenues: this can be done on the basis of product lines, departments or cost centres.

Budget organisation and administration:

In organising and administering a budget system the following characteristics may apply:

a) *Budget centres:* Units responsible for the preparation of budgets. A budget centre may encompass several cost centres.

b) *Budget committee:* This may consist of senior members of the organisation, e.g. departmental heads and executives (with the managing director as chairman). Every part of the organisation should be represented on the committee, so there should be a representative from sales, production, marketing and so on. Functions of the budget committee include:

- Coordination of the preparation of budgets, including the issue of a manual
- Issuing of timetables for preparation of budgets
- Provision of information to assist budget preparations
- Comparison of actual results with budget and investigation of variances.

c) *Budget Officer:* Controls the budget administration The job involves:

- liaising between the budget committee and managers responsible for budget preparation
- dealing with budgetary control problems
- ensuring that deadlines are met
- educating people about budgetary control.

d) *Budget manual:*

This document:

- charts the organisation
- details the budget procedures
- contains account codes for items of expenditure and revenue
- timetables the process
- clearly defines the responsibility of persons involved in the budgeting system.

Budget preparation

Firstly, determine the principal budget factor. This is also known as the key budget factor or limiting budget factor and is the factor which will limit the activities of an undertaking. This limits output, e.g. sales, material or labour.

a) Sales budget: this involves a realistic sales forecast. This is prepared in units of each product and also in sales value. Methods of sales forecasting include:

- sales force opinions
- market research
- statistical methods (correlation analysis and examination of trends)
- mathematical models.

In using these techniques consider:

- company's pricing policy
- general economic and political conditions
- changes in the population
- competition
- consumers' income and tastes
- advertising and other sales promotion techniques
- after sales service
- credit terms offered.

b) Production budget: expressed in quantitative terms only and is geared to the sales budget. The production manager's duties include:

- analysis of plant utilisation
- work-in-progress budgets.

If requirements exceed capacity he may:

- subcontract
- plan for overtime
- introduce shift work
- hire or buy additional machinery
- The materials purchases budget's both quantitative and financial.

c) Raw materials and purchasing budget:

- The materials usage budget is in quantities.
- The materials purchases budget is both quantitative and financial.

Factors influencing a) and b) include:

- production requirements
- planning stock levels
- storage space
- trends of material prices.

d) Labour budget: is both quantitative and financial. This is influenced by:

- production requirements
- man-hours available
- grades of labour required
- wage rates (union agreements)
- the need for incentives.

e) Cash budget: a cash plan for a defined period of time. It summarises monthly receipts and payments. Hence, it highlights monthly surpluses and deficits of actual cash. Its main uses are:

- to maintain control over a firm's cash requirements, e.g. stock and debtors

- to enable a firm to take precautionary measures and arrange in advance for investment and loan facilities whenever cash surpluses or deficits arises

- to show the feasibility of management's plans in cash terms

- to illustrate the financial impact of changes in management policy, e.g. change of credit terms offered to customers.

Receipts of cash may come from one of the following:

- cash sales
- payments by debtors
- the sale of fixed assets
- the issue of new shares
- the receipt of interest and dividends from investments.

Payments of cash may be for one or more of the following:

- purchase of stocks
- payments of wages or other expenses
- purchase of capital items
- payment of interest, dividends or taxation.

Steps in preparing a cash budget

i) Step 1: set out a pro forma cash budget month by month. Below is a suggested layout.

	Month 1	**Month 2**	**Month 3**
	$	**$**	**$**
Cash receipts			

Receipts from debtors
Sales of capital items
Loans received
Proceeds from share issues
Any other cash receipts
Cash payments
Payments to creditors
Wages and salaries
Loan repayments
Capital expenditure
Taxation
Dividends
Any other cash expenditure
Receipts less payments

Opening cash balance b/f	W	X	Y
Closing cash balance c/f	X	Y	Z

ii) Step 2: sort out cash receipts from debtors

iii) Step 3: other income

iv) Step 4: sort out cash payments to suppliers

v) Step 5: establish other cash payments in the month

Figure 4.1 shows the composition of a master budget analysis.

Figure 4.1 Composition of a master budget

OPERATING BUDGET	**FINANCIAL BUDGET**
consists of:-	consists of
Budget P/L acc: get:	Cash budget
Production budget	Balance sheet
Materials budget	Funds statement
Labour budget	
Admin. budget	
Stocks budget	

f) Other budgets:

These include budgets for:

- administration
- research and development
- selling and distribution expenses
- capital expenditures
- working capital (debtors and creditors).

The master budget (figure 4.1) illustrates this. Now attempt exercise 4.1.

Exercise 4.1 Budgeting I

Draw up a cash budget for *D. Sithole* showing the balance at the end of each month, from the following information provided by her for the six months ended 31 December 19X2.

a) Opening Cash $ 1,200.

					19X2						19X3	
Sales at $20 per unit	**MAR**	**APR**	**MAY**	**JUN**	**JUL**	**AUG**	**SEP**	**OCT**	**NOV**	**DEC**	**JAN**	**FEB**
	260	200	320	290	400	300	350	400	390	400	260	250

Cash is received for sales after 3 months following the sales.

c) Production in units: 240 270 300 320 350 370 380 340 310 260 250

d) Raw materials cost $5/unit. Of this 80% is paid in the month of production and 20% after production.

e) Direct labour costs of $8/unit are payable in the month of production.

f) Variable expenses are $2/unit. Of this 50% is paid in the same month as production and 50% in the month following production.

g) Fixed expenses are $400/month payable each month.

h) Machinery costing $2,000 to be paid for in October 19X2.

i) Will receive a legacy of $ 2,500 in December 19X2.

j) Drawings to be $300/month.

An example

A sugar cane farm in the Lowveld district may devise an operating budget as follows:

- Cultivation
- Irrigation
- Field maintenance
- Harvesting
- Transportation.

With each operation, there will be costs for labour, materials and machinery usage. Therefore, for e.g. harvesting, these may include four resources, namely:

- Labour:

-cutting
-sundry

- Tractors
- Cane trailers
- Implements and sundries.

Having identified cost centres, the next step will be to make a quantitative calculation of the resources to be used, and to further break this down to shorter periods, say, one month or three months. The length of period chosen is important in that the shorter it is, the greater the control that can be exercised by the budget but the greater the expense in preparation of the budget and reporting of any variances.

Variance Analysis: Material, Labour, Overhead and Sales Variances!

The function of standards in cost accounting is to reveal variances between standard costs which are allowed and actual costs which have been recorded. The Chartered Institute of Management Accountants (UK) defines variances as the difference between a standard cost and the comparable actual cost incurred during a period. Variance analysis can be defined as the process of computing the amount of, and isolating the cause of variances between actual costs and standard costs. Variance analysis involves two phases:

(1) Computation of individual variances, and

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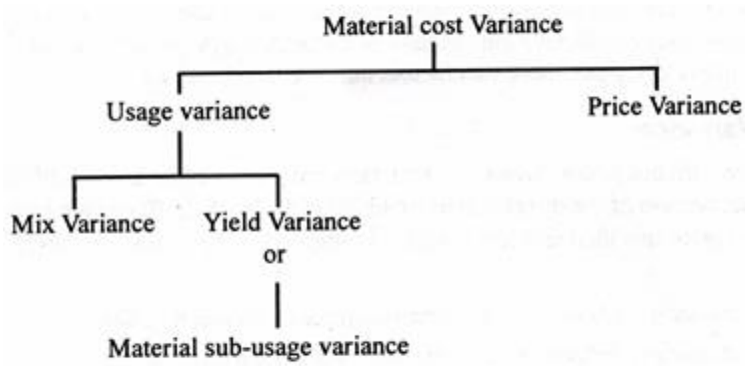
(2) Determination of Cause (s) of each variance.

We now turn to explain below the computation of material, labour and factory overhead variances:

I. Material Variance:

The following variances constitute materials variances:



Material Cost Variance:

Material cost variance is the difference between the actual cost of direct material used and standard cost of direct materials specified for the output achieved. This variance results from differences between quantities consumed and quantities of materials allowed for production and from differences between prices paid and prices predetermined.

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This can be computed by using the following formula:

Material cost variance = (AQ X AP) – (SQ X SP)

Where AQ = Actual quantity

AP = Actual price

SQ = Standard quantity for the actual output

SP = Standard price

Material Usage Variance:

The material quantity or usage variance results when actual quantities of raw materials used in production differ from standard quantities that should have been used to produce the output achieved. It is that portion of the direct materials cost variance which is due to the difference between the actual quantity used and standard quantity specified.

As a formula, this variance is shown as:

Materials quantity variance = (Actual Quantity – Standard Quantity) x Standard Price

A material usage variance is favourable when the total actual quantity of direct materials used is less than the total standard quantity allowed for the actual output.

Example:

Compute the materials usage variance from the following information:

Standard material cost per unit Materials issued

Material A — 2 pieces @ Rs. 10=20 (Material A 2,050 pieces)

Material B — 3 pieces @ Rs. 20 =60 (Material B 2,980 pieces)

Total = 80

Units completed 1,000

Solution:

Material usage variance = (Actual Quantity – Standard Quantity) x Standard Price

Material A = (2,050 – 2,000) x Rs. 10 = Rs. 500 (unfavourable)

Material B = (2980 – 3000) x Rs. 20 = Rs. 400 (favourable)

Total = Rs. 100 (unfavourable)

It should be noted that the standard rather than the actual price is used in computing the usage variance. Use of an actual price would have introduced a price factor into a quantity variance. Because different departments are responsible, these two factors must be kept separate.

(a) Material Mix Variance:

The materials usage or quantity variance can be separated into mix variance and yield variance.

For certain products and processing operations, material mix is an important operating variable, specific grades of materials and quantity are determined before production begins. A mix variance will result when materials are not actually placed into production in the same ratio as the standard formula. For instance, if a product is produced by adding 100 kg of raw material A and 200 kg of raw material B, the standard material mix ratio is 1: 2.

Actual raw materials used must be in this 1: 2 ratio, otherwise a materials mix variance will be found. Material mix variance is usually found in industries, such as textiles, rubber and chemicals, etc. A mix variance may arise because of attempts to achieve cost savings, effective resources utilisation and when the needed raw materials quantities may not be available at the required time.

Materials mix variance is that portion of the materials quantity variance which is due to the difference between the actual composition of a mixture and the standard mixture.

It can be computed by using the following formula:
Material mix variance = (Standard cost of actual quantity of the actual mixture – Standard cost of actual quantity of the standard mixture)

Or

Materials mix variance = (Actual mix – Revised standard mix of actual input) x Standard price

Revised standard mix or proportion is calculated as follows:

Standard mix of a particular material/Total standard quantity x Actual input

Example:

A product is made from two raw materials, material A and material B. One unit of finished product requires 10 kg of material.

The following is standard mix:

Material A –	20% –	2 kg @ ₹ 20	=	₹ 40
Material B –	80% –	8 kg @ ₹ 10	=	₹ 80
	100% –	10 kg @ ₹ 12	=	₹ 120

During a period one unit of product was produced at the following costs:

Material A –	8 kg @ ₹ 20	=	₹ 160
Material B –	4 kg @ ₹ 12.5	=	₹ 50
	12 kg @ ₹ 17.5	=	₹ 210

Compute the materials mix variance.

Solution:

Material mix variance = (Actual proportion – Revised standard proportion of actual input) x Standard price.

Revised standard proportion =

$$\frac{\text{Standard proportion of a particular mix}}{\text{Total standard quantity}} \times \text{Actual input}$$

Revised standard proportion:

Material A = 2/10 × 12 = 2.40 kg.

Material B = 8/10 × 12 = 9.60 kg.

Materials mix variance:

Material A = (8 kg – 2.40 kg) × 20

= 5.60 × 20 = ₹ 112.0 (unfavourable)

Material B = (4 kg – 9.60) × 1.00

= 5.60 × 10 = ₹ 56 (favourable)

Total mix variance = ₹ 56 (unfavourable)

(b) Materials Yield Variance:

Materials yield variance explains the remaining portion of the total materials quantity variance. It is that portion of materials usage variance which is due to the difference between the actual yield obtained and standard yield specified (in terms of actual inputs). In other words, yield variance occurs when the output of the final product does not correspond with the output that could have been obtained by using the actual inputs. In some industries like sugar, chemicals, steel, etc. actual yield may differ from expected yield based on actual input resulting into yield variance.

The total of materials mix variance and materials yield variance equals materials quantity or usage variance. When there is no materials mix variance, the materials yield variance equals the total materials quantity variance. Accordingly, mix and yield variances explain distinct parts of the total materials usage variance and are additive.

The formula for computing yield variance is as follows:

Yield Variance = (Actual yield – Standard Yield specified) x Standard cost per unit

Example:

Standard input = 100 kg, standard yield = 90 kg, standard cost per kg of output = Rs 200

Actual input 200 kg, actual yield 182 kg. Compute the yield variance.

Solution:

Standard yield for the actual input = $\frac{90}{100} \times 200 = 180$ kg

Yield variance = (Actual yield – Standard yield for the actual input) × Standard cost per unit (per kg)

= 182 – 180 × ₹ 200

= 2 × 200 = ₹ 400 (favourable)

The above yield variance can be computed by using another formula also, e.g.,

Yield Variance = (Actual Loss–Standard Loss on Actual Input)×Standard Cost per unit

= (18 kg – 20 kg) × ₹ 200

= ₹ 400 (favourable)

In this example, there is no mix variance and therefore, the materials usage variance will be equal to the materials yield variance.

The above formula uses output or loss as the basis of computing the yield variance. Yield variance can also be computed on the basis of input factors only. The fact is that loss in inputs equals loss in output. A lower yield simply means that a higher quantity of inputs have been used and the anticipated or standard output (based on actual inputs) has not been achieved.

Yield, in such a case, is known as sub-usage variance (or revised usage variance) which can be computed by using the following formula:

Sub-usage or revised usage variance = (Revised Standard Proportion of Actual Input – Standard quantity) x Standard Cost per unit of input

Example:

Standard material and standard price for manufacturing one unit of a product is given below:

	Standard material	Standard price
Material A	5 kg	@ ₹ 40
Material B	3 kg	@ ₹ 60

The actual production of the product is 400 units.

The actual material A 2,500 kg @ ₹ 39

B 1,000 kg @ ₹ 62.5

Calculate the materials sub-usage variance.

Solution:

Revised standard proportion of actual input:

Material A = 5/8 × 3,500 = 2,187.5 kg

Material B = 3/8 × 3,500 = 1,312.5 kg

Material sub-usage variance:

(Revised standard proportion of actual input – Standard quantity) × SP

Material A = (2,187.5 – 2,000) × 40

= 187.5 × 40 = ₹ 7,500 (unfavourable)

Material B = (1,312.5 – 1,200) × 60

= 112.5 × 60 = ₹ 6,750 (unfavourable)

Total materials sub-usage variance = ₹ 14,250 (unfavourable)

Or

$$(3{,}500 - 3{,}200) \times \frac{₹\ 1{,}52{,}000}{3{,}200}$$

$$= 300 \times \frac{1{,}52{,}000}{3{,}200} = ₹\ 41{,}250 \text{ (unfavourable)}$$

Materials yield variance always equal sub-usage variance. The difference lies only in terms of calculation. The former considers the output or loss in output and the latter considers standard inputs and actual input used for the actual output. Mix and yield variance both provide useful information for production control, performance evaluation and review of operating efficiency.

Materials Price Variance:

A materials price variance occurs when raw materials are purchased at a price different from standard price. It is that portion of the direct materials which is due to the difference between actual price paid and standard price specified and cost variance multiplied by the actual quantity. Expressed as a formula, Materials price variance = (Actual price – Standard price) x Actual quantity

Materials price variance is un-favourable when the actual price paid exceeds the predetermined standard price. It is advisable that materials price variance should be calculated for materials purchased rather than materials used. Purchase of materials is an earlier event than the use of materials.

Therefore, a variance based on quantity purchased is basically an earlier report than a variance based on quantity actually used. This is quite beneficial from the viewpoint of performance measurement and corrective action. An early report will help the management in measuring the performance so that poor performance can be corrected or good performance can be expanded at an early date.

Recognizing material price variances at the time of purchase lets the firm carry all units of the same materials at one price—the standard cost of the material, even if the firm did not purchase all units of the materials at the same price. Using one price for the same materials facilities management control and simplifies accounting work.

If a direct materials price variance is not recorded until the materials are issued to production, the direct materials are carried on the books at their actual purchase prices. Deviations of actual purchase prices from the standard price may not be known until the direct materials are issued to production.

Example:

Assuming in Example 1 that material A was purchased at the rate of Rs 10 and material B was purchased at the rate of Rs 21, the material price variance will be as follows:

Materials price variance = (Actual Price – Standard Price) x Actual Quantity

Material A = (10 – 10) x 2,050 = Zero

Material B = (21 – 20) x 2,980 = 2980 (un-favourable)

Total material price variance = Rs 2980 (un-favourable)

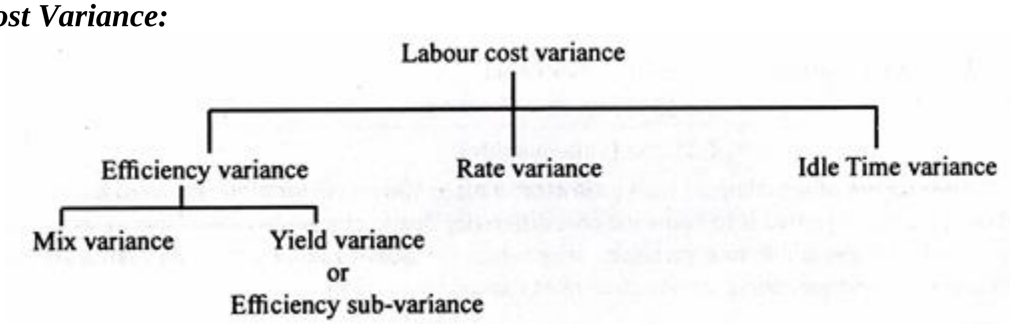
The total of materials usage variance and price variance is equal to materials cost variance.

II. Labour Variances:

Direct labour variances arise when actual labour costs are different from standard labour costs. In analysis of labour costs, the emphasis is on labour rates and labour hours.

Labour variances constitute the following:

Labour Cost Variance:



Labour cost variance denotes the difference between the actual direct wages paid and the standard direct wages specified for the output achieved.

This variance is calculated by using the following formula:

Labour cost variance = (AH x AR) – (SH x SR)

Where:

AH = Actual hours

AR = Actual rate

SH = Standard hours

SR = Standard rate

1. Labour Efficiency Variance:

The calculation of labour efficiency or usage variance follows the same pattern as the computation of materials usage variance. Labour efficiency variance occurs when labour operations are more efficient or less efficient than standard performance. If actual direct labour hours required to complete a job differ from the number of standard hours specified, a labour efficiency variance results; it is the difference between actual hours expended and standard labour hours specified multiplied by the standard labour rate per hour.

Labour efficiency variance is computed by applying the following formula:

Labour efficiency variance = (Actual hours – Standard hours for the actual output) x Std. rate per hour.

Assume the following data:

Standard labour hour per unit = 5 hr

Standard labour rate per hour = Rs 30

Units completed = 1,000

Labour cost recorded = 5,050 hrs @ Rs 35

Labour efficiency variance = (5,050-5,000) x Rs 30 = Rs 1,500 (unfavourable) It may be noted that the standard labour hour rate and not the actual rate is used in computing labour efficiency variance. If quantity variances are calculated, changes in prices/rates are excluded, and when price variances are calculated, standard quantities are ignored.

(i) Labour Mix Variance:

Labour mix variance is computed in the same manner as materials mix variance. Manufacturing or completing a job requires different types or grades of workers and production will be complete if labour is mixed according to standard proportion. Standard labour mix may not be adhered to under some circumstances and substitution will have to be made. There may be changes in the wage rates of some workers; there may be a need to use more skilled or expensive types of labour, e.g., employment of men instead of women; sometimes workers and operators may be absent.

These lead to the emergence of a labour mix variance which is calculated by using the following formula:

Labour mix variance = (Actual labour mix – Revised standard labour mix in terms of actual total hours) x Standard rate per hour

To take an example, suppose the following were the standard labour cost data per unit in a factory:

Class	Proportion				
A	50%	3 hours @	₹ 40	=	₹ 120
B	50%	3 hours @	₹ 20	=	₹ 60
	100%	6 hours	₹ 30		₹ 180

In a period, many class B workers were absent and it was necessary to substitute class B workers. Since the class A workers were less experienced with the job, more labour hours were used.

The recorded costs of a unit were:

Class	Proportion			Costs
A	75%	6 hours @	₹ 40	₹ 240
B	25%	2 hours @	₹ 20	₹ 40
	100%	8 hours	₹ 35	₹ 280

Labour mix variance will be calculated as follows:

Labour mix variance = (Actual proportion – Revised standard proportion of actual total hours) x standard rate per hour

Revised standard proportion:

$$\text{Class A} = \frac{3}{6} \times 8 = 4 \text{ hours}$$

$$\text{Class B} = \frac{3}{6} \times 8 = 4 \text{ hours}$$

Applying the formula:

Class A = (6 – 4) × ₹ 40 = 80 (unfavourable)

Class B = (2 – 4) × ₹ 20 = ₹ 40 (favourable)

Total labour mix variance = ₹ 40 (unfavourable)

(ii) Labour Yield Variance:

The final product cost contains not only material cost but also labour cost. Therefore, gain or loss (higher or lower output than the standard output) should take into account labour yield variance also. A lower output simply means that final output does not correspond with the production units that should have been produced from the hours expended on the inputs.

It can be computed by applying the following formula:

Labour yield variance = (Actual output – Standard output based on actual hours) x Av. Std. Labour Rate per unit of output.

Or

Labour yield variance = (Actual loss – Standard loss on actual hours) x Average standard labour rate per unit of output

Labour yield variance is also known as labour efficiency sub-variance which is computed in terms of inputs, i.e., standard labour hours and revised labour hours mix (in terms of actual hours).

Labour efficiency sub-variance is computed by using the following formula:

Labour efficiency sub-variance = (Revised standard mix – standard mix) x Standard rate

2. Labour Rate Variance:

Labour rate variance is computed in the same manner as materials price variance. When actual direct labour hour rates differ from standard rates, the result is a labour rate variance. It is that portion of the direct wages variance which is due to the difference between actual rate paid and standard rate of pay specified.

The formula for its calculation is:

Labour rate variance = (Actual rate – Standard rate) x Actual hours

Using data from the example given above, the labour rate variance is Rs 25,250, i.e.,

Labour rate variance = (35 – 30) x 5050 hours = 5 x 5050 = Rs 25,250 (unfavourable)

The number of actual hours worked is used in place of the number of the standard hours specified because the objective is to know the cost difference due to change in labour hour rates, and not hours worked. Favourable rate variances arise whenever actual rates are less than standard rates; unfavourable variances occur when actual rates exceed standard rates.

3. Idle Time Variance:

Idle time variance occurs when workers are not able to do the work due to some reason during the hours for which they are paid. Idle time can be divided according to causes responsible for creating idle time, e.g., idle time due to breakdown, lack of materials or power failures. Idle time variance will be equivalent to the standard labour cost of the hours during which no work has been done but for which workers have been paid for unproductive time.

Suppose, in a factory 2,000 workers were idle because of a power failure. As a result of this, a loss of production of 4,000 units of product A and 8,000 units of product B occurred. Each employee was paid his normal wage (a rate of? 20 per hour). A single standard hour is needed to manufacture four units of product A and eight units of product B.

Idle time variance will be computed in the following manner:

Standard hours lost:

Product A = 4, 000/ 4 = 1,000 hr.

Product B = 8, 000 / 8 = 1,000 hr.

Total hours lost = 2,000 hr.

Idle time variance (power failure)

2,000 hours @ Rs 20 per hour = Rs 40,000 (Adverse)

Part A (ONE Mark)

Multiple Choice Questions

Online Examination

) Marginal costing – Cost volume profit analysis, BEP

(b) Budgetary control, Operating and Financial Budgets, Flexible Budgets.

(c) Standard Costing – Materials Cost and Labour cost variances only.

Part B

(2 Marks)

1. Define Marginal Costing
2. List out the methods of Cost volume profit analysis?
3. What do you mean by BEP?
4. Write a short note on budgetary control
5. What do you mean operating budget?
6. What is financial budget?
7. Define standard costing
8. How does material cost variance affect labour cost variance
9. Write a short note flexible budget
10. List out the methods of marginal costing.

Part C (8 Marks)

1. Elaborate the various basis of classification of cost and various types of cost?
2. From the following particulars of a manufacturing firm, prepare a statement of cost

Stock of materials on January 1, 1996	20,000
Purchases of raw materials in January, 2016	5,50,000
Stock of finished goods on January, 1 2016	25,000
Productive wages	2,50,000
Finished goods sold	12,00,000
Works overhead charges	75,000
Office and general expenses	50,000

Stock of materials on 31st January, 2016	70,000
Stock of finished goods on 31st January, 2016	30,000

3. Elaborate the steps to followed in Preparation of Cost Sheet?

4. Describe the different methods of costing and state the particular industries to which they can be applied?

5. Describe the concept of accounting treatment of under and over absorption

6. Explain the elements of costing with suitable examples.

7. From the following particulars of a manufacturing firm, prepare a statement of cost

	Rs.
Stock of materials on January 1, 1996	20,000
Purchases of raw materials in January, 2016	5,50,000
Stock of finished goods on January, 1 2016	25,000
Productive wages	2,50,000
Finished goods sold	12,00,000
Works overhead charges	75,000
Office and general expenses	50,000
Stock of materials on 31st January, 2016	70,000
Stock of finished goods on 31st January, 2016	30,000

8. Explain the cost Accounting Systems with suitable examples?
9. Identifying the overheads with cost center to allocation of expenses.
10. Explain the concept of Activity Based Costing

Part D (11 Marks)

Mr. X furnishes the following data relating to the manufacture of a standard product during the month of April 2016

Raw materials consumed	60, 000
Direct labour charges	36,000
Machine hours worked	3,600
Machine hour rate	Rs. 5.00
Administrative overheads	20% on works cost
Selling Overheads	Re.1.00 per unit

Units produced	10,000
Unit sold	9,000 at Rs. 20 per unit

Prepare a cost sheet from the above information

a) Cost per unit

b) Profit per unit sold and profit for the period

UNIT 5

S.No	Question	Option - I	Option - II	Option - III	Option - IV	Answer
1	_______ is a cost management tool for reducing the overall cost of a product	Target Costing	Job Costing	Batch Costing	Marginal Costing	Target Costing
2	_________ records costs more accurately and facilitates cost control	Target Costing	Job Order Costing	Batch Costing	Marginal Costing	Job Order Costing
3	PV ratio = ___________	fixed cost perunit / Selling price per unit	Contribution perunit / profit per unit	Contribution perunit / Selling price per unit	Variable cost / Selling price per unit	Contribution perunit / Selling price per unit
4	Target costing which has been widely used by ______ firms since 1970's	Japanese	Germany	Britain	USA	Japanese
5	_____ has become an essential tool of management for controlling costs and maximizing profit	Cost control	Budgetary control	Cost reduction	Raw material control	Budgetary control
6	________ allows the profitability of a product to be determined before it is produced	Target Costing	Job Costing	Batch Costing	Marginal Costing	Target Costing
7	Break even analysis is a widely used technique to study _________ relationship	Cost volume profit	Profit and cost	Job Costing and Batch Costing	Target cost and Marginal Cost	Job Costing and Batch Costing

8	Costs are accumulated for each process for a job is called _____ costing	Target Costing	Job Costing	Batch Costing	Marginal Costing	Job Costing
9	_______ means the amount at any given volume of output by which aggregate costs are changed if the volume of output is increased by one unit	Batch Costing	Target Costing	Marginal cost	Job Costing	Marginal cost
10	Target costing has ______ processes.	8	4	3	7	4
11	______ is the first process in Target costing	Define the product	Set the target	Achieve the target	Maintain competitive cost	Define the product
12	_______ is the second process in Target costing	Define the product	Set the target	Achieve the target	Maintain competitive cost	Set the target
13	_______ is the third process in Target costing	Define the product	Set the target	Achieve the target	Maintain competitive cost	Achieve the target
14	_______ is the fourth process in Target costing	Define the product	Set the target	Achieve the target	Maintain competitive cost	Maintain competitive cost
15	Target costing = ________	sales-total cost	Anticipated selling price - desired profit	Anticipated selling price + desired profit	Sales - Fixed cost	Anticipated selling price - desired profit
16	Procurement and production costing technique that considers all _________	Target cost	Life cycle cost	Product cost	Job cost	Life cycle cost
17	________ aims to	Target cost	Life cycle cost	Product cost	Contract Costing	Life cycle cost

	determine the loweset cost of ownership of a fixed asset					
18	Loss caused due to plant break down is termed as _________	Normal Loss	Process Loss	Abnormal Process Loss	Production Loss	Abnormal Process Loss
19	__________ is the form of specific order costing which applies to where the work is undertaken according to customers requirements	Target cost	Life cycle cost	Product cost	Contract Costing	Contract Costing
20	Life cycle begins with ______________	Introduction of new product	Maturity	Growth	Decline	Introduction of new product
21	The second stage of life cycle cost is _________	Decline	Growth	Maturity	Introduction of new product	Growth
22	Predetermination of costing is known as ______	Standard cost	Life cycle cost	Product cost	Job cost	Standard cost
23	The fourth stage of life cycle cost is _________	Introduction of new product	Maturity	Growth	Decline	Decline
24	______ is a conceptual representation	Product life cycle	ABC	Transfer price	Target cost	Product life cycle
25	To set a target cost for the products through the use of ____________	VED Analysis	Value Engineering	Transfer price	Desired profit	Value Engineering
26	Target cost can be attained at the production stage by use of __________	Job cost	Batch cost	Standard cost	Unit cost	Standard cost
27	Target cost = Anticipated selling price - _______	Profit	Loss	Desired profit	Desired Loss	Desired profit
28	Target cost = _______	Profit	Loss	Anticipated selling	Desired Loss	Anticipated selling

	minus Desired profit			price		price
29	_____ cost is the total of costs incurred in operation of a business undertaking other than the cost of manufacturing and production	Prime	Commercial	Factory	Administrative	Commercial
30	______ cost is an irrecoverable cost	Total	Sunk	Operation	Process	Sunk
31	____ cost is the cost of replacing a material or as set in current market	Total	Replacement	Policy	Shutdown	Replacement
32	Abnormal gain should reduce the normal loss and balance is transferred to costing _______ account	Profit and Loss	Revenue	Income	Balance sheet	Profit and Loss
33	The method of costing applied in steel industries is ____ costing	Operating	Process	Batch	Contract	Process
34	When actual loss is more than the estimated loss, the difference between the two is considered as _____ loss	Normal	Abnormal	Standard	Fixed	Abnormal
35	_______ is a form of specific order costing	Job cost	Batch cost	Standard cost	Unit cost	Batch cost
36	When 1000 units are 60% complete in a process, it is equivalent	600	400	60	6	600

	to ____ completed units.					
37	Equivalent unit represent the production of a process in terms of ___ units	Incompleted	Completed	Standard	Fixed	Completed
38	In each process, an estimate is made of the degree of completion of _____ in terms of percentage	Finished Products	Estimated Products	Standard Products	Work-in-progress	Work-in-progress
39	Scrap value of _____ is deducted from the material cost	Normal Loss	Abnormal Loss	Abnormal Gain	Norma Gain	Normal Loss
40	______ process loss should be transferred to costing profit and loss account	Abnormal	Normal	Actual	standard	Normal
41	Where actual loss in a process is less than the anticipated loss, the difference between the two is considered to be ____	Normal gain	Abnormal gain	Normal loss	Abnormal loss	Abnormal gain
42	The normal process loss represents the loss would be expected under _____ conditions	Normal	Abnormal	Standard	Contingency	Normal
43	______ costing mainly deals with continuous type of production	Job	Contract	Process	Unit	Process
44	Units of abnormal gain are represented by ___	Work-in-progress	Finished Product	Materials	Goods	Finished Product

45	Costs are accumulated for each process for a period in ______ costing	Process	Unit	Batch	Job	Process
46	____ cost drivers are structural and executional in nature	Economic	Political	Organizational	Social	Organizational
47	____ cost drivers are those determinants of a firm's cost position the hinge on its ability to execute successfully	Executional	Structural	Organizational	Transport	Executional
48	_____ aims at reducing inefficiencies and wastages and setting up determined costs and in achieving them	Cost Control	Planning	Scheduling	Cost control and scheduling	Cost Control
49	Profit can be maximized by reducing _______	Sales	Cost	Production	Productivity	Cost
50	____ aims an improvement of human efforts	Cost Reduction	Cost Control	Planning	Scheduling	Cost Reduction
51	CPU - ______________	Cost Per Unit	Central processing Unit	Control Production Unit	Control per Unit	Cost Per Unit
52	WIP - ____________	Waste in Product	Work In Progress	Work in production	Work internal Product	Work In Progress
53	__________ refers to a conversion of part completed units into equivalent number of wholly completed units	Production	Productivity	Equivalent units	Units	Equivalent units
54	__________ refers to the cost incurred by a business when	Total cost	Production cost	Fixed cost	Variable cost	Production cost

	manufacturing a goods or providing services					
55	Production cost are classified into __________	4	3	2	7	2
56	Implicit cost is also known as _________	Explicit cost	Fixed cost	Historical cost	Opportunity cost	Opportunity cost
57	__________ is total variable cost divided by output	Average variable cost	Average total cost	Average cost	Average fixed cost	Average variable cost
58	______ is total fixed cost divided by output	Average variable cost	Average total cost	Average cost	Average fixed cost	Average fixed cost
59	______ is an example for direct cost	Salary	Wages	Advertising	Stationery	Wages
60	________ is an example for indirect cost	Wages	Carriage inwards	Power	Salary	Salary