

LECTURE NOTES

ON

ACCOUNTING FOR MANAGERS

2018 – 2019

I M.B.A I Semester

Ms. K YAMUNA, Assistant Professor



CHADALAWADA RAMANAMMA ENGINEERING COLLEGE

(AUTONOMOUS)

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Department of Management Studies



CHADALAWADA RAMANAMMA ENGINEERING COLLEGE, TIRUPATI

Day/Time	1 09:30 10:20	2 10:20 11:10	3 11:10 12:00	4 12:00 12:50	5 01:30 02:20	6 02:20 03:10	7 03:10 04:00
Monday							
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Thursday							
Friday							
Saturday							

(AUTONOMOUS)

DEPARTMENT OF MANAGEMENT STUDIES

*- SEMINAR

M.B.A. I year First Semester, Academic Year: 2018-19

Course Name	:	ACCOUNTING FOR MANAGERS (17CE00103)
Course Coordinator	:	
L – T – P	:	4 – 0 – 0
Course Instructor	:	Ms. K YAMUNA

SYLLABUS

Unit – I	Introduction to accounting	Classes: 14
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Introduction to Accounting: Need and Types of Accounting, Users of Accounting, concepts and conventions of Accounting, Accounting Equation (problems on accounting equation), Generally Accepted Accounting Principles (GAAP).

Preparation of books of Accounts: Journals, Subsidiary books, three column cash book, ledgers and trial balance. Depreciation- Straight line and Written down Value Methods.

Unit – II	Preparation of financial statements	Classes: 13
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Preparation of Financial Statements: Final Accounts: Meaning, Features, Uses and Preparation of Trading Account, Statement of Profit and Loss and Balance Sheet – Adjusting and Closing Entries. (Basic problems on Final accounts of companies)

Rectification of Errors: Types of Errors – Rectification of Errors before and after Preparations of Trial balance.

Unit - III	Analysis of financial statements	Classes: 14
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Analysis of Financial Statements I: Ratio Analysis- solvency ratios, profitability ratios, activity ratios, liquidity ratios, market capitalization ratios; Common Size Statement; Comparative Balance Sheet and Trend Analysis.

Bank Reconciliation Statement – Need – Reasons for Difference between Cash Book and Pass Book Balances – Problems on Favourable and Overdraft Balances.

Unit – IV	Analysis of financial statements	Classes: 14
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Analysis of Financial Statements II: *Funds Flow Statement:* Meaning, Concept of Gross and Net Working Capital, Preparation of Schedule of Changes in Working Capital, Preparation of Funds Flow Statement and its analysis;

Cash Flow Statement: Various cash and non-cash transactions, flow of cash, difference between cash flow and fund flow, preparation of Cash Flow Statement and its analysis.

Unit – V	Accounting standards and IFRS and emerging issues in accounting	Classes: 10
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Accounting Standards and IFRS: Need for accounting standards - IFRS and proposed changes in Indian Accounting Standards. **Emerging issues in Accounting:** Corporate Governance and clause 49 of the listing agreement, Human Resource Accounting, Forensic Accounting, Window Dressing- Sustainability Reporting. **Fundamentals of Taxation:** Overview of Heads of Income, deductions u/s 80C, Income Tax Rates and Returns – For Individuals only (Only Theory)

Text books:

- Financial Accounting: A Managerial Perspective, Narayanaswamy R, 5/e , PHI, 2014
- A Text book of Accounting For Management, Maheswari S. N, Maheswari Sharad K. Maheswari , 2/e, Vikas Publishing house (P) Ltd.
- Financial Accounting, Tulsian P. C, 1/e, Pearson Education.
- Accounting for managers, Madegowda J, Himalaya Publishing House.
- Advanced Accountancy, Gupta R. L & Radhaswamy M, Sultan Chand Publications.
- Financial Accounting, Jain S. P and Narang K L, Kalyani Publishers.
- Business Taxation, Akhileshwar Pathak and Savan Godiawala, 2/e, McGraw Hill Education(India) Pvt. Ltd, 2013.

Reference books:

- Financial Accounting for Management: An Analytical Perspective, Ambrish Gupta, 4/e, Pearson Education.
- Introduction to Financial Statement Analysis, Ashish K Bhattacharya, Elsevier India.
- Financial Accounting – Raman B. S, Vol I & Vol II, 1 /e, United Publishers, 2009.



CHADALAWADA RAMANAMMA ENGINEERING COLLEGE, TIRUPATI
(AUTONOMOUS)
DEPARTMENT OF MANAGEMENT STUDIES

LESSON PLAN

Subject: _ ACCOUNTING FOR MANAGERS

Sub Code: 17CE00103

**Class: M.B.A Section: A & B Branch: M.B.A Semester: I _
Academic**

Year: 2018-19

Name of the faculty: Ms. K YAMUNA

Lecture No.	Date (As per Academic calendar)	Topics to be covered	Actual Date of completion	Remarks
1		Introduction to Accounting		
2		Need and Types of Accounting		
3		Users of Accounting		
4		Accounting Principles (GAAP)		
5		Accounting concepts and conventions		
6		Accounting Equation (problems on accounting)		
7		Journals (theory and problems)		
8		Journals (problems)		
9		Ledgers (theory and problems)		
10		Ledgers (problems)		
11		Trial balance (theory and problems)		
12		Subsidiary books – 6 types explanation		
13		Purchase book (problem)		
14		Purchase return book (problem)		
15		sales book (problem)		
16		Sales return book (problem)		
17		Bills payable book (problem)		
18		Bills Receivable book (problem)		
19		Cash book – one and two columns		
20		Three column cash book (problem)		
21		Depreciation methods – theory explanation		
22		Depreciation – straight line method (problem)		

Lecture No.	Date (As per Academic calendar)	Topics to be covered	Actual Date of completion	Remarks
23		Depreciation – Written Down Value method (problem)		
24		Final Accounts: Meaning, Features, Uses and Preparation of final accounts		
25		Trading Account (Explanation and problem)		
26		Statement of Profit and Loss (Explanation and problem)		
27		Balance Sheet (Explanation and problem)		
28		Final accounts (simple problems)		
29		Final accounts (problems with adjustments)		
30		Types of Errors, Rectification of Errors before and after Preparations of Trial balance.		
31		Rectification of Errors (problems)		
32		Ratio Analysis – meaning , explanation , types of ratios, advantages and disadvantages		
33		liquidity ratios, activity ratios (theory and problem)		
34		solvency ratios, profitability ratios (theory and problem)		
35		Ratio analysis (complex problems)		
36		Ratio analysis (complex problems)		
37		Common Size Statement (income)- problem		
38		Common Size Statement (balance sheet)- problem		
39		Comparative income statement – problem		
40		Comparative Balance Sheet – problem		
41		Trend Analysis – problem		
42		Bank Reconciliation Statement – Need – Reasons for Difference between Cash Book and Pass Book Balances		
43		Problems on Favourable and Overdraft Balances		
44		Problems on Favourable and Overdraft Balances		
45		<i>Funds Flow Statement</i> : Meaning, Concept of Gross and Net Working Capital		
46		Preparation of Schedule of Changes in Working Capital (problems)		
47		Preparation of Funds Flow Statement and its analysis (problems)		

Lecture No.	Date (As per Academic calendar)	Topics to be covered	Actual Date of completion	Remarks
48		Various cash and non-cash transactions, flow of cash, difference between cash flow and fund flow		
49		preparation of Cash Flow Statement and its analysis (problems)		
50		Accounting Standards – meaning, Need for accounting standards,		
51		IFRS and proposed changes in Indian Accounting Standards		
52		Corporate Governance and clause 49 of the listing agreement,		
53		Human Resource Accounting, Forensic Accounting,		
54		Window Dressing- Sustainability Reporting		
55		Fundamentals of Taxation		
56		Overview of Heads of Income		
57		Deductions u/s 80C, Income Tax Rates and Returns		
58		Simple problems to calculate Heads of Income		
59		Case studies		

Course Instructor**Head of the Dept.****Principal**

UNIT-I**INTRODUCTION**

Introduction to Accounting: Need and Types of Accounting, Users of Accounting, concepts and conventions of Accounting, Accounting Equation (problems on accounting equation), Generally Accepted Accounting Principles (GAAP).

Preparation of books of Accounts: Journals, Subsidiary books, three column cash book, ledgers and trial balance. Depreciation- Straight line and Written down Value Methods.

Learning Objectives

After reading this lesson, the reader should be able to:

- Know the Evolution of Accounting
- Understand the Definition of Accounting
- Comprehend the Scope and Function of Accounting
- Ascertain the Users of Accounting Information
- Know the Specialized Accounting Fields
- Understand the Accounting Concepts and Conventions
- Realize the Need for Accounting Standards

1.1 ACCOUNTING - INTRODUCTION

Accounting is aptly called the language of business. This designation is applied to accounting because it is the method of communicating business information. The basic function of any language is to serve as a means of communication. Accounting duly serves this function. The task of learning accounting is essentially the same as the task of learning a new language. But the acceleration of change in business organization has contributed to increase the complexities in this language. Like other languages, it is undergoing continuous change in an attempt to discover better means of communications. To enable the accounting language to convey the same meaning to all stakeholders, it should be made standard. To make it a standard language certain accounting principles, concepts and standards have been developed over a period of time. This lesson dwells upon the different dimensions of accounting, accounting concepts, accounting principles and the accounting standards.

1.2 Evolution of Accounting

Accounting is as old as money itself. It has evolved, as have medicine, law and most other fields of human activity in response to the social and economic needs of society. People in all civilizations have maintained various types of records of business activities. The oldest known are clay tablet records of the payment of wages in babylonia around 600 b.c. accounting was practiced in india twenty-four centuries ago as is clear from kautilya's book 'arthshastra' which clearly indicates the existence and need of proper accounting and audit.

For the most part, early accounting dealt only with limited aspects of the financial operations of private or governmental enterprises. Complete accounting system for an enterprise which came to be called as "double entry system" was developed in italy in the 15th century. The first known description of the system was published there in 1494 by a franciscan monk by the name luca Pacioli.

The expanded business operations initiated by the industrial revolution required increasingly large amounts of money which in turn resulted in the development of the corporation form of organizations. As corporations became larger, an increasing number of individuals and institutions looked to accountants to provide economic information about these enterprises. For e.g. Prospective investors and creditors sought information about a corporation's financial status. Government agencies required financial information for purposes of taxation and regulation. Thus accounting began to expand its function of meeting the needs of relatively few owners to a public role of meeting the needs of a variety of interested parties.

1.3 Definition of Accounting

Before attempting to define accounting, it may be made clear that there is no unanimity among accountants as to its precise definition. Anyhow let us examine three popular definitions on the subject:

Accounting has been defined by the American Accounting Association Committee as:

“the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information”. This may be considered as a good definition because of its focus on accounting as an aid to decision making.

Another popular definition on accounting was given by American Accounting Principles Board in 1970, which defined it as:

“accounting is a service society. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is useful in making economic decision, in making reasoned choices among alternative courses of action”.

1.4 Nature and scope of Accounting

- Accounting may be regarded as an art of recording, classifying and summarizing of money transactions and events
- Accounting may be regarded as a science in its being able to use scientific and analytical techniques for solving managerial problems
- Accounting may be regarded as an information system for providing information needed by the stakeholders
- Accounting may be regarded as a service function in being able to serve the society through social accounting
- Accounting may be regarded as a language of the business because the preparers and interpreters of the financial information should understand the common language of accounting

1.5 Limitations of Accounting

- **Historical information:** Accounting reports are based on the past historical information
- **Financial information:** Accounting does not reveal non monetary information like customer satisfaction, market competition, market share, etc.
- **Inadequate Cost information:** Accounting does not provide cost information to gauge the product or department-wise profitability

- **Personal judgment:** Financial information is clouded by personal judgment of the preparers like provisions, valuations, etc.

1.6 FUNCTIONS OF ACCOUNTING:

- **Keeping Systematic Records:**

This is the fundamental function of accounting. The transactions of the business are properly recorded, classified and summarized into final financial statements – income statement and the balance sheet.

- **Protecting The Business Properties:**

The second function of accounting is to protect the properties of the business by maintaining proper record of various assets and thus enabling the management to exercise proper control over them.

- **Communicating The Results:**

As accounting has been designated as the language of business, its third function is to communicate financial information in respect of net profits, assets, liabilities, etc., to the interested parties.

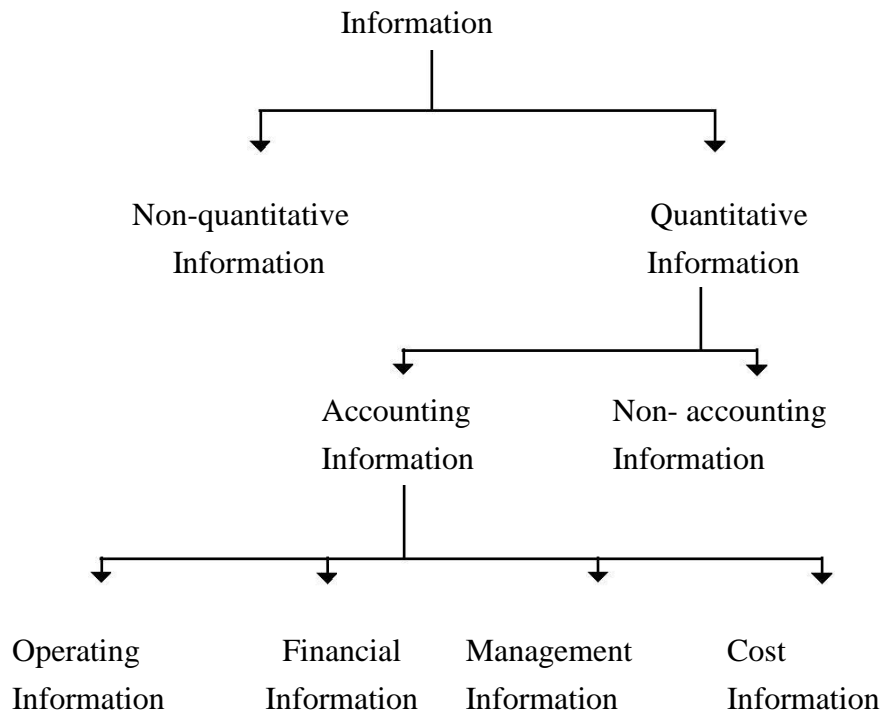
- **Meeting Legal Requirements:**

The fourth and last function of accounting is to devise such a system as will meet the legal requirements. The provisions of various laws such as the companies act, income tax act, etc., require the submission of various statements like income tax returns, annual accounts and so on. Accounting system aims at fulfilling this requirement of law.

1.7 TYPES OF ACCOUNTING:

The information needs of a business enterprise can be outlined and illustrated with the help of the following chart:

Chart Showing Types of Information



Operating Information:

By operating information, we mean the information which is required to conduct the day-to-day activities. Examples of operating information are: amount of wages paid and payable to employees, information about the stock of finished goods available for sale and each one's cost and selling price, information about amounts owed to and owing by the business enterprise, information about stock of raw materials, spare parts and accessories and so on. By far, the largest quantity of accounting information provides the raw data (input) for financial accounting, management accounting and cost accounting.

Financial Accounting:

Financial accounting information is intended both for owners and managers and also for the use of individuals and agencies external to the business. This accounting is concerned with the recording of transactions for a business enterprise and the periodic preparation of various reports from such records. The records may be for general purpose or for a special purpose. A detailed account of the function of financial accounting has been given earlier in this lesson.

Management Accounting:

Management accounting employs both historical and estimated data in assisting management in daily operations and in planning for future operations. It deals with specific

problems that confront enterprise managers at various organizational levels. The management accountant is frequently concerned with identifying alternative courses of action and then helping to select the best one. For e.g. The accountant may help the finance manager in preparing plans for future financing or may help the sales manager in determining the selling price to be fixed on a new product by providing suitable data. Generally management accounting information is used in three important management functions: (1) control (2) co-ordination and (3) planning. Marginal costing is an important technique of management accounting which provides multi dimensional information that facilitates decision making.

Cost Accounting:

The industrial revolution in England posed a challenge to the development of accounting as a tool of industrial management. This necessitated the development of costing techniques as guides to management action. Cost accounting emphasizes the determination and the control of costs. It is concerned primarily with the cost of manufacturing processes. In addition, one of the principal functions of cost accounting is to assemble and interpret cost data, both actual and prospective, for the use of management in controlling current operations and in planning for the future.

All of the activities described above are related to accounting and in all of them the focus is on providing accounting information to enable decisions to be made.

1.8 GROUPS INTERESTED IN ACCOUNTING INFORMATION

There are several groups of people who are interested in the accounting information relating to the business enterprise. Following are some of them:

Shareholders:

Shareholders as owners are interested in knowing the profitability of the business transactions and the distribution of capital in the form of assets and liabilities. In fact, accounting developed several centuries ago to supply information to those who had invested their funds in business enterprise.

Management:

With the advent of joint stock company form of organization the gap between ownership and management widened. In most cases the shareholders act merely as renders of

capital and the management of the company passes into the hands of professional managers. The accounting disclosures greatly help them in knowing about what has happened and what should be done to improve the profitability and financial position of the enterprise.

Potential Investors:

An individual who is planning to make an investment in a business would like to know about its profitability and financial position. An analysis of the financial statements would help him in this respect.

Creditors:

As creditors have extended credit to the company, they are much worried about the repaying capacity of the company. For this purpose they require its financial statements, an analysis of which will tell about the solvency position of the company.

Government:

Any popular government has to keep a watch on big businesses regarding the manner in which they build business empires without regard to the interests of the community. Restricting monopolies is something that is common even in capitalist countries. For this, it is necessary that proper accounts are made available to the government. Also, accounting data are required for collection of sale-tax, income-tax, excise duty etc.

Employees:

Like creditors, employees are interested in the financial statements in view of various profit sharing and bonus schemes. Their interest may further increase when they hold shares of the companies in which they are employed.

Researchers:

Researchers are interested in interpreting the financial statements of the concern for a given objective.

Citizens:

Any citizen may be interested in the accounting records of business enterprises

including public utilities and government companies as a voter and tax payer.

1.9 SPECIALISED ACCOUNTING FIELDS

As in many other areas of human activity, a number of specialized fields in accounting also have evolved besides financial accounting. Management accounting and cost accounting are the result of rapid technological advances and accelerated economic growth. The most important among them are explained below:

Tax Accounting:

Tax accounting covers the preparation of tax returns and the consideration of the tax implications of proposed business transactions or alternative courses of action. Accountants specializing in this branch of accounting are familiar with the tax laws affecting their employer or clients and are up to date on administrative regulations and court decisions on tax cases.

International Accounting:

This accounting is concerned with the special problems associated with the international trade of multinational business organizations. Accountants specializing in this area must be familiar with the influences that custom, law and taxation of various countries bring to bear on international operations and accounting principles.

Social Responsibility Accounting:

This branch is the newest field of accounting and is the most difficult to describe concisely. It owes its birth to increasing social awareness which has been particularly noticeable over the last three decades or so. Social responsibility accounting is so called because it not only measures the economic effects of business decisions but also their social effects, which have previously been considered to be immeasurable. Social responsibilities of business can no longer remain as a passive chapter in the text books of commerce but are increasingly coming under greater scrutiny. Social workers and people's welfare organizations are drawing the attention of all concerned towards the social effects of business decisions. The management is being held responsible not only for the efficient conduct of business as reflected by increased profitability but also for what it contributes to social well-being and progress.

Inflation Accounting:

Inflation has now become a world-wide phenomenon. The consequences of inflation are dire in case of developing and underdeveloped countries. At this juncture when financial statements or reports are based on historical costs, they would fail to reflect the effect of changes in purchasing power or the financial position and profitability of the firm. Thus, the utility of the accounting records, not taking care of price level changes is seriously lost. This imposes a demand on the accountants for adjusting financial accounting for inflation to know the real financial position and profitability of a concern. Thus emerged a future branch of accounting called inflation accounting or accounting for price level changes. It is a system of accounting which regularly records all items in financial statements at their current values.

Human Resources Accounting:

Human resources accounting is yet another new field of accounting which seeks to report and emphasize the importance of human resources in a company's earning process and total assets. It is based on the general agreement that the only real long lasting asset which an organization possesses is the quality and caliber of the people working in it. This system of accounting is concerned with, *"the process of identifying and measuring data about human resources and communicating this information to interested parties"*.

1.10 GAAP (generally accepted accounting principles)

GAAP (generally accepted accounting principles) is a collection of commonly-followed accounting rules and standards for financial reporting. The acronym is pronounced "gap." AAP specifications include definitions of concepts and principles, as well as industry-specific rules. The purpose of GAAP is to ensure that financial reporting is transparent and consistent from one organization to another.

There is no universal GAAP standard and the specifics vary from one geographic location or industry to another. In the United States, the Securities and Exchange Commission (SEC) mandates that financial reports adhere to GAAP requirements. The Financial Accounting Standards Board (FASB) stipulates GAAP overall and the Governmental Accounting Standards Board (GASB) stipulates GAAP for state and local government. Publicly traded companies must comply with both SEC and GAAP requirements.

Many countries around the world have adopted the International Financial Reporting Standards (IFRS). IFRS is designed to provide a global framework for how public companies prepare and

disclose their financial statements. Adopting a single set of world-wide standards simplifies accounting procedures for international countries and provides investors and auditors with a cohesive view of finances. IFRS provides general guidance for the preparation of financial statements, rather than rules for industry-specific reporting.

1.10.1 ACCOUNTING PRINCIPLES

Obviously, if each business organisation conveys its information in its own way, we will have a babel of unusable financial data.

Personal systems of accounting may have worked in the days when most companies were owned by sole proprietors or partners, but they do not anymore, in this era of joint stock companies.

These companies have thousands of stakeholders who have invested millions, and they need a uniform, standardised system of accounting by which companies can be compared on the basis of their performance and value.

Therefore, accounting principles based on certain concepts, convention, and tradition have been evolved by accounting authorities and regulators and are followed internationally.

These principles, which serve as the rules for accounting for financial transactions and preparing financial statements, are known as the “Generally Accepted Accounting Principles,” or GAAP.

The application of the principles by accountants ensures that financial statements are both informative and reliable.

It ensures that common practices and conventions are followed, and that the common rules and procedures are complied with. This observance of accounting principles has helped developed a widely understood grammar and vocabulary for recording financial statements.

However, it should be said that just as there may be variations in the usage of a language by two people living in two continents, there may be minor differences in the application of accounting rules and procedures depending on the accountant.

For example, two accountants may choose two equally correct methods for recording a particular transaction based on their own professional judgement and knowledge.

Accounting principles are accepted as such if they are (1) objective; (2) usable in practical situations; (3) reliable; (4) feasible (they can be applied without incurring high costs); and (5) comprehensible to those with a basic knowledge of finance.

Accounting principles involve both accounting concepts and accounting conventions. Here are brief explanations.

1.10.1.1 Accounting Concepts

Business entity concept: A business and its owner should be treated separately as far as their

financial transactions are concerned.

Money measurement concept: Only business transactions that can be expressed in terms of money are recorded in accounting, though records of other types of transactions may be kept separately.

Dual aspect concept: For every credit, a corresponding debit is made. The recording of a transaction is complete only with this dual aspect.

Going concern concept: In accounting, a business is expected to continue for a fairly long time and carry out its commitments and obligations. This assumes that the business will not be forced to stop functioning and liquidate its assets at “fire-sale” prices.

Cost concept: The fixed assets of a business are recorded on the basis of their original cost in the first year of accounting. Subsequently, these assets are recorded minus depreciation. No rise or fall in market price is taken into account. The concept applies only to fixed assets.

Accounting year concept: Each business chooses a specific time period to complete a cycle of the accounting process—for example, monthly, quarterly, or annually—as per a fiscal or a calendar year.

Matching concept: This principle dictates that for every entry of revenue recorded in a given accounting period, an equal expense entry has to be recorded for correctly calculating profit or loss in a given period.

Realisation concept: According to this concept, profit is recognised only when it is earned. An advance or fee paid is not considered a profit until the goods or services have been delivered to the buyer.

1.10.1.2 ACCOUNTING CONVENTIONS

There are four main conventions in practice in accounting: conservatism; consistency; full disclosure; and materiality.

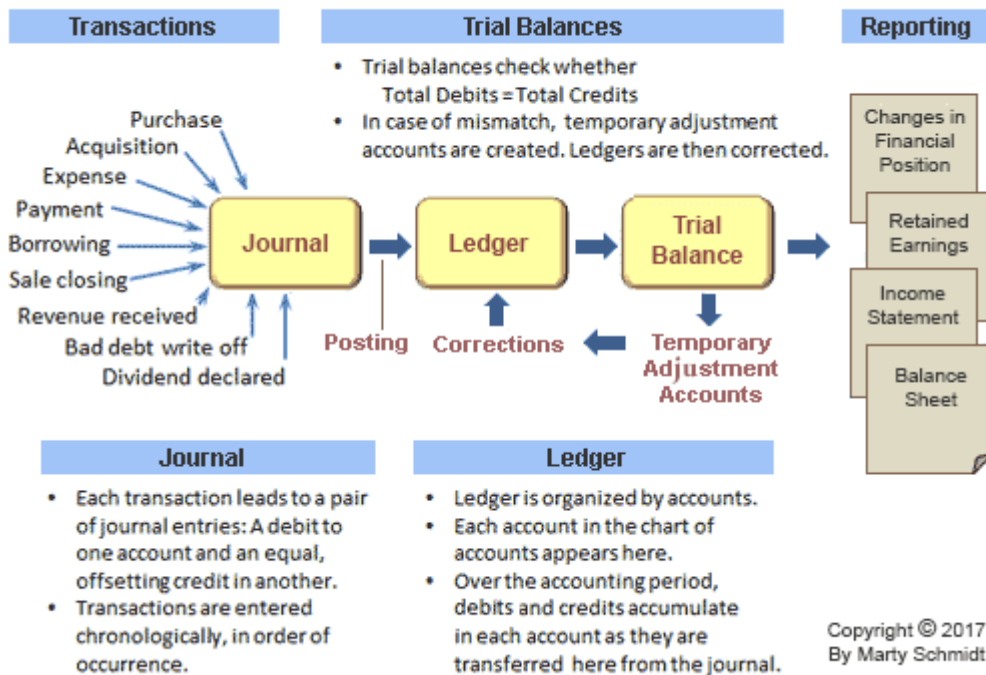
Conservatism is the convention by which, when two values of a transaction are available, the lower-value transaction is recorded. By this convention, profit should never be overestimated, and there should always be a provision for losses.

Consistency prescribes the use of the same accounting principles from one period of an accounting cycle to the next, so that the same standards are applied to calculate profit and loss.

Materiality means that all material facts should be recorded in accounting. Accountants should record important data and leave out insignificant information.

Full disclosure entails the revelation of all information, both favourable and detrimental to a business enterprise, and which are of material value to creditors and debtors.

The Accounting Cycle



The Ledger

The book in which accounts are maintained is called ledger. Generally, one account is opened on each page of this book, but if transactions relating to a particular account are numerous, it may extend to more than one page. All transactions relating to that account are recorded chronologically. From journal each transaction is posted to at least two concerned accounts - debit side of one account and credit side of another account. Remember that, if there are two accounts involved in a journal entry, it will be posted to two accounts in the ledger and if the journal entry consists of three accounts (compound entry) it will be posted to three different accounts in the ledger. The process of transferring information from journal to ledger accounts is known as posting. The goal of all transactions is ledger. Ledger is known as the destination of entries in journal but it must be remembered that transactions cannot be recorded directly in the ledger - they must be routed through journal. This concept is illustrated below:

Transaction

↓

Journal

↓

Ledger

So, the books in which all the transactions of a business concern are finally recorded in the concerned accounts in a summarized form is called ledger.

Characteristics of Ledger Account:

The ledger has the following main characteristics:

It has two identical sides - left hand side (debit side) and right hand side (credit side).

Debit aspect of all the transactions are recorded on the debit side and credit aspects of all the transactions are recorded on credit side according to date.

The difference of the totals of the two sides represents balance. The excess of debit side over credit side indicates debit balance, while excess of credit side over debit side indicates the credit balance. If the two sides are equal, there will be no balance.

Generally the balance is drawn at the year end and recorded on the lesser side to make the two sides equal. This balance is know as closing balance.

The closing balance of the current year becomes the opening balance of the next year.

Types or Forms of Ledger Accounts:

There are two forms of ledger accounts. These are:

Standard form

Self-balancing form

Posting Procedure:

Transferring information i.e. entries from journal to ledger accounts is called posting. The procedure of posting from journal to ledger is as follows:

Locate the ledger account from the first debit in the journal entry.

Record the date in the date column on the debit side of the account. The date is the date of transaction rather than the date of the posting.

Record the name of the opposite account (account credited in entry) in the particular (also know as reference column, description column etc) column.

Record the page number of the journal in the journal reference (J.R) column from where the entry is being posted.

Record the amount of the debit in the "amount column"

Locate the ledger account for the first credit in the journal and follow the same procedure.

Balancing an Account:

The difference between the two sides of an account is its balance. The balance is written on the lesser side to make the two sides equal. The process of equalizing the two sides of an account is known as balancing

The rules for balancing an account are stated as below:

Add up the amount columns of both the sides of an account and write the totals in a separate slip of paper.

Find out the difference of the two totals.

Write down the difference on the lesser side of the account.

Now total up both the sides and write the totals and draw double lines under them.

Again write the difference on the opposite side below the double line.

If the debit side of an account is heavier, its balance is known as debit balance. and if the credit side of an account is heavier its balance is known as credit balance. If the two sides are equal, that account will show zero balance. The rules for determining the balance is as follows:

Total debit = More than total credit = Debit balance

Total credit = More than total debit = Credit balance

Total debit = Total credit = Nil balance

It may be noted that at the time of balancing an account debit balance is placed on the credit side and credit balance on debit site. This balance is known as closing balance. What is closing balance in this year, is the opening balance of the next year.

Dr.								Cr.
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)	

JOURNAL:**Meaning of Journal:**

Journal is the book of original entry in which, after following the rules of debit and credit, all business transactions are recorded in a chronological order. The word journal has been derived from the French word “jour”, which means “a day”. Thus, journal means a book which records all monetary transactions of a business on daily basis. The monetary transactions are recorded in chronological order i.e., in the order of their occurrence.

As the recording of transactions is done first in the journal, it is also called book of original entry or prime entry. Journalizing is defined as the process of recording transactions in the journal. After determining the particular account to be debited and credited, each transaction is separately recorded.

Utility of Journal:**(i) A primary book of original entry:**

As the first recording of a transaction is done in the journal, it is called book of original entry or prime entry. All business transactions first find place in journal and then only they are recorded in separate ledger accounts.

(ii) A fundamental book in line with the double entry book keeping:

After determining the particular account to be debited and credited, each transaction is separately recorded. If we do not open journal in an enterprise, chances of maintaining books of accounts, as per the principles of double entry system are remote.

(iii) Transactions in chronological order:

All the transactions are recorded in the journal in chronological order. So, the chances of omitting any transactions in the books of accounts are very thin.

(iv) Complete information about business transactions:

All journal entries are supported with brief narrations. These narrations help to understand the meaning and purpose of the transaction in future date.

(v) Classification of all transactions becomes easier:

All journal entries are based on vouchers and are recorded in the journal as and when they occur. So, the transactions are classified spontaneously when they occur.

(vi) Helps in division of labour:

In large business, journal is sub-divided into more than one. This sub-division helps to record one type of transactions in that book. For example, sales book records only credit sales and purchase book records only credit purchases. These sub-journals are handled and controlled by different

and separate persons. In such cases, naturally, that person acquires expertise which helps the enterprise to achieve its common goal efficiently and effectively.

(vii) Ensures arithmetical accuracy:

In journal, total of debit column and credit column should match and agree. Disagreement is a quick indication of commitment of some errors, which can be easily detected and rectified.

Limitations of Journal:

(i) Bulky and voluminous:

Journal is a main book of original entry which records all business transactions. Sometimes, it becomes so bulky and voluminous that it cannot be handled easily.

(ii) Information in scattered form:

In this book, all information is recorded on daily basis and scattered form; hence it is very difficult to locate a particular transaction unless one remembers the date of occurrence of that transaction.

(iii) Time consuming:

Unlike posting from subsidiary books, posting the transactions from journal to ledger accounts take too much time because every time one has to post the transactions in different ledger accounts.

(iv) Lack of internal control:

Unlike other books of original entries like subsidiary books and cash book, journal does not facilitate the internal control, because in journal only transactions are recorded in chronological order. However, subsidiary books and cash book gives a clear picture of special type of transactions recorded therein.

Format of Journal:

The format of Journal is as under:

JOURNAL				
Date	Particulars	L.F.	Debit ₹	Credit ₹

Usually there are five columns in the journal:

They are:

(i) Date

(ii) Particulars

(iii) L.F.

(iv) Amount Dr. and

(v) Amount Cr.

(i) Date:

The 'Date' column shows the date of transaction. It should be noted that all the transactions are to be recorded in the journal in the chronological order.

(ii) Particulars:

In 'Particulars' column, the accounts which are to be debited and credited are written. The account(s) to be debited is written in the first row following the word 'Dr' towards the end of the row. Leaving sufficient margin on the left side in the next row, the account(s) to be credited is written and prefixed with the word 'To'. A brief description of the transaction is written below the credited account. This description prefixed with 'Being' or 'For', is known as narration and is given in the brackets after writing these two types of accounts.

(iii) Ledger Folio (L.F.):

Folio means page and the ledger folio means page number of ledger. In this column, page number of ledger on which debit and credit items are posted is written. In practical accounting, this column is very useful for cross-checking and auditing the accounts of an enterprise.

(iv) Amount (Debit):

In this column, the amount of the debit account is written. At the top of this column, the unit of measurement of monetary transactions viz. Rs. is written.

(v) Amount (Credit):

In this column, the amount of the credit account is written. At the top of this column, the unit of measurement of monetary transactions viz. Rs. is written.

Example:

Mr. Anil sell goods for cash Rs. 5,000. In this transaction, two accounts are involved viz. Cash Account and Sales Account. After proper analysis of rules of debit and credit, it can be established that Cash Account is to be debited and Sales Account is to be credited.

The entry in the journal will be shown as under:

JOURNAL				
Date	Particulars	L.F.	Debit ₹	Credit ₹
Debit Account Credit Account Narration	Cash A/c To Sales A/c (Being goods sold for cash)	Dr	5,000	5,000

The points which we have discussed so far can very well be explained with the help of the following simple illustration.

Illustration :

January 1 - started business with rs.3,000 January 2 - bought goods worth rs.2,000

January 9 - received order for half of the goods from 'g' January 12 - delivered the goods, g invoiced rs.1,300

January 15 - received order for remaining half of the total goods purchased January 21 - delivered goods and received cash rs.1,200

January 30 - g makes payment January 31 - paid salaries rs.210
- received interest rs.50

Let us now analyze the transactions one by one.

January 1 – Started Business With Rs.3,000:

The two accounts involved are cash and owners' equity. Cash, an asset increases and hence it has to be debited. Owners' equity, a liability also increases and hence it has to be credited.

January 2 – Bought Goods Worth Rs.2,000:

The two accounts affected by this transaction are cash and goods (purchases). Cash balance decreases and hence it is credited and goods on hand, an asset, increases and hence it is to be debited.

January 9 – Received Order For Half Of The Goods From ‘G’:

No entry is required as realization of revenue will take place only when goods are delivered (realization concept).

January 15 – Received Order For Remaining Half Of Goods:

No entry.

January 21 – Delivered Goods And Received Cash Rs.1,200:

This transaction affects cash a/c. Since cash is realized, the cash balance will increase and hence cash account is to be debited. Since the stock of goods becomes nil due to sale, sales a/c is to be credited (as asset in the form of goods on hand has reduced due to sales).

January 30 - ‘G’ Makes Payment:

Both the accounts affected by this transaction are asset accounts – cash and receivables. Cash balance increases and hence it is to be debited. Receivables balance decreases and hence it is to be credited.

January 31 – Paid Salaries Rs.210:

Because of payment of salaries cash balance decreases and hence cash account is to be credited. Salary is an expense and since expense has the effect of reducing owners’ equity and as owners’ equity account decreases on the debit side, expenses account is to be debited.

January 31 – Received Interest Rs.50:

The receipt of interest increases cash balance and hence cash a/c is to be debited. Interest being revenue which has the effect of increasing the owners’ equity, it has to be credited as owners’ equity account increases on the credit side.

JOURNAL:

Date	Particulars	L.F.	Debit	Credit
Jan. 1	Cash A/C Dr. To Capital A/C (Being Business Started)		3,000	3,000
Jan. 2	Purchases A/C Dr. To Cash (Being Goods Purchased)		2,000	2,000
Jan. 12	Receivables A/C Dr. To Sales A/C (Being Goods Sold On Credit)		1,300	1,300
Jan. 21	Cash A/C Dr. To Sales A/C (Being Goods Sold For Cash)		1,200	1,200
Jan. 30	Cash A/C Dr. To Receivables A/C (Being Cash Received For Sale Of Goods)		1,300	1,300
Jan. 31	Salaries A/C Dr. To Cash A/C (Being Salaries Paid)		210	210
Jan. 31	Cash A/C Dr. To Interest A/C (Being Interest Received)		50	50

Now the above journal entries are posted into respective ledger accounts which in turn are balanced.

Cash Account

Debit	Rs.	Credit	Rs.
To Capital A/C	3,000	By Purchases A/C	2,000
To Sales A/C	1,200	By Salaries A/C	210
To Receivables A/C	1,300	By Balance C/D	3,340
To Interest A/C	50		
	5,550		5,550

Capital Account

Debit	Rs.	Credit	Rs.
	3,000		3,000
To Balance C/D	3,000	By Cash A/C	3,000

Purchases Account

Debit	Rs.	Credit	Rs.
	2,000		2,000
To Cash A/C	2,000	By Balance C/D	2,000

Receivables Account

Debit	Rs.	Credit	Rs.
	1,300		1,300
To Balance C/D	1,300	By Cash A/C	1,300

Sales Account

Debit	Rs.	Credit	Rs.
	2,500	By Receivables A/C	1,300
To Balance C/D	2,500	By Cash A/C	1,200
			2,500

Salaries Account

Debit	Rs.	Credit	Rs.
	210		210
To Cash A/C	210	By Balance C/D	210

Interest Account

Debit	Rs.	Credit	Rs.
To Balance C/D	50	By Cash A/C	50
	50		50

Now A Trial Balance Can Be Prepared And When Prepared It Would Appear As Follows:

Trial Balance

Debit	Rs.	Credit	Rs.
Cash	3,340	Capital	3,000
Purchases	2,000	Sales	2,500
Salaries	210	Interest	50
	5,550		5,550

1.11 Trial Balance

The Trial Balance is, as the name suggests, is a table where we lay out all our debit accounts and all our credit accounts to see if they balance or not.

A trial balance is important because it acts as a summary of all of our accounts. By looking at our trial balance, we can immediately see our bank balance, our loan balance, our owner's equity balance. In fact, we can immediately see the balance of every single account in our business.

How to Make a Trial Balance

First of all, we take all the balances from our ledgers and enter them into our trial balance table. Remember the accounting equation:

DEBIT SIDE Assets + Expenses + Drawings

CREDIT SIDE Liabilities + Revenue + Owners Equity

[**Assets = Debit balance**

Liabilities = Credit balance

Expenses = Debit Balance

Equity = Credit balance

Revenue = Credit balance]

EXAMPLE:

Trial Balance December 31, 2005		
Account Title	Debit	Credit
Cash	\$7,000	
Accounts Receivable	3,000	
Office Supplies	3,000	
Office Equipment	5,000	
Bank Loan		\$5,000
Accounts Payable		1,000
Common Stock		10,000
Consulting Revenue		7,000
Rent Expense	600	
Salaries Expense	2,500	
Supplies Used	1,200	
Utilities Expense	700	
Total	\$23,000	\$23,000

1.12 SUBSIDIARY BOOKS

Subsidiary book is the sub division of Journal. These are known as books of prime entry or books of original entry as all the transactions are recorded in their original form. In these books the details of the transactions are recorded as they take place from day to day in a classified manner.

The important subsidiary books used are as following:-

- Cash Book : Used to record all the cash receipts and payments.
- Purchase Book : Used to record all the credit purchases.
- Sales Book : Used to record all the credit sales
- Purchase Return Book : Used to record all goods returned by business to the supplier
- Sales Return Book : Used to record all good returned by the customer to the business.
- Bills Receivable Book : Used to record all accepted bills received by business.
- Bills Payable Book : Used to record all bill accepted by us to our creditors.
- Journal Proper : Used to record those transactions for which there is no separate book.

These subsidiary books are maintained because it may be impossible to record each transaction into the ledger as it occurs. And these books record the details of the transactions and therefore help the ledger to become brief. Future reference and any desired analysis becomes easy as transactions of similar nature are recorded together.

List the type of transactions entered in Journal proper.

The Journal proper is used to record following transactions:-

- Opening Entries : are the entries which are made at the starting of the financial year.

-Closing Entries : At the close of the accounting period balances from the various accounts are transferred in order to balance the books of accounts. Thus, this process of transferring balances of the trading and profit and loss account at the end of year is called closing the books and entries passed at that time are called closing entries.

-Transfer Entries : are the entries which are passed in order to transfer one account to another account.

- Adjustment Entries : are passed at the end of an accounting period in order to modify the accounts.

-Rectification Entries : are passed to rectify the error detected the books through an entry in journal proper.

-Entries for rare transactions : Journal proper is used for rare transactions.

-Entries for which there is no special journal : When the transactions cannot be recorded in the above sub journals then the same are entered in the journal proper.

Examples of such transactions are: Distribution of goods as free sample, Goods destroyed by fire, etc

1. Purchase Book or Purchase Journal:

Purchase book is a book of original entry in which only credit purchases of goods are recorded. Cash purchases of goods are recorded in the cash book. Credit purchases of other assets are also not recorded in the purchase book; they are recorded in the journal proper.

Goods here mean the items or articles in which business enterprise is dealing with or we can say that goods are the items which are used by the business enterprise for regular sale. For example, purchase of computer by a business enterprise which is dealing in cloth shall not be treated as its goods and items related to computers shall be regarded as its assets. Similarly, purchase of cloth by a business enterprise which is dealing in computers shall not be treated as its goods since items relating to only computers are its goods.

Instead of recording transactions in the journal, the transactions relating to credit purchases of goods are directly recorded in the purchases book. However, the total of the purchases book shall be recorded on the debit side of the 'Purchases Account'. The main intention for preparing the purchases book is to know the credit purchases at any particular period of time.

Purchase Book

तारीख (Date)	विवरण (Particulars)	बीजक-संख्या (Invoice No.)	पृष्ठ-संख्या (L.F.)	विस्तृत वर्णन (Details)	कुल रकम (Total Amounts)
1	2	3	4	5	6

Explanations to Various Columns of Purchase Book:

(a) Date:

In this column, the date of the transaction, on which goods were purchased on credit, shall be recorded.

(b) Invoice Number:

The number of invoice (i.e., source document) showing the purchase of goods shall be recorded in this column.

(c) Name of the Suppliers (particulars):

In this column, name of the person/supplier, from whom the goods were purchased, shall be written along with detailed description of goods viz., quantity, quality, rate, gross amount, trade discount and sales tax etc.

(d) Ledger Folio (L.F.):

Page number of the ledger of the supplier on which the transaction is recorded shall be recorded in this column.

(e) Details:

The individual total amount of various items, if purchased from the same supplier, shall be recorded in this column. Total trade discount by the supplier and sales tax paid (if any) shall also be adjusted in this column.

(f) Total Amount:

In this, the net amount payable to the supplier shall be recorded. The total of this column shall be transferred to the debit side of purchases account.

2. Sales Book or Sales Journal:

Sales book is a book of original entry in which only credit sales of goods are recorded. Cash sales of goods are recorded in the cash book. Credit sales of other assets are also not recorded in the sales book; they are recorded in the journal proper.

Goods here mean the items or articles in which business enterprise is dealing or we can say that goods are the items which are used by the business enterprise for regular sale. For example, sale of furniture by a business enterprise which is dealing in stationery shall not be treated as its goods and items related to stationery alone shall be regarded as its goods.

Instead of recording transactions in the journal, the transactions relating to credit sales of goods are directly recorded in the sales book. However, the total of the sales book shall be recorded on the credit side of the 'Sales Account' The main intention for preparing the sales book is to know the credit sales at any particular period of time.

The format of sales book is as under:

SALES BOOK					
Date	Invoice No.	Name of the Customers (Account to be debited)	L.F.	Details ₹	Total Amount ₹
		Sales A/c	Cr.		

Explanations to Various Columns of Sales Book:

(a) Date:

In this column, the date of the transaction, on which goods were sold on credit, shall be recorded.

(b) Invoice Number:

The number of invoice (i.e., the source document) showing the sales of goods shall be recorded in this column.

(c) Name of the Customers:

In this column, name of the person/customers, to whom the goods were sold on credit, is written along with all details and description of goods viz., quantity, quality, rate, gross

amount and trade discount etc.

(d) Ledger Folio (L.F.):

Page number of the ledger of the customer, on which the transaction is recorded, shall be recorded in this column.

(e) Details:

The individual total amount of various items, if sold to the same customer, shall be recorded in this column. Total trade discount allowed to the customer (if any) shall also be adjusted in this column.

(f) Amount:

In this the net amount receivable from the customer shall be recorded. The total of this column shall be transferred to the credit side of sales account.

3. Purchases Return Book or Purchases Return Journal:

Purchases return book is a book of original entry in which transactions related to the return of purchases of goods are recorded.

There may be several reasons for returning the goods to the supplier; some of them are as under:

- (a) On finding some defects in the goods.
- (b) When goods sent are not as per the samples or specifications.
- (c) If the quantity of goods supplied is more than the requirements.
- (d) When there is a breach of agreement between the seller and the purchaser.

When the business enterprise returns the goods to the supplier, a debit note is sent to the party to whom this document is sent. Business enterprise may make a debit note against the supplier for an amount which is to be recovered from him when the business enterprise returns some goods which are defective in nature or not as per specifications.

In this document, all details about the date and amount of transaction, the name of the party whose account is debited along with reason for debiting his account shall be mentioned. It should be noted that the trade discount availed at the time of purchase shall also be adjusted at

the time of returning the goods.

FORMAT OF PURCHASES RETURN BOOK

Purchase Returns Book						
Date	Particulars	Debit Note No.	L.F.	Amount R.S.		Remarks
				Details	Total	

4. Sales Return Book Or Sales Return Journal:

Sales return book is a book of original entry in which transactions related to the return of sales of goods are recorded. The sales return book does not record return of goods sold on cash basis. There may be several reasons for returning the goods by the customers.

Some of them are as under:

- (a) On finding some defects in the goods.
- (b) When there is delay in supply of goods to the customers.
- (c) When goods sent are not as per the samples or specifications.
- (d) If there is an oversupply of goods.
- (e) When there is a breach of agreement between the seller and the purchaser.

When a business enterprise receives back the goods sold earlier, it makes a credit note in favour of the purchaser showing that his account has been credited in the books of business enterprise. In this document, all details about the date and amount of transaction, the name of the party whose account is credited along with reason for crediting his account shall be mentioned. It should be noted that the trade discount allowed at the time of credit sale shall also be adjusted at the time of receiving goods.

The format of sales return book is as under:

SALES RETURN BOOK					
Date	Credit Note No.	Particulars	L.F.	Details ₹	Total Amount ₹
		Sales Return A/c	Dr.		

5. Bills Receivable Book:

In the case of credit sales, sometimes the business enterprise draws a bill on the purchaser (debtor) and after its acceptance from the debtor it becomes a bill of exchange. In practical life, there are large number of sellers and purchasers and there are numerous numbers of transactions among them for drawing, accepting and making the payment in respect of bills of exchange.

The bill is due for payment after adding 3 days to the period of the bill. Hence, it is very important to keep a close watch on all the bills due for payment. For this purpose, a separate book is to be kept in record which is known as Bills Receivable Book. All particulars of the bills viz. date of receipt, name of the party, period of the bill, due date of the bill, Ledger Folio (L.F.), amount of the bill etc. are to be recorded in this book.

The format of the bills receivable book is as under:

BILLS RECEIVABLE BOOK

No of Bill	Date of Received	Date of Bill	From whom Received	Drawer	Acceptor	Where Payable	Term	Due Date	Ledger Folio	Amount ₹	Cash Book Folio	Remarks

6. Bills Payable Book:

In the case of credit purchases, sometimes the business enterprise accepts a bill which is drawn by the seller (creditor) which is known as bills of exchange and for the business enterprise it is known as bills payable. The bill is due for payment after adding 3 days to the period of the bill. Thus, it is very important to keep a close watch on all the bills due for payment. For this purpose, a separate book is to be kept in record which is known as Bills Payable Book. All particulars of the bills viz. date of acceptance, name of the party to whom bill is given, period of the bill, due date of the bill, Ledger Folio (L.F.), amount of the bill etc. are to be recorded in this book.

The format of the bills payable book is as under:

BILLS PAYABLE BOOK												
No of Bill	Date of Bill	To whom Given	Drawer	Payee	Where Payable	Term	Due Date	L. F.	Amount Paid ₹	Date	Cash Book Folio	Remarks

7. Journal Proper or General Journal:

So far we have discussed that in the case of sub divisions of journal, transactions relating to the cash are recorded directly in the cash book and transactions relating to non-cash specialised items, are directly recorded in subsidiary books viz. sales book, purchase book, sales return, purchase return, bills receivable and bills payable book.

Now the question arises what will happen to those transactions which neither relate to cash nor relate to the other subsidiary books, like sale/purchase of an asset on credit? It cannot be recorded in the cash book as no cash flow is there and asset being not included in the terminology of goods; it cannot be recorded in the purchase book either. These are the residual transactions which cannot find place in any of the sub divisions of journal and are recorded in the journal known as journal proper or general journal.

Usually, the following types of transactions are recorded in the journal proper:

(i) Opening Entries:

Through opening entries, the balances in respect of various assets, liabilities and capital appearing at the end of previous accounting year are brought forward at the beginning of current accounting year.

(ii) Closing Entries:

Closing entries are the entries which are passed to transfer nominal accounts to respective income statements so that financial statements of the business enterprise can be prepared.

(iii) Transfer Entries:

Transfer entries are those entries which are passed to transfer an amount of an account or the balance of an account to another account. For example, transferring the balance of current account to capital account.

(iv) Adjusting Entries:

At the end of an accounting year, some adjustments are to be carried out which were revealed later on. For example, recording closing stock, depreciation and various outstanding expenses or incomes. These items are recorded through passing adjusting entries.

(v) Entries for rectification of errors:

To rectify any accounting errors, these entries are to be passed.

(vi) Other Entries:

The entries related to credit sale or purchase of assets etc. are recorded in the journal proper.

CASH BOOK

Definition:

The book in which all cash transactions (either cash is received or paid) are primarily recorded according to dates, is called 'Cash Book'.

Features:

A Cash Book has the following features:

It plays a dual role. It is both a book of original entry as well as a book of final entry. All cash transactions are primarily recorded in it as soon as they take place; so it is a journal (a book of original entry). On the other hand, the cash aspect of all cash transactions is finally recorded in

the Cash Book (no posting in Ledger); so a Cash Book is also a Ledger (a book of final entry). Only one aspect of cash transaction is posted to the ledger account. The other aspect (i.e. cash aspect) needs no posting in Cash A/c. Since the Cash Book is the substitute for Cash A/c, no Cash A/c is opened in the ledger.

It has two identical sides-left hand side, the debit side and right hand side, the credit side.

All the items of cash receipts are recorded on the left hand side and all items of cash payments on the right hand side in order of date.

The difference between the total of two sides shows cash in hand.

Its balance is verified by counting actual cash in the cash box.

It always shows debit balance. It can never show credit balance.

Advantages:

Generally cash transactions are numerous. What is credit transaction today, will be cash transactions tomorrow. In other words, all credit transactions are finally settled by cash. If like all other transactions cash transactions are also recorded primarily in Journal, the cash aspect of the transactions will be required to be posted to Cash A/C, in the Ledger separately. This involves much time and labour. This is why, cash transactions are recorded in a separate book named Cash Book. It saves much time and labour.

Besides this the Cash Book renders the following benefits:

Daily cash receipts and cash payments are easily ascertained.

Cash in hand at any time can easily be ascertained through Cash Book balance.

Any mistake in the book can be easily detected at the time of verification of cash.

Any defalcation of money can be detected while verifying cash.

Since cash is verified daily, Cash Book is always kept up-to-date.

Is Cash Book a Journal or a Ledger?

From the above discussion it appears that the Cash Book is the substitute for the Cash Account. In fact, no separate Cash Account is opened in the Ledger, Cash Book serves the purpose of the Cash Account. The entries in Cash Book are regarded as one aspect of the Double Entry System - the other aspect is posted to the Ledger in the concerned account. L.C. Cropper remarked "Every entry in the Cash Book makes one half of a double entry; the other half of the double entry appears on the opposite side of some account in the Ledger."From this

angle, 'Cash Book is a Ledger'.

On the other hand, all cash transactions are primarily recorded in the Cash Book in order of date and thereafter posted to the concerned ledger accounts. Judging from this angle, 'Cash Book is a Journal'. Thus we see that a Cash Book is the 'mixture of Journal and Ledger'. According to Spicer & Pegler, "the Cash Book is actually a ledger account, but owing to the large number of entries made therein, it is kept in a separate book, called a Cash Book, which is used also as a book of prime entry."

Dr.					Cr.				
Receipts					Payment				
Date	Particulars	V No.	L. F.	Amount (Rs)	Date	Particulars	V. No.	L. F.	Amount (Rs)

The Columns of the Cash Book are Explained Below:

1. Date:

The date of transaction is written in this column in two lines—in the first line, the year and in the second line, the name of the month followed by the actual date.

2. Particulars:

In this column the name of the opposite account is written (the second aspect of cash transaction). Below this is written the narration of the transaction.

3. L.F. (Ledger Folio):

The page number of the Ledger where the concerned (opposite) account has been opened, is written in this column. This will help to locate the account from the Ledger. It may be noted that in a Ledger account J.F. is written as reference, while in a Cash Book L.F. is written. It is so, because cash transactions are not recorded in any Journal.

4. Amount:

The amount of the transaction is recorded in this column. The amount of cash received is recorded on the debit side in amount column and the amount of cash paid is recorded on the credit side in amount column.

5. V. NO. (Voucher Number):

The voucher number of each item of receipt and payment is also written. A voucher is necessary for each item of receipt and payment. Generally, a voucher has a serial number and this number-is written in this column (V. No).

When cash is received from a debtor or customer, generally a receipt or 'cash memo' is issued to the debtor which is called Receipt Voucher. Again, when money is paid to a creditor or supplier a receipt is obtained from him which is called 'Payment Voucher, Cash transactions are recorded in the Cash Book on the basis of Receipt Voucher and Payment Voucher.

Thus, a document evidencing cash receipts and payments and forming the basis for making entries in the Cash Book is called Cash Voucher.

2. Double Column:

Double Column Cashbook has a two account column on both sides of the cash book. it is three Type shown as below:

- I. Discount and Cash Column
- II. Bank and Cash Column
- III. Discount and Bank Column

Cash Book is an original entry book So we need to record full transaction but in single column cash book, it is not possible to record properly of those cash transactions which are including discount account also. So we need discount and cash column cash book.

For example, Received cash from Pawan for Rs 9900/- and allow discount Rs 100/-.

The journal entry of this transaction will be

Cash A/c Dr. 9,900

Discount A/c Dr. 100

To Pawan a/c 10,000/-

In Single column cash book, it not possible to record full transaction because we did not have any column for recording the amount of discount. So We have to prepare double column cash book.

Advantages:

The following advantages are derived from Double Column Cash Book:

All entries made in "Bank" Column of Double Column Cash Book form a part of double entry system and hence a separate Bank A/C need not be opened in ledger. It saves time, labour and cost.

Both cash transactions and bank transactions are recorded in the same book. So both cash balance and bank balance are easily available from the same book.

Thus it is said that the Double Column Cash Book has two accounts in it, the Cash A/C and the Bank A/C.

Contra Entry

In any account we can only have one half of a double entry. An account cannot be debited and credited at the same time. For example, when we sell goods for cash, cash received will be recorded on the debit side of Cash Book and the goods sold will be posted on the credit side of Sales Account. But in Double Column Cash Book, we have two accounts, Cash A/c and the Bank A/c, so it is possible to have both a debit entry and a credit entry at the same time. For example, cash of \$5,000 is deposited into the bank. In this transaction both Bank A/c and Cash A/c are involved and they will be recorded on both sides of Double Column Cash Book i.e. on the debit side in bank column and on the credit side in cash column.

Thus a transaction in which Cash A/c and Bank A/c are involved, is recorded on both the sides of Double Column Cash Book, it is called "contra entry", from the Latin prefix contra meaning 'opposite to or against'.

In recording such a transaction the letter "C", is written in 'L.F' column because both aspects of the transactions are recorded and there is no need to post them into the ledger.

In this connection, the difference between contra entry and other entries in Cash Book may be noted. "The Double entry work of contra entry is completed in Cash Book. They need not be posted to ledger". But the double entry work of other entries in Cash Book is not completed, one aspect (i.e. cash aspect) of the transaction is, however, completed in Cash Book, but the other aspect is not completed, which is to be posted to the concerned account in ledger.

Contra entry will be passed in the following cases:

When cash is deposited into the Bank:

Bank column - debit -- Cash column - credit.

When cash or Cheques (Cheques received but not deposited on the same date) enters into cash box, Cash Column is debited and when cash or cheque goes out of the cash box. Cash Column is credited. On the other hand, when Cash or cheque enters into bank box, Bank Column is debited and when cash goes out of bank box, bank column is credited.

Dr.						Cr.					
Receipts						Payment					
Date	Particulars	V. No.	L. F.	Cash Rs.	Bank Rs.	Date	Particulars	V. No.	L. F.	Cash Rs.	Bank Rs.

3. Triple Column

Every Businessman has a minimum of one current account in the bank. It is a very convenient way for him to get paid by cheque and make payment to others by cheque. So, he has to record these payments and receipts in the cash book for this an additional column will require name bank column. So now total three columns will be required to record proper payment and receipts in the cash book these are shown below

- I. Cash Column
- II. Bank Column
- III. Discount Column

Triple Column Books

Dr.							Cr.						
Receipts							Payment						
Date	Particulars	V No.	L F.	Disc. All.	Cash Rs.	Bank Rs.	Date	Particulars	V No.	L F.	Disc. Rec.	Cash Rs.	Bank Rs.

DEPRECIATION

Introduction

With the passage of time, all fixed assets lose their capacity to render services, the exceptions being land and antiques. Accordingly, a fraction of the cost of the asset is chargeable as an expense in each of the accounting periods in which the asset renders services. The accounting process for this gradual conversion of capitalised cost of fixed assets into expense is called depreciation. This lesson explains the different aspects of depreciation.

Meaning Of Depreciation

In common parlance depreciation means a fall in the quality or value of an asset. But in accounting terminology, the concept of depreciation refers to the process of allocating the initial or restated input valuation of fixed assets to the several periods expected to benefit from their acquisitions and use. Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation and not of valuation.

The international accounting standards committee (iasc) (now international accounting standards board) defines depreciation as follows: depreciation is the allocation of the depreciable amount of an asset over the estimated useful life. The useful life is in turn defined as the period over which a depreciable asset is expected to be used by the enterprise. The depreciable amount of a depreciable asset is its historical cost in the financial statements, less the estimated residual value. Residual value or salvage value is the expected recovery or sales value of the asset at the end of its useful life.

Need For Depreciation Accounting

The need for depreciation accounting arises on three grounds:

(i) To calculate proper profit: according to matching concept of accounting, profit of any year can be calculated only when all costs of earning revenues have been properly charged against them. Asset is an important tool in earning revenues. The fall in the book value of assets reflects the cost of earning revenues from the use of assets in the current year and hence like other costs like wages, salary, etc., it must also be provided for proper matching of revenues with expenses.

(ii) To show true financial position: the second ground for providing depreciation is that it should result in carrying forward only that part of asset which represents the unexpired cost of expected future service. If the depreciation is not provided then the asset will appear in the balance sheet at the overstated value.

(iii) To make provision for replacement of assets: if no changes were made for depreciation, profits of the concern would be more to that extent. By making an annual charge for depreciation, a concern would be accumulating resources enough to enable it to replace an asset when necessary. Replacement, thus, does not disturb the financial position of the concern.

METHODS OF DEPRECIATION:

Straight Line Method Of Depreciation

This method which is also known as 'fixed installment system', provides for equal amount of depreciation every year. Under this method, the cost of acquisition plus the installation charges, minus the scrap value, is spread over the estimated life of the asset to arrive at the annual charge. In other words, this method writes off a fixed percentage, say 20%, of the original cost of the asset every year in such a way that the asset is reduced to nil or scrap value at the end of its life.

Evaluation:

The chief merit of this method is that it is easy to calculate depreciation, and hence, it is simple. Depreciation charge is constant from year to year, regardless of the extent of use of the asset. This method can be employed in the case of assets like furniture and fixtures, short leases, etc., which involve little capital outlay, or which have no residual value. This method is criticized on the ground that the depreciation charge remaining the same every year, cost of repairs and maintenance would be increasing as the asset becomes older. With the efficiency of the asset declining, it is unfair to charge the same amount of depreciation every year.

Diminishing Balance Method

This method which is also known as the, 'reducing installment system', or 'written

down value method', applies depreciation as a fixed percentage to the balance of the net cost of the asset not yet allocated at the end of the previous accounting period. The percentage of depreciation is so fixed that, theoretically, the balance of the unallocated cost at the end of the estimated useful life of the asset should be equal to the estimated residual value.

Evaluation:

Unlike the fixed installment system, depreciation under this method is not fixed, but gradually decreasing. As such, in the initial periods, the amount will be much higher, but negligible in the later period of the asset. Thus, this method tends to offset the amount of depreciation on the one hand and repairs and maintenance on the other. This method is also simple, although the calculation of depreciation is a bit complicated. Further, as and when additions are made to the asset, fresh calculations do not become necessary. This method is best suited to assets such as plant and machinery which have a long life.

Illustration 1:

On 1-1-2003, machinery was purchased for rs.3,00,000. Depreciation at the rate of 10% has to be written off. Write up the machinery account for three years under:

1. Straight line method (SLM) and
2. Written down value method (WDV)

Solution:

Machinery Account

Date	Particulars	SLM	WDV	Date	Particulars	SLM	WDV
1-1-2003	To Bank A/C	3,00,000	3,00,000	31-12-2003	By Depreciation	30,000	30,000
		-----	-----	31-12-2003	By Balance C/D	2,70,000	2,70,000
		3,00,000	3,00,000			-----	-----
		-----	-----				
1-1-2004	To Balance B/D	2,70,000	2,70,000	31-12-2004	By Depreciation	30,000	27,000
		-----	-----	31-12-2004	By Balance C/D	2,40,000	2,43,000
		2,70,000	2,70,000			-----	-----
		-----	-----				
1-1-2005	To Balance B/D	2,40,000	2,43,000	31-12-2005	By Depreciation	30,000	24,300
		-----	-----	31-12-2005	By Balance C/D	2,10,000	2,18,700
		2,40,000	2,43,000			-----	-----
		-----	-----				
1-1-2006	To Balance B/D	2,10,000	2,18,700				

From the above illustration it can be seen that under SLM method each year depreciation is calculated at 10% on original cost of asset i.e. On rs.3,00,000, while under WDV method each year depreciation is calculated at 10% on the written down value i.e. For e.g. In the 2nd year depreciation is calculated at 10% on rs.2,70,000 and so on.

Illustration 2:

On 1-1-2002, machinery was purchased for rs.30,000. Depreciation at the rate of 10% on original cost was written off during the first two years. For the next two years 15% was written off the diminishing balance of the amount. The machinery was sold for rs.15,000. Write up the machinery account for four years and close the same.

Machinery Account

Date	Particulars	SLM	Date	Particulars	SLM
1-1-2002	To Bank A/C	30,000 ----- 30,000 -----	31-12- 2002	By Depreciation	3,000 27,000 -----
			31-12- 2002	By Balance C/D	----- 30,000 -----
1-1-2003	To Balance B/D	27,000 ----- 27,000 -----	31-12- 2003	By Depreciation	3,000 24,000 -----
			31-12- 2003	By Balance C/D	----- 27,000 -----
1-1-2004	To Balance B/D	24,000 ----- 2,40,000 ----- 20,400	31-12- 2004	By Depreciation	3,600 2,0,400 -----
			31-12- 2004	(15% On 24,000) By Balance C/D	----- 24,000 ----- 3,060
1-1-2005	To Balance B/D	20,400 ----- 20,400	31.12.2005	By Depreciation	15,000 2,340 -----
			31.12.2005 31.12.2005	(15% On 20,400) By Bank (Sale) By Profit & Loss A/C (Loss On Sale)	----- 20,400 -----

Illustration 3:

A company, whose accounting year is the calendar year, purchased a machinery on 1-1-2003 for rs.40,000. It purchased further machinery on 1-10-2003 for rs.20,000 and on 1st July 2005 for rs.10,000. On 1-7-2006, one-fourth of the machinery installed on 1-1-2003 became obsolete and was sold for rs.6,800. Show the machinery account for all the 3 years

under fixed installment system. Depreciation is to be provided at 10%p.a.

Machinery Account

Date	Particulars	Rupees	Date	Particulars	Rupees
2003 Jan 1	To Bank- Purchase	40,000	2003 Dec 31	By Depreciation	
Oct 10	To Bank- Purchase	20,000		-On Rs.40000 For 1 Year	4,000
		-----			500
		60,000	Dec 31	-On Rs.20000 For 3 Month	55,500
		-----			-----
				By Balance C/D	60,000
2004 Jan 1	To Balance B/D	55,500	2004 Dec 31		-----
July 1	To Bank- Purchase	10,000		By Depreciation	4,000
		-----		-On Rs.40000 For 1 Year	2,000
		65,500	Dec 31	-On Rs.20000 For 1 Year	500
		-----		-On Rs.10000 For 6 Month	59,000
				By Balance C/D	-----
		59,000	2005 July 1		500
			July 1		6,800
			July 1		700
2005 Jan 1	To Balance B/D		Dec 31	By Depreciation	3,000
				On Machine Sold	2,000
				By Bank-Sale	1,000
				By P&L A/C (Loss On Sale)	45,000
		-----		By Depreciation	-----
		59,000			59,000

				-On Rs.30000 For 1 Year	
				-On Rs.20000 For 1 Year	
				-On Rs.10000 For 1 Year	
				By Balance C/D	

Working Notes – Loss On Sale Of Machinery

Original cost of machinery on 1-1-2003:	= 10,000
Less depreciation for 2003 at 10% 1,000 (4000 x ¼)	= 1,000

Book value on 1-1-2004	9,000
Less depreciation for 2004 at 10% on 10,000	1,000

Book value on 1-1-2005	8,000
Less depreciation upto 1-7-2005 at 10% on 10000	500

Book value on date of sale	7,500
Less sale proceeds	6,800

Loss on sale	700

BASIC ACCOUNTING TERMS

Accounting equation: The accounting equation, the basis for the double-entry system (see below), is written as follows:

$$\text{Assets} = \text{Liabilities} + \text{Stakeholders' equity}$$

This means that all the assets owned by a company have been financed from loans from creditors and from equity from investors. “Assets” here stands for cash, account receivables, inventory, etc., that a company possesses.

Accounting methods: Companies choose between two methods—cash accounting or accrual accounting. Under cash basis accounting, preferred by small businesses, all revenues and expenditures at the time when payments are actually received or sent are recorded. Under accrual basis accounting, income is recorded when earned and expenses are recorded when incurred.

Account receivable: The sum of money owed by your customers after goods or services have been delivered and/or used.

Account payable: The amount of money you owe creditors, suppliers, etc., in return for goods and/or services they have delivered.

Accrual accounting: See “accounting methods.”

Assets (fixed and current): Current assets are assets that will be used within one year.

For example, cash, inventory, and accounts receivable (see above). Fixed assets (non-current) may provide benefits to a company for more than one year—for example, land and machinery.

Balance sheet: A financial report that provides a gist of a company's assets and liabilities and owner's equity at a given time.

Capital: A financial asset and its value, such as cash and goods. Working capital is current assets minus current liabilities.

Cash accounting: See “accounting methods.”

Cash flow statement: The cash flow statement of a business shows the balance between the amount of cash earned and the cash expenditure incurred.

Credit and debit: A credit is an accounting entry that either increases a liability or equity account, or decreases an asset or expense account. It is entered on the right in an accounting entry. A debit is an accounting entry that either increases an asset or expense account, or decreases a liability or equity account. It is entered on the left in an accounting entry.

Double-entry bookkeeping: Under double-entry bookkeeping, every transaction is recorded in at least two accounts—as a credit in one account and as a debit in another.

For example, an automobile repair shop that collects Rs. 10,000 in cash from a customer enters this amount in the revenue credit side and also in the cash debit side. If the customer had been given credit, “account receivable” (see above) would have been used instead of “cash.” (Also see “single-entry bookkeeping,” below.)

Financial statement: A financial statement is a document that reveals the financial transactions of a business or a person. The three most important financial statements for businesses are the balance sheet, cash flow statement, and profit and loss statement (all three listed here alphabetically).

General ledger: A complete record of financial transactions over the life of a company.

Journal entry: An entry in the journal that records financial transactions in the chronological order.

Profit and loss statement (income statement): A financial statement that summarises a company's performance by reviewing revenues, costs and expenses during a specific period.

Single-entry bookkeeping: Under the single-entry bookkeeping, mainly used by small or businesses, incomes and expenses are recorded through daily and monthly summaries of cash receipts and disbursements. (Also see “double-entry bookkeeping,” above.)

Types of accounting: Financial accounting reports information about a company's performance to investors and credits. Management accounting provides financial data to

managers for business development.

Depreciable Asset: It is that asset on which depreciation is written off.

Depreciation: It is the allocation of the depreciable amount of an asset over estimated useful life.

Useful Life: It is the period over which a depreciable asset is expected to be used by the enterprise.

Depreciable Amount: The depreciable amount of a depreciable asset is its historical cost less estimated residual value.

Residual Value: It is the expected recovery or sales value of an asset at the end of its useful life.

UNIT-2**PREPARATION OF FINANCIAL STATEMENTS**

Preparation of Financial Statements: Final Accounts: Meaning, Features, Uses and Preparation of Trading Account, Statement of Profit and Loss and Balance Sheet – Adjusting and Closing Entries. (Basic problems on Final accounts of companies)

Rectification of Errors: Types of Errors – Rectification of Errors before and after Preparations of Trial balance.

Learning Objectives

After reading this lesson the reader should be able to:

- § Understand the Basic Ideas of Income and Expense
- § Prepare a Trading & Profit and Loss Account/Income Statement in the Proper Format
- § Understand the Basic Ideas About a Balance Sheet
- § Classify the Different Assets and Liabilities
- § Prepare a Balance Sheet in the Proper Format
- § rectify the errors before and after preparation of Trial Balance.

2.1 Introduction

The primary objective of any business concern is to earn income. Ascertainment of the periodic income of a business enterprise is perhaps the important objective of the accounting process. This objective is achieved by the preparation of profit and loss account or the income statement. Profit and loss account is generally considered to be of greatest interest and importance to end users of accounting information. The profit and loss account enables all concerned to find out whether the business operations have been profitable or not during a particular period. Usually the profit and loss account is accompanied by the balance sheet as on the last date of the accounting period for which the profit and loss account is prepared. A balance sheet shows the financial position of a business enterprise as of a specified moment of time. It contains a list of the assets, the liabilities and the capital of a business entity as of a specified date, usually at the close of the last day of a month or a year. While the profit and loss account is categorized as a flow report (for a particular period), the balance sheet is

categorized as a status report (as on a particular date).

2.2 Basic Ideas About Income And Expense

Profit and loss account consists of two elements: one element is the inflows that result from the sale of goods and services to customers which are called as revenues. The other element reports the outflows that were made in order to generate those revenues; these are called as expenses. Income is the amount by which revenues exceed expenses. The term 'net income' is used to indicate the excess of all the revenues over all the expenses. The basic equation is:

$$\text{Revenue} - \text{Expenses} = \text{Net Income}$$

This is in accordance with the matching concept.

Income And Owner's Equity:

The net income of an accounting period increases owner's equity because it belongs to the owner.

Income Vs. Receipts:

Income of a period increases the owner's equity but it need not result in increase in cash balance. Loss of a period decreases owner's equity but it need not result in decrease in cash balance. Similarly, increase in cash balance need not result in increased income and owner's equity and decrease in cash balance need not denote loss and decrease in owner's equity. All these are due to the fact that income is not the same as cash receipt. The following examples make clear the above point:

- I) when goods costing rs.20,000 are sold on credit for rs.28,000 it results in an income of rs.8,000 but the cash balance does not increase.
- Ii) when goods costing rs.18,000 are sold on credit for rs.15,000 there is a loss of rs.3,000 but there is no corresponding decrease in cash.
- Iii) when a loan of rs.5,000 is borrowed the cash balance increases but there is no impact on income.
- Iv) when a loan of rs.8,000 is repaid it decreases only the cash balance and not the income.

Expenses:

An expense is an item of cost applicable to an accounting period. It represents economic resources consumed during the current period. When expenditure is incurred the

cost involved is either an asset or an expense. If the benefits of the expenditure relate to further periods, it is an asset. If not, it is an expense of the current period. Over the entire life of an enterprise, most expenditure becomes expenses. But according to accounting period concept, accounts are prepared for each accounting period. Hence, we get the following four types of transactions relating to expenditure and expenses:

Expenditures That Are Also Expenses:

This is the simplest and most common type of transaction to account for. If an item is acquired during the year, it is expenditure. If the item is consumed in the same year, then the expenditure becomes expense. E.g. Raw materials purchased are converted into saleable goods and are sold in the same year.

Assets That Become Expenses:

when expenditures incurred result in benefits for the future period they become assets. When such assets are used in subsequent years they become expenses of the year in which they are used. For e.g. Inventory of finished goods are assets at the end of a particular accounting year. When they are sold in the next accounting year they become expenses.

Expenditures That Are Not Expenses:

As already pointed, out when the benefits of the expenditure relate to future periods they become assets and not expenses. This applies not only to fixed assets but also to inventories which remain unsold at the end of the accounting year. For e.g. The expenditure incurred on inventory remaining unsold is asset until it is sold out.

Expenses Not Yet Paid:

Some expenses would have been incurred in the accounting year but payment for the same would not have been made within the accounting year. These are called accrued expenses and are shown as liabilities at the year end.

Form And Presentation Of Profit And Loss Account / Income Statement

In practice there is considerable variety in the format and degree of detail used in income statements. The profit and loss account is usually prepared in “t” shape. The following (illustration-a) is the summarized profit and loss account of ali akbar ltd.

Illustration – A:**Ali Akbar Ltd****Profit And Loss Account For The Year Ended 31st March 2017**

(rs. In `000)

Particulars	Rs.	Particulars	Rs.
Cost Of Goods Sold	78,680	Sales(Less Dis count)	89,740
Expenses (Schedule17)	33,804	Other Income (Sched- ule 13)	39,947
Interest (Schedule 18)	2,902		
Director's Fees	11		
Depreciation	20,94		
Provision For Taxation	6,565		
Net Profit	5,,625		
	1,29,687		1,29,687

In the “t” shaped profit and loss account, expenses are shown on the left hand side i.e., the debit side and revenues are shown on the right hand side i.e., the credit side. Net profit or loss is the balancing figure.

The profit and loss account can also be presented in the form of a statement when it is called as income statement. There are two widely used forms of income statement: single step form and multiple-step form. The single-step form of income statement derives its name from the fact that the total of all expenses is deducted from the total of all revenues.

Illustration – a can be presented in the single-step form as given in illustration – b.

Illustration – B:**Ali Akbar Ltd****Income Statement For The Year Ended 31st March 2017**

(Rs. In `000)

Revenues		
Sales (Less Discount)	89,740	
Other Income (Sched- ule 13)	39,947	1,29,687

Illustration – A:**Ali Akbar Ltd**

Profit And Loss Account For The Year Ended 31st March 2017

(rs. In `000)

Particulars	Rs.	Particulars	Rs.
Cost Of Goods Sold	78,680	Sales(Less Dis count)	89,740
Expenses (Schedule 17)	33,804	Other Income (Schedule 13)	39,947
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Illustration – B:**Ali Akbar Ltd****Income Statement For The Year Ended 31st March 2017**

(Rs. In `000)

Revenues		
Sales (Less Discount)	89,740	
Other Income (Schedule 13)	39,947	1,29,687

Expenses		
Cost Of Goods Sold	78,680	
Expenses (Schedule 17)	33,804	
Interest (Schedule 18)	2,902	
Director's Fees	11	
Depreciation	20,94	

Provision For Taxation	6,565	1,24,062
		5,625

The single-step form has the advantage of simplicity but it is inadequate for analytical purpose.

The multi-step form income statement is so called because of its numerous sections, sub-sections and intermediate balances. Illustration – c is a typical proforma of multiple-step income statement.

Illustration – C:

Proforma Of A Multiple-Step Income Statement

Gross Sales		Xxx
Less: Sales Returns		Xxx
Net Sales		Xxx
Less: Cost Of Goods Sold		
Raw Materials Cost		
Opening Stock Of Raw Material	Xxx	
Add Purchase Of Raw Material	Xxx	
Freight	Xxx	
Raw Materials Available	Xxx	
Less Closing Stock Of Raw Material	Xxx	
Raw Materials Consumed	Xxx	
Direct Labour Cost	Xxx	
Manufacturing Expenses	Xxx	
Total Production Cost	Xxx	
Add Opening Work-In-Progress	Xxx	
Total	Xxx	
Less Closing Work-In-Progress	Xxx	

Cost Of Goods Manufactured	Xxx	
Add Opening Finished Goods	Xxx	
Cost Of Goods Available For Sale	Xxx	
Less Closing Finished Goods	Xxx	
	Xxx	
Cost Of Goods Sold		
Gross Profit	Xxx	
Less Operating Expenses	Xxx	
Administrative Expenses		
Selling And Distribution Expenses	Xxx	
Operating Profit	Xxx	Xxx

		Xxx
Add Non-Operating Income (Such As Dividend Received Profit On Sale Of Assets Etc.)		
	Xxx	Xxx
Less Non-Operating Expenses (Such As Discount On Issue Of Shares Written Off, Loss On Sale Of Assets, Etc.)		
	Xxx	Xxx
Profit (Or) Earnings Before Interest & Tax (Ebit)	Xxx	
Less Interest	Xxx	Xxx
Profit (Or) Earnings Before Tax (Ebt)	Xxx	
Less Provision For Income-Tax	Xxx	Xxx
Net Profit (Or) Earnings After Tax (Eat)	Xxx	
Earnings Per Share Of Common Stock	Xxx	Xxx

The Multiple-Step Form Of Illustration 'C' Would Be As Given Under Illustration 'D'.

Illustration – D

Ali Akbar Ltd

Income Statement For The Year Ended 31st March 2017

(rs. In `000)

Net Sales		98,740
Less: Cost Of Goods Sold		78,686
Gross Profit		11,054
Less Operating Expenses Expenses (Schedule 17)		
	33,804	
Director's Fee		
	11	
Depreciation		
	2,094	35,909
Operating Loss		(-) 24,855
Add Non-Operating Income		
Other Income (Schedule 13)		39,947
Profit (Or) Earnings Before Interest & Tax(Ebit)		15,092
Less Interest (Schedule 18)		2,902
Profit (Or) Earnings Before Tax (Ebt)		12,190
Less Provision For Income-Tax		6,565
Net Profit (Or) Earnings After Tax (Eat)		5,625

The advantage of multiple-step form of income statement over single step form and the “t” shaped profit and loss account is that there are a number of significant sub totals on the road to net income which lend themselves for significant analysis.

Income statements prepared for use by the managers of an enterprise Usually contain more detailed information than that shown in the above illustrations.

Explanation Of Items On The Income Statement

The heading of the income statement must show:

- I) the business enterprise to which it relates (ali akbar ltd.) I i) the name of the statement (income statement)
- I ii) the time period covered (year ended 31st march of the relevant year)

The income statement is generally followed by various schedules that give detailed account of the items, listed on them. Information about these schedules are given against each item in the financial statements.

One important objective in reporting revenue on an income statement is to disclose the major source of revenue and to separate it from miscellaneous sources. For most companies the major source of revenue is the sale of goods and services.

Sales Revenue:

An income statement often reports several separate items in the sales revenue section, the net of which is the net sales figure. Gross sales is the total invoice price of the goods sold or services rendered during the period. It should not include sales taxes or excise duties that may be charged to the customers. Such taxes are not revenues but rather represent collections that the business makes on behalf of the government and are liabilities to the government until paid. Similarly, postage, freight or other items billed to the customers at cost are not revenues. These items do not appear in the sales figure but instead are an offset to the costs the company incurs for them. Sales returns and allowances represent the sales values of goods that were returned by customers or allowance made to customers because the goods were defective. The amount can be subtracted from the sales figure directly without showing it as a separate item

on the income statement. But it is always better to show them separately.

Sometimes called as cash discounts, sales discounts are the amount of discounts allowed to customers for prompt payment. For e.g. If a business offers a 3% discount to customers who pay within 7 days from the date of the invoice and it sells rs.30,000 of goods to a customer who takes advantage of this discount, the business receives only rs.29,100 in cash and records the balance rs.900 as sales discount. There is another kind of discount called as trade discount which is given by the wholesaler or manufacturer to the retailers to enable them to sell at catalogue price and make a profit: e.g. List less 30 percent. Trade discount does not appear in the accounting records at all.

Miscellaneous Or Secondary Sources Of Revenues:

These are revenues earned from activities not associated with the sale of the enterprise's goods and services. Interest or dividends earned on marketable securities, royalties, rents and gains on disposal of assets are examples of this type of revenues. For e.g. In the case of ali akbar ltd., its operating loss has been converted into net profit only because of other income, other than sales revenue. Schedule 13 gives details of other income earned by ali akbar ltd.

Schedule 13 – Other Income

	(rs. `000)
Income From Trade Investments	825
Interest On Bank Deposits & Others	1,042
Profit On Sale Of Investments	456
Profit On Sale Of Inventories	813
Miscellaneous Income	2,394
Factory Charges Recovered	9,081
Bottle Deposits Forfeited	25,336
	39,947

Cost Of Goods Sold:

when income is increased by the sale value of goods or services sold, it is also decreased by the cost of these goods or services. The cost of goods or services sold is called the cost of sales. In manufacturing firms and retailing business it is often called the cost of goods sold. The complexity of calculation of cost of goods sold varies depending upon the

nature of the business. In the case of a trading concern which deals in commodities it is very simple to calculate the most of goods sold and it is done as follows:

	Opening stock	xxx
Add:	purchase	xxx
	Freight	xxx
	Goods available for sale	xxx
Less:	closing stock	xxx
	Cost of goods sold	xxx

The calculation becomes a complicated process in the case of manufacturing concern, especially when a number of products are manufactured because it involves the calculation of the work in progress and valuation of inventory. The cost of goods sold in the case of ali akbar ltd., would have been calculated as given in illustration `e`.

Illustration E:

Cost Of Goods Sold

	(rs. `000)
Opening Stock	4,436
Raw Materials Consumed	22,151
Packing Materials Consumed	48,536
Excise Duty	7,805
	82,928
Less: Closing Stock	4,242
Cost Of Goods Sold	78,686

Gross Profit:

The excess of sales revenue over cost of goods sold is gross margin or gross profit. In the case of multiple-step income statement it is shown as a separate item. Significant managerial decisions can be taken by calculating the percentage of gross profit on sale. This percentage indicates the average mark up obtained on products sold. The percentage varies widely among industries, but healthy companies in the same industry tend to have similar gross profit percentages.

Operating Expenses:

Expenses which are incurred for running the business and which are not directly related to the company's production or trading are collectively called as operating expenses. Usually operating expenses include administration expenses, finance expenses, depreciation and selling and distribution expenses. Administration expenses generally include personnel expenses also. However sometimes personnel expenses may be shown separately under the heading establishment expenses.

Until recently most companies included expenses on research and development as part of general and administrative expenses. But now- a-days the financial accounting standards board (fasb) requires that this amount should be shown separately. This is so because the expenditure on research and development could provide an important clue as to how cautious the company is in keeping its products and services up to date.

Operating Profit: operating profit is obtained when operating expenses are deducted from gross profit.

Non-Operating Expenses:

These are expenses which are not related to the activities of the business e.g. Loss on sale of asset, discount on shares written off etc. These expenses are deducted from the income obtained after adding other incomes to the operating profit. Other incomes or miscellaneous receipts have already been explained. The resultant profit is called as profit (or) earning before interest and tax (ebit).

Interest Expenses:

Interest expense arises when part of the expenses are met from borrowed funds. The fasb requires separate disclosure of interest expense. This item of expense is deducted from income or earnings before interest and tax. The resultant figure is profit (or) earnings before tax (ebt).

Income Tax: the provision for tax is estimated based on the quantum of profit before tax. As per the corporate tax laws, the amount of tax payable is determined not on the basis of reported net profit but the net profit arrived at has to be recomputed and adjusted for determining the tax liability. That is why the liability is always shown as a provision.

Net Profit:

This is the amount of profit finally available to the enterprise for Appropriation. Net profits is reported not only in total but also per share of stock. This per share amount is

obtained by dividing the total amount of net profit by the number of shares outstanding. The net profit is usually referred to as profit or earnings after tax. This profit could either be distributed as dividends to shareholders or retained in the business. Just like gross profit percentage, net profit percentage on sales can also be calculated which will be of great use for managerial analysis.

Statement Of Retained Earnings

The term retained earnings means the accumulated excess of earnings over losses and dividends. The statement of retained earnings is generally included with almost any set of financial statements although it is not considered to be one of the major financial statements. A typical statement of retained earnings starts with the opening balance of retained earnings, the net income for the period as an addition, the dividends as a deduction, and ends with the closing balance of retained earnings. The statement may be prepared and shown on a separate sheet or included at the bottom of the income statement. The balance shown by the income statement is transferred to the balance sheet through the statement of retained earnings after making necessary appropriations. This statement thus links the income statement to the retained earning item on the balance sheet. This statement can be prepared in 't' shape also when it is called as profit and loss appropriation account. Illustration 'f' gives the statement of retained earning of ali akbar ltd.

Illustration – F Ali Akbar Ltd.

For The Year Ended 31st March 2017

		(Rs.`000)
Retained Earnings At The Beginning Of The Year		700
Add: Net Income		5,625
		6,325
Less: Dividends	5,600	
General Reserve	625	6,225
Retained Earnings At The End Of The Year		100

Balance Sheet

The balance sheet is basically a historical report showing the cumulative effect of past transactions. It is often described as a detailed expression of the following fundamental accounting equation:

Assets = Liabilities + Owners' Equity (Capital)

Assets are costs which represent expected future economic benefits to the business enterprise. However, the rights to assets have been acquired by the Enterprise as a result of past transactions.

Liabilities also result from past transactions. They represent obligations which require settlement in the future either by conveying assets or by performing services. Implicit in these concepts of the nature of assets and liabilities is the meaning of owners' equity as the residual interest in the assets of the enterprise.

Form And Presentation Of A Balance Sheet

Two objectives are dominant in presenting information in a balance sheet. One is clarity and readability; the other is disclosure of significant facts within the framework of the basic assumptions of accounting. Balance sheet classification, terminology and the general form of presentation should be studied with these objectives in mind.

It is proposed to explain the various aspects of the balance sheet with the help of the following typical summarized balance sheet of an imaginary Partnership firm:

Conventions Of Preparing The Balance Sheet:

There are two conventions of preparing the balance sheet, the American and the English. According to the American convention, assets are shown on the left hand side and the liabilities and the owners' equity on the right hand side. Under the English convention just the opposite is followed i.e. Assets are shown on the right hand side and the liabilities and owners' equity are shown on the left hand side. In the illustration 'a', the American convention has been followed.

Forms Of Presenting The Balance Sheet:

There are two forms of presenting the balance sheet – account form and report form. When the assets are listed on the left hand side and liabilities and owners' equity on the right hand side, we get the account form of balance sheet. It is so called because it is similar to an account. An alternative practice is the report form of balance sheet where the assets are listed at the top of the page and the liabilities and owners' equity are listed beneath them. In illustration 'a' we have followed the account form of balance sheet. Now-a-days joint stock companies present balance sheet in the form of a statement in the annual reports.

Listing Of Items On The Balance Sheet

Assets in balance sheet are generally listed in two ways – i) in the order of liquidity or according to time i.e. In the order of the degree of ease with which they can be converted into cash or ii) in the order of permanence or according to purpose i.e., in the order of the desire to keep them in use. Some assets cannot be easily classified. For e.g. Investments can be easily sold but the desire may be to keep them. Investments may therefore be both liquid and semi-permanent that is why they are shown as a separate item in the balance sheet. Liabilities can also be grouped in two ways; either in the order of urgency of payment or in the reverse order. The various assets and liabilities grouped in the two orders will appear as follows:

Order of liquidity:

Bank Overdraft	Cash
Bills Payable	Bank
Creditors	Marketable Securities
Outstanding Expenses	Debtors
Income Received In Advance	Inventory
Provision For Income-Tax	Bills Receivable
Mortgage Loan	Prepaid Expenses
Debentures	Investments
Owners' Equity	Furniture And Fixtures
	Plant And Machinery
	Land And Buildings
	Patents
	Trade Marks
	Goodwill
	Preliminary Expenses

Order Of Permanence

Owners' Equity	Goodwill
Debentures	Trade Marks
Mortgage Loan	Patents
Provision For Income-Tax	Land And Buildings
Income Received In Advance	Plant And Machinery
Outstanding Expenses	Furniture And Fixtures
Creditors	Investments

Bills Payable	Prepaid Expenses
	Inventory
	Debtors
	Marketable Securities
	Bank
	Cash
	Bills Receivables

Whatever is the order, it is always better to follow the same order for both assets and liabilities.

Classification Of Items In The Balance Sheet

Although each individual asset or liability can be listed separately on the balance sheet, it is more practicable and more informative to summarize and group related items into categories called as account classifications. The classifications or group headings will vary considerably depending on the size of the business, the form of ownership, the nature of its operations and the users of the financial statements. For e.g. While listing assets, the order of liquidity is generally used by sole traders, partnership firms and banks, whereas joint stock companies by law follow the order of permanence. As a generalization which is subject to many exceptions, the following classification of balance sheet items is suggested as representative:

Assets

Current assets

Investments

Fixed assets

Intangible assets

Other assets

Liabilities

Current liabilities

Long term liabilities

Owners' Equity

Capital

Retained earnings

Classification Of Assets

Consumed Current Assets:

Current assets are those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business enterprise or within one year, whichever is longer. By operating cycle we mean the average period of time between the purchase of goods or raw materials and the realisation of cash from the sale of goods or the sale of products produced with the help of raw materials. Current assets generally consist of cash, marketable securities, bills receivables, debtors, inventory and prepaid expenses.

Cash:

Cash consists of funds that are readily available for disbursement. It includes cash kept in the cash chest of the enterprise as also cash deposited on call or current accounts with banks.

Marketable Securities:

These consist of investments that are both readily marketable and are expected to be converted into cash within a year. These investments are made with a view to earn some return on cash that otherwise would be temporarily idle.

Accounts Receivable:

Accounts receivable consist of amounts owed to the enterprise by its consumers. This represents amounts usually arising out of normal commercial transactions. These amounts are listed in the balance sheet at the amount due less a provision for portion that may not be collected. This provision is called as provision for doubtful debts. Amounts due to the enterprise by someone other than a consumer would appear under the heading 'other receivables' rather than 'accounts receivables'. If the amounts due are evidenced by written promises to pay, they are listed as bills receivables. Accounts receivables are expected to be realised in cash.

Inventory:

Inventory consists of i) goods that are held in stock for sale in the ordinary course of business, ii) work-in-progress that are to be currently consumed in the production of goods or services to be available for sale. Inventory is expected to be sold either for cash or on credit to customers to be converted into cash. It may be noted in this connection that inventory relates to goods that will be sold in the ordinary course of business. A van offered for sale by a van dealer is inventory. A van used by the dealer to make service calls is not inventory but an item of equipment which is a fixed asset.

Prepaid Expenses:

These items represent expenses which are usually paid in advance such as rent, taxes, subscriptions and insurance. For e.g. If rent for three months for the building is paid in advance then the business acquires a right to occupy the building for three months. This right to occupy is an asset. Since this right will expire within a fairly short period of time it is a current asset.

Long Term Investments:

The distinction between a marketable security shown under current asset and as an investment is entirely based on time factor. Those investments like investments in shares, debentures, bonds etc. That will be retained for more than one year or one operating cycle will appear under this classification.

Fixed Assets:

Tangible assets used in the business that are of a permanent or relatively fixed nature are called plant assets or fixed assets. Fixed assets include furniture, equipment, machinery, building and land. Although there is no standard criterion as to the minimum length of life necessary for classification as fixed assets, they must be capable of repeated use and are ordinarily expected to last more than a year. However the asset need not actually be used continuously or even frequently. Items of spare equipments held for use in the event of breakdown of regular equipment or for use only during peak periods of activity are also included in fixed assets.

With the passage of time, all fixed assets with the exception of land lose their capacity to render services. Accordingly the cost of such assets should be transferred to the related expense amounts in a systematic manner during their expected useful life. This periodic cost expiration is called depreciation. While showing the fixed assets in the balance sheet the accumulated depreciation as on the date of balance sheet, is deducted from the respective assets.

Intangible Assets:

While tangible assets are concrete items which have physical existence such as buildings, machinery etc., intangible assets are those which have no physical existence. They cannot be touched and felt. They derive their value from the right conferred upon their owner by possession. Examples are: goodwill, patents, copyrights and trademarks.

Fictitious Assets:

These items are not assets. Yet they appear in the asset side simply because of a debit balance in a particular account not yet written off – e.g. Debit balance in current account of partners, profit and loss account, etc.

Classification Of Liabilities**Current Liabilities:**

When the liabilities of a business enterprise are due within an accounting period or the operating cycle of the business, they are classified as current liabilities. Most of the current liabilities are incurred in the acquisition of materials or services forming part of the current assets. These liabilities are expected to be satisfied either by the use of current assets or by the creation of other current liabilities. The one year time interval or current operating cycle criterion applies to classifying current liabilities also. Current liabilities generally consists of bills payable, creditors, outstanding expenses, income received in advance, provision for income-tax etc.

Accounts Payable:

These amounts represent the claims of suppliers related to goods supplied or services rendered by them to the business enterprise for which they have not yet been paid. Usually these claims are unsecured and are not evidenced by any formal written acceptance or

promise to pay. When the enterprise gives a written promise to pay money to a creditor for the purchase of goods or services used in the business or the money borrowed, then the written promise is called as bills payable or notes payable. Amounts due to financial institutions which are suppliers of funds, rather than of goods or services are termed as short-term loans or by some other name that describes the nature of the debt instrument, rather than accounts payable.

Outstanding Expenses:

These are expenses or obligations incurred in the previous accounting period but the payment for which will be made in the next accounting period. A typical example is wages or rent for the last month of the accounting period remaining unpaid. It is usually paid in the first month of the next accounting period and hence it is an outstanding expense.

Income Received In Advance:

These amounts relate to the next accounting period but received in the previous accounting period. This item of liability is frequently found in the balance sheet of enterprises dealing in the publication of newspapers and magazines.

Provision For Taxes:

This is the amount owed by the business enterprise to the government for taxes. It is shown separately from other current liabilities both because of the size and because the amount owed may not be known exactly as on the date of balance sheet. The only thing known is the existence of liability and not the amount.

Long Term Liabilities:

All liabilities which do not become due for payment in one year and which do not require current assets for their payment are classified as long-term liabilities or fixed liabilities. Long term liabilities may be classified as secured loans or unsecured loans. When the long-term loans are obtained against the security of fixed assets owned by the enterprise, they are called as secured or mortgaged loans. When any asset is not attached to these loans they are called as unsecured loans. Usually long-term liabilities include debentures and bonds, borrowings from financial institutions and banks, public debts, etc. Interest accrued on a particular secured long term loan, should be shown under the appropriate sub-heading.

Contingent Liabilities:

Contingent liabilities are those liabilities which may or may not result in liability. They become liabilities only on the happening of a certain event. Until then both the amount and the liability are uncertain. If the event happens there is a liability; otherwise there is no liability at all. A very good example for contingent liability is a legal suit pending against the business enterprise for compensation. If the case is decided against the enterprise the liability arises and in the case of favourable decision there is no liability at all. Contingent liabilities are not taken into account for the purpose of totaling of balance sheet.

Capital Or Owners' Equity:

As mentioned earlier, owners' equity is the residual interest in the assets of the enterprise. Therefore the owners' equity section of the balance sheet shows the amount the owners have invested in the entity. However, the terminology 'owners' equity, varies with different forms of organisations depending upon whether the enterprise is a joint stock company or sole proprietorship / partnership concern.

	Rs.
Owner's capital as on 1-1-2011	2,50,00
Add: 2011 – profit	30,000
Less: 2011 – drawings	2,80,00
	15,000
Owner's capital as on 31-12-2011	<u>2,65,000</u>

Joint Stock Companies:

In the case of joint stock companies, according to the legal requirements, owners' equity is divided into two main categories. The first category called share capital or contributed capital is the amount the owners have invested directly in the business. The second category of owners' equity is called retained earnings.

Share capital is the capital stock pre-determined by the company by the time of registration. It may consist of ordinary share capital or preference share capital or both. The capital stock is divided into units called as shares and that is why the capital is called as share

capital. The entire predetermined share capital called as authorised capital need not be raised at a time. That portion of authorised capital which has been issued for subscription as on a date is referred to as issued capital.

Retained earnings is the difference between the total earning to date and the amount of dividends paid out to the shareholders to date. That is, the difference represents that part of the total earnings that have been retained for use in the business. It may be noted that the amount of retained earnings on a given date is the accumulated amount that has been retained in the business from the beginning of the company's existence up to that date. The owners' equity increases through retained earnings and decreases when retained earnings are paid out in the form of dividends.

Summary

The profit and loss account or income statement summarizes the revenues and expenses of a business enterprise for an accounting period. The information on the income statement is regarded by many to be more important than information on the balance sheet because the income statement reports the results of operations and enables to analyze the reasons for the enterprises' profitability or loss thereof. A close relationship exists between income statement and balance sheet; the statement of retained earnings which is a concomitant of income statement explains the change in retained earnings between the balance sheets prepared at the beginning and the end of the period.

Balance sheet is one of the most important financial statements which shows the financial position of a business enterprise as on a particular date. It lists as on a particular date, usually at the close of the accounting period, the assets, liabilities and capital of the enterprise. An analysis of balance sheet together with profit and loss account will give vital information about the financial position and operations of the enterprise. The analysis becomes all the more useful and effective when a series of balance sheets and profit and loss accounts are studied.

Key Words

Income: Revenues – expenses.

Expense: Item of cost applicable to an accounting period.

Cost Of Goods Sold: Opening stock + purchase + freight – closing stock. **Gross Profit:** Excess of sales revenue over cost of goods sold.

Operating Expenses: Expenses incurred for running the business. **Operating Profit:** Gross profit – operating expenses.

Non Operating Expenses: Expenses which are not related to the activities of the business.

Net Profit: Amount of profit finally available to the enterprise for appropriation.

Retained Earnings:

The term retained earnings means the accumulated excess of earnings over losses and dividends.

Status Report: Financial position on a particular date.

Flow Report:

Financial position for a particular period.

Assets: costs which represent expected future economic benefits to the business enterprise.

Liabilities:

Represent obligations which require settlement in the future.

Current Assets:

Assets which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business enterprise or within one year, whichever is longer.

Operating Cycle:

The average period of time between the purchase of goods or raw materials and the realization of cash from the sale of goods.

Fixed Assets: tangible assets used in the business that are of a permanent or relatively fixed nature.

Intangible Assets:

Those assets which have no physical existence.

Fictitious Assets:

They are not assets but appear in the asset side simply because of a debit balance in a particular account not yet written off.

Current Liabilities:

Liabilities due within an accounting period or the operating cycle of the business.

Long Term Liabilities:

Liabilities that become due for payment after one year.

Contingent Liabilities:

Items which become a liability only on the happening of a certain event.

Capital Or Owner's Equity:

this is the residual interest in the assets of the Enterprise.

Rectification of Errors

In financial accounting, every single transaction & events occurring in monetary terms is recorded. Sometimes we omits or forgot to record the transaction or it might be recorded incorrect. Whatever the reason may be, there is always a chance of error in the books of accounts which need to be rectify. The process which is adopted to rectify these types of error are known as rectification of errors.

Types of accounting errors:

The accounting errors are classified into

Errors of omission
Error of commission
Compensating Error
Errors of principle

1. Errors of omission. These errors are incurred in those cases when a transaction

is completely omitted from the books of accounts. It happen: when a transaction is not recorded in the books of the original entry (i.e., various journals). For example, if a purchase of goods on credit from Shri Ram Lal has not at all been recorded in the books of accounts, such an error will be teimed as an error of omission. Since, there has been neither a debit entry nor a credit entry, therefore, the two sides of the TYial Balance will not be at all affected on account of this error. Such errors, therefore, cannot be located out very easily. They come to the notice of the businessman when statement of accounts are received from or sent to creditors or debtors as the case might be.

2. Errors of commission. Such errors include errors on account of wrong balancing of an account, wrong posting, wrong carry forwards, wrong totalling, etc. For example, if a sum of

Rs 50 received from Mukesh is credited to his account as Rs 500, this is an error of commission. Similarly, if the total of the debit side of an account is carried forward from one page to another and the mistake is committed in such carry forward (e.g. total of Rs 996 is carried forwards as Rs 699) such an error is an error of commission. Errors of commission affect the agreement of the Trial Balance and, therefore, their location is easier.

3. Errors of principle. Errors of principle are committed in those cases where a proper distinction between revenue and capital items is not made. i.e., a capital expenditure is taken as a revenue expenditure or vice-versa. Similarly, a capital receipt may have been taken as a revenue receipt or vice-versa. For example, a sale of old furniture of Rs 500 should be credited to the furniture account, but if it is credited to the Sales Account, it will be termed as an error of principle. Sale of old furniture is a capital receipt. If it is credited to Sales Account, it has been taken as a revenue receipt. Such errors by themselves do not affect the agreement of the Trial Balance. Therefore, they also are difficult to be located.

4. Compensating errors. As the name indicates, compensating errors are those errors which compensate each other. For example, if a sale of Rs 500 to Ram is debited as only of Rs 50 to his account, while a sale of Rs 50 to Shyam is debited as of Rs 500 to his account, it is a compensating error. These errors also do not affect the agreement of the Trial Balance and, therefore, their location is also difficult.

The accounting errors will hardly affect the accuracy of trial balance of the business because the trial balance is the final proof of the books of accounts. There are some of the methods to rectify the accounting errors happened in the books of accounts. The important two methods for rectifying the accounting errors are as follow.

à Striking of the wrong Entry.

à Making appropriate entries to correct the errors.

Procedure for rectifying Accounting errors.

There are mainly three steps to rectify the accounting errors in the books of accounts.

- a. Ascertain the error occurred
- b. Identify the correct record of transaction which has to be done.
- c. Decide the rectification entry.

These all are the different kinds of accounting errors and the methods to rectify those errors.

Final Accounts:

Every businessman goes into a business with the idea of making profit, which is the reward of this effort. He tries his best to get more and more profit at the smallest economic cost.

The role of accounting is to accumulate accounting data in such a manner that the amount of profit made or loss sustained during a particular period ascertained. The "final accounts" enable us to check on the conduct of the business, and to discover whether it is being run profitably. They are the means of conveying to the owner/owners, management, creditors, and interested outsiders a concise picture of profitability and financial position of the business.

The preparation of the final accounts is not the first stage of an accounting cycle but they are the final products of the accounting cycle, that is why, they are called final accounts.

These accounts summaries all the accounting information recorded in the original books of entry and the ledger consisted of hundreds of thousands of pages.

The final accounts or financial statements consists of:

- Trading and profit and loss account or income statement, which is prepared to know the profit earned or loss suffered by the business during a specific period.
- Balance sheet, which is prepared to know the financial position of the business on a particular date.

These two items or statements are collectively known as "final accounts or financial statements"

Trading account:

Definition and Explanation:

The account which is prepared to determine the gross profit or gross loss of a business concern is called trading account.

It should be noted that the result of the business determined through trading account is not true result. The true result is the net profit or the net loss which is determined through profit and loss account. The trading accounting has the following features:

It is the first stage of final accounts of a trading concern.

It is prepared on the last day of an accounting period.

Only direct revenue and direct expenses are considered in it.

Direct expenses are recorded on its debit side and direct revenue on its credit side.

All items of direct expenses and direct revenue concerning current year are taken into account but no item relating to past or next year is considered in it.

If its credit side exceeds it represents gross profit and if debit side exceeds it shows gross loss.
Purpose of Preparing Trading Account:

The profit or loss determined by a trading account is the gross result of the business but not the net result. If so, then a question arises - what is the use of preparing a trading account? This account is necessary because of the following advantages.

Gross profit of a business is very important data, since all business expenses are met out of it. So the amount of gross profit should be adequate to meet the indirect expenses of a business concern.

The amount of net sales can be determined through this account. Gross sales can be ascertained from sales account in the ledger, but net sales cannot be so obtained. The true sales of a business is net sales - not gross sales. Net sales are determined by deducting sales returns from gross sales in trading account.

The success or failure of a business can be ascertained by comparing net sales of the current year with that of the last year. It should be noted that an increase in the amount of net sales of the current year over the last year may not be regarded as a sign of success, since sales may increase because of rise in price level.

Percentage of gross profit on net sales (gross profit ratio) can be easily determined from trading account. This percentage is very important yardstick for measuring the success or failure of a business. Compared to last year, if the rate increases, it indicates success; on the other hand if the rate decreases, it is an indication of failure.

Percentage of different items of buying expenses (direct expenses) on gross profit can be easily determined and by comparing the percentage of the current year with that of the previous year the variations can be ascertained. An analysis of variances will disclose their cause which will help in controlling the amount of expenses.

Inventory or stock turnover ratio can be determined from trading account. The success or failure of a business can be measured by this rate. Higher rate indicates a favorable sign i.e. goods are sold soon after their purchase. On the other hand, low rate signifies deterioration, i.e. goods are sold long after their purchase.

If credit side exceeds the debit side = Gross profit
If debit side exceeds the credit side = Gross loss

**Trading Account
for the year ending 31st March 2003**

Dr.			Cr.		
Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Opening Stock		xxx	By Sales	xxx	
To Purchases	xxx		Less : Returns		
Less: Returns			Inward	xxx	xxx
outward	xxx	xxx	By Closing stock		xxx
To Wages		xxx	By Gross Loss c/d		xxx
To Freight		xxx	(transferred to		
To Carriage			P&L A/c)		
Inwards		xxx			
To Clearing charges		xxx			
To Packing charges		xxx			
To Dock dues		xxx			
To Power (factory)		xxx			
To Octroi Duty		xxx			
To Gross Profit c/d		xxx			
(transferred to					
P&L A/c)					
		xxx			xxx

Profit and loss account:

Definition and Explanation:

The account through which annual net profit or loss of a business is ascertained, is called profit and loss account. Gross profit or loss of a business is ascertained through trading account and net profit is determined by deducting all indirect expenses (business operating expenses) from the gross profit through profit and loss account. Thus profit and loss account starts with the result provided by trading account.

Profit & Loss Account is part of final accounts, prepared by a business firm to know the net profit of the business activities during a particular period.

Profit and Loss Account is different from Trading Account because Trading account shows only the gross profit while profit and loss account shows net earnings of the business firm. In profit and loss account all indirect expenses and indirect incomes are shown. After preparing trading account the decision is taken regarding the costing of products but after preparing profit and loss account decision is taken in respect to control the expenditures to maximize the profitability of the firm. In short, both statements are very important for a business firm.

Who prepares Profit and Loss Account?

Profit and Loss Account is prepared by all business and professional firms.

What are the benefits of preparation of Profit and Loss Account?

It is very necessary to prepare Profit and Loss Account to pay exact income tax to the income tax authorities.

Without profit and loss account, income of partners also can not be ascertained.

To know the actual profit of a firm, it is compulsory to prepare profit and loss account.

Unless profit and loss account is prepared, balance sheet can not be prepared.

Profit and loss account is mandatory for all the companies which are listed in stock exchange.

In Limited Companies, dividend is declared as per the availability of profit with company.

Without preparation of profit and loss account, the accounts are incomplete. It is the part of accounting system.

When a Profit and Loss Account is Prepared?

It can be prepared by a business firm on any particular date. It can be prepared on monthly basis or quarterly basis or half yearly basis or yearly basis according to its requirement. For example all the companies registered with stock exchanges furnish monthly details relating to sale, and profits. Therefore these companies have to prepare the Trading account as well as Profit and Loss Account on monthly basis. But if we talk in general then it is prepared at the end of the financial year.

Contents of Profit and Loss Account:- A Profit and Loss Account shows the following details:-

Gross profit or gross loss brought forward from the Trading account.

All indirect incomes

All indirect expenditures

Net profit.

How a Profit and Loss Account is prepared? Profit and Loss Account is prepared with the help of Trial Balance. Profit and Loss Account is just like Trading Account which is divided in two parts i.e. Income part and Expenditure Part.

In income part, we show the following accounts:-

Gross Profit brought forward.

Indirect Income i.e. interest received, commission received, rent received etc. In other words indirect income means which is not directly related to purchase or sales.

In Expenditure part, we show the following details:-

Gross Loss brought forward

All indirect Expenses i.e. any expenses which are not related to purchase and sales

BALANCE SHEET:**Definition and Explanation:**

Balance sheet is a list of the accounts having debit balance or credit balance in the ledger. On one side it shows the accounts that have a debit balance and on the other side the accounts that have a credit balance. The purpose of a balance sheet is to show a true and fair financial position of a business at a particular date. Every business prepares a balance sheet at the end

of the account year. A balance sheet may be defined as:

"It is a statement of assets, liabilities and owner's equity (capital) on a particular date".

"It is a statement of what a business concern owns and what it owes on a particular date".
What is owns are called assets and what it owes are called liabilities.

"It is a statement which discloses total assets, total liabilities and total capital (owner's equity) of a concern on a particular date".

"It is a statement where all the ledger account balances which remain open after the preparation of trading and profit and loss account, find place".

Balance sheet is so called because it is prepared with the closing balance of ledger accounts at the end of the year. It has two sides - assets side or left hand side and liabilities side or right hand side. The accounts have a debit balance are shown on the asset side and those have a credit balance are shown on the liabilities side and the total of the two sides will agree.

Assets means all the things and properties under the ownership of the business i.e. building, plant, furniture, machinery, stock, cash etc. Assets also include anything against which money or service will be received i.e. creditors accrued income, prepaid expenses etc.

Liabilities means our dues to others or anything against which we are to pay money or render service, i.e. creditors, outstanding expenses, amount payable to the owner of the business (capital) etc.

Asset side of the balance sheet indicates the different types of assets owned by a concern, while liabilities side discloses the various sources through which funds have been obtained in order to acquire those assets. Balance sheet reveals the financial position of the firm on a particular date at a point of time, so it is also called "position statement". It is prepared on the last day of the accounting year and discloses concern for the whole year cannot be determined through the balance sheet because financial position is ever changing. The is why the heading of the balance sheet is given as under:

Balance Sheet as at 31st December, 2005
(If accounting year ends on 31 Dec. 2005)
Features of Balance Sheet:

Balance sheet has the following features:

It is the last stage of final accounts

It is prepared on the last day of an accounting year.

It is not an account under the double entry system - it is a statement only.

It has two sides - left hand side known as asset side and right hand side known as liabilities side.

The total of both sides are always equal.

The balances of all asset accounts and liability accounts are shown in it. No expense accounts and revenue accounts are shown here.

It discloses the financial position and solvency of the business.

It is prepared after the preparation of trading and profit and loss account because the net profit or net loss of a concern is included in it through capital account.

Method of Preparation of Balance Sheet:

All the information necessary for the preparation of balance sheet is available from trial balance and from some other ledger accounts. After transferring accounts relating to expenses and revenues to trading and profit and loss account, the trial balance contains only the accounts of assets, liabilities, and capital. All assets have debit balances and all liabilities and capital have credit balances. The assets are shown on the asset side of the balance sheet and liabilities and capital are shown on the liabilities side of the balance sheet after arranging them properly.

Types of Adjustments Entries in Final Accounts:

Closing Stock:

As the value of closing inventories is ascertained at the end of the accounting year, it appears as an adjustment. It should be credited to Trading a/c and shown in the asset side of the B/S.

The adjusting entry is:

Closing Stock a/c Dr.

To Trading a/c

Trading Account			
			Rs.
			By Sales
			By Closing Stock

Balance Sheet Cr			
Liabilities	Rs.	Assets	Rs.
		Closing Stock	

Outstanding Expenses:

These are the expenses incurred within the accounting year but the payment has not been made. Outstanding or unpaid expenses should be added to the concerned expenses a/c in P&L a/c and will be shown as a current liability in the B/S.

For example, the Rent for the month of December 2002 Rs. 1,000 remain unpaid. The calendar year is the accounting year.

Adjusting Entry:

Rent account Dr. Rs.1000

To Outstanding Rent a/c Rs. 1,000

Profit and Loss Account

		Rs.	
To Rent Account	[11 months rent]	11,000	
Add: Outstanding	[December]	1,000	12,000

Balance Sheet as on 31st December 2002

Liabilities	Rs.	Assets	
Outstanding Expenses:			
Rent	1,000		

Prepaid Expenses:

These are the expenses, which have been paid, but part of the amount paid extends to the next year. It is also called as 'Un-expired expenses'. Advance amount paid should be deducted from the concerned expenses and be shown as a Current Asset in the B/S.

For example, the insurance premium of Rs.2,400 a year was paid on 1st July 2002. The calendar year is the accounting year. Since one year's premium has been paid on 1st July, the premium for 6 months, i.e., half the amount relates to the current year and the other half relates to the next year.

Hence, Rs. 1,200 must be treated as prepaid and deducted from the premium paid and be shown as an asset in the B/S.

Adjusting Entry:

Prepaid Insurance a/c Dr. Rs. 1, 200

To Insurance Premium a/c Rs. 1, 200

Profit and Loss Account

	Rs.	Rs.	
To Insurance Premium a/c	2,400		
Less: Prepaid insurance	1,200	1,200	

Balance Sheet

Liabilities	Rs.	Assets	Rs.
		Prepaid Insurance	1,200

Accrued Income:

It is the income that has already been earned [i.e., the service has already been rendered] but the money has not been received. For example, Interest on investments accrued Rs. 1,200.

The interest for the current year is due at the close of the year. The amount may be actually received in the next year. At present it represents an income, which has become receivable or accrued. Hence it is credited to P&L a/c and being accounts receivable, shown as an asset in the B/S.

Adjusting Entry:

Accrued Interest a/c Dr. Rs. 1,200

To Interest a/c Rs. 1,200

Profit and Loss Account

	By Interest on investments	
	Add: Interest accrued	1,200	

Balance Sheet

Liabilities	Rs.	Assets	Rs.
		Interest accrued	1,200

Incomes Received in Advance:

These are incomes received during the current year, but part of the amount received relates to the next year. Such amount must be deducted from the total amount received in P&L a/c and shown on the liabilities side of the B/S as it represents an amount, which the business is obliged to return.

For example, a business concern has received apprentice premium for three years amounting to Rs.6, 000. In this amount Rs.2, 000 i.e., 1/3 of Rs.6, 000 is for current year and should be credited to P&L a/c as income. And the balance Rs.4, 000 represents a liability as the business is obliged to return.

Adjusting Entry:

Apprentice Premium a/c Dr. Rs. 4000

To Apprentice Premium received in advance Rs. 4000

Profit and Loss Account

		Rs.	Rs.
	By Apprentice Premium	6,000	
	Less: Received in advance	4,000	2,000

Balance Sheet

Liabilities	Rs.	Assets	Rs.
Apprentice Premium received in advance	4,000		

Depreciation on Assets:

Depreciation means diminution or fall in value of an asset due to its constant use. It may also arise on account of wear and tear, lapse of time and obsolescence. It is a loss to the business.

It is usually calculated at a certain percentage on the value of asset and the amount so obtained is first shown on the debit side of the P&L a/c and then deducted from the original value of asset in the B/S.

For Example, a business has furniture of the value of Rs.50, 000 at the end of the year it is depreciated at 5%.

Adjusting Entry:

Depreciation a/c Dr. Rs. 2,500

To Furniture a/c Rs. 2,500

[5% on Rs.50, 000 = 2,500]

Profit and Loss Account

	Rs.	
To Depreciation a/c Furniture	2,500	

Balance Sheet

Liabilities	Rs.	Assets	Rs.
		Furniture	50,000
		Less: Depreciation	2,500
			47,500

Bad Debts:

Debts represent money due from debtors [i.e., uncollected portion of credit sales]. When debts become irrecoverable, it becomes bad debts and is treated as a loss. The amount of

bad debts is debited to P&L a/c and is deducted from Sundry Debtors in the B/S.

For example, the ledger balance in respect of sundry debtors of a trader shows Rs.20, 000 and of this Rs. 1,000 is estimated to be irrecoverable.

Adjusting Entry:

Bad Debts a/c Dr. Rs. 1,000

To Sundry Debtors a/c Rs. 1,000

Provision for Bad and Doubtful Debts:

Every business has a lot of dealings by way of credit transactions. This gives rise to a sizable amount of book debts or debtors. But it is seldom that 100 percent of these debts will be recovered.

Hence, it becomes necessary to bring down the debtors balance to its true position. The usual practice is to calculate such doubtful debts at a certain percentage, based on past experience on debtors. It is called as Provision or Reserve for Doubtful Debts.

However, the provision for bad and doubtful debts is calculated on good debts i.e., after deducting bad debts not adjusted earlier.

Example:

The sundry debtors of a trader at the close of the year stood at Rs.21, 000. It is estimated that Rs. 1,000 is written off as bad debts and 5% provision is created for doubtful debts.

Adjusting Entries:

Bad Debts a/c Dr. Rs. 1,000

To Sundry Debtors a/c Rs. 1,000

Profit and Loss a/c Dr. Rs. 2,000

To Bad Debts a/c Rs. 1,000

To Provision for Doubtful Debts 1,000

Profit and Loss Account

	Rs.	
To Bad Debts	1,000	
To Reserve for Doubtful Debts	1,000	

If there is an old provision for doubtful debts, it should be adjusted [deducted] against the

new provision.

Balance Sheet

Liabilities	Rs.	Assets		Rs.
		Sundry Debtors	21,000	
		Less: Bad Debts	1,000	
			20,000	
		Less: Provision for Doubtful Debts	1,000	19,000

Provision for Discount on Debtors:

Cash discounts are allowed to debtors in order to encourage them to make prompt payments. After providing for bad and doubtful debts, the balance of debtors represents debts due from sound parties.

They may try to pay their dues on time and avail themselves of the cash discounts permissible. Hence, this discount should be anticipated and provided for. It is, therefore, the usual practice in business is to provide for discount on debtors at certain percentage on good debts.

Example:

Suppose a trader has sundry debtors amounting to Rs.20, 000 and he estimates that after a provision of 5% for doubtful debts, a provision for discounts at 2% is desirable. Then, on the sound debts, i.e., Rs. 19,000 a provision of 2% is made as Reserve for Discount on Debtors.

Adjusting Entry:

Profit and Loss a/c Dr. Rs.380

To Reserve for Discount on Debtors a/c Rs.380

Profit and Loss Account

	Rs.	
To Bad Debts		
To Reserve for Doubtful Debts	1,000	
To Reserve for Discount on Debtors	380	

Balance Sheet

Liabilities	Rs.	Assets		Rs.
		Sundry Debtors	20,000	
		Less: Provision for Doubtful Debts	1,000	
			19,000	
		Less: Provision for Discounts on Debtors	380	18,620

Provision for Discount on Creditors:

Creditors represent the amount owed by the business to suppliers of goods on credit. Sound business concerns make it a practice to settle accounts with creditors in time to earn goodwill of the creditors and also the discount allowed by them.

In that case the liability in respect of sundry creditors can be reduced to the extent of discounts anticipated. Based on the past practice, a certain percentage on creditors balance is calculated as Provision for discounts and deducted from the creditors balance in the B/S and the same amount is credited as gain in the P&L a/c.

Example:

A trader had sundry creditors at Rs. 10,000 on 31st December 2002. It is desired to make a provision of 3% on this amount for discounts.

Adjusting Entry:

Reserve for Discounts on Creditors a/c Dr. Rs. 300

To Profit and Loss a/c Rs. 300

Profit and Loss Account

	Rs.		Rs.
		By Reserve for Discount on Creditors	300

Balance Sheet

Liabilities	Rs.			
Sundry Creditors	10,000			
Less: Reserve for Discounts	300	9,700		

Interest on Capital:

Often, interest at a normal rate is allowed on the capital of the proprietor employed in the business. This is necessary in order to assess the efficiency of the business. Otherwise the profits would include the interest and appear at a higher rate.

The interest so charged is a loss to the business and gain to the proprietor. So it is debited to the Profit and Loss a/c and added to the capital in the Balance Sheet.

Adjusting Entries:

Interest on Capital a/c Dr.

To Capital a/c

Profit and Loss a/c Dr.

To Interest on Capital a/c

Interest on Drawings:

Drawings are money withdrawn by the proprietor from his capital. Just as the business allows interest on capital, it charges interest on drawings. It is a gain to the business and a loss to the proprietor. So, it is credited to the Profit and Loss a/c and deducted from the capital in the Balance Sheet.

Profit and Loss Account

	Rs.		Rs.
To Interest on Capital		By Interest on Drawings	

Balance Sheet

Liabilities	Rs.		
Capital			
Add: Interest on Capital			
Less: Drawings			
Interest on Drawings			

UNIT – 3**ANALYSIS OF FINANCIAL STATEMENTS**

Analysis of Financial Statements I: Ratio Analysis- solvency ratios, profitability ratios, activity ratios, liquidity ratios, market capitalization ratios; Common Size Statement; Comparative Balance Sheet and Trend Analysis.

Bank Reconciliation Statement – Need – Reasons for Difference between Cash Book and Pass Book Balances – Problems on Favourable and Overdraft Balances.

Introduction

Financial statements by themselves do not give the required information both for internal management and for outsiders. They are passive statements showing the results of the business i.e. Profit or loss and the financial position of the business. They will not disclose any reasons for dismal performance of the business if it is so. What is wrong with the business, where it went wrong, why it went wrong, etc. Are some of the questions for which no answers will be available in the financial statements. Similarly, no information will be available in the financial statements about the financial strengths and weaknesses of the concern. Hence, to get meaningful information from the financial statements which would facilitate vital decisions to be taken, financial statements must be analysed and interpreted. Through the analysis and interpretation of financial statements full diagnosis of the profitability and financial soundness of the business is made possible. The term 'analysis of financial statements' means methodical classification of the data given in the financial statements. The term 'interpretation of financial statements' means explaining the meaning and significance of the data so classified. A number of tools are available for the purpose of analysing and interpreting the financial statements. This lesson discusses in brief tools like common size statement, trend analysis, etc., and gives a detailed discussion on ratio analysis.

Nature Of Financial Analysis

The focus of financial analysis is on the key figures contained in the financial statements and the significant relationship that exists between them. "analyzing financial statements is a process of evaluating the relationship between the component parts of the financial statements to obtain a better understanding of a firm's position and performance".

The type of relationship to be investigated depends upon the objective and purpose of evaluation. The purpose of evaluation of financial statements differs among various groups: creditors, shareholders, potential investors, management and so on. For example, short-term

creditors are primarily interested in judging the firm's ability to pay its currently-maturing obligations. The relevant information for them is the composition of the short-term (current) liabilities. The debenture-holders or financial institutions granting long-term loans would be concerned with examining the capital structures, past and projected earnings and changes in the financial position. The shareholders as well as potential investors would naturally be interested in the earnings per share and dividends per share as these factors are likely to have a significant bearing on the market price of shares. The management of the firms, in contrast, analyses the financial statements for self-evaluation and decision making.

The first task of the financial analyst is to select the information relevant to the decision under consideration from the total information contained in the financial statements. The second step involved in financial analysis is to arrange the information in such a way as to highlight significant relationships. The final step is the interpretation and drawing of inferences and conclusions. In brief, financial analysis is the process of selection, relation and evaluation.

Types Of Financial Analysis

Financial analysis may be classified on the basis of parties who are undertaking the analysis and on the basis of methodology of analysis. On the basis of the parties who are doing the analysis, financial analysis is classified into external analysis and internal analysis.

External Analysis:

When the parties external to the business like creditors, investors, etc. do the analysis, the analysis is known as external analysis. This analysis is done by them to know the credit-worthiness of the concern, its financial viability, its profitability, etc.

Internal Analysis:

This analysis is done by persons who have control over the books of accounts and other information of the concern. Normally this analysis is done by management people to enable them to get relevant information to take vital business decision.

On the basis of methodology adopted for analysis, financial analysis may be either horizontal analysis or vertical analysis.

Horizontal Analysis:

When financial statements of a number of years are analysed, then the analysis is known as horizontal analysis. In this type of analysis, figures of the current year are compared with the standard or base year. This type of analysis will give an insight into the concern's performance over a period of years. This analysis is otherwise called as dynamic analysis as it extends over a number of years.

Vertical Analysis:

This type of analysis establishes a quantitative relationship of the various items in the financial statements on a particular date. For e.g. The ratios of various expenditure items in terms of sales for a particular year can be calculated. The other name for this analysis is 'static analysis' as it relies upon one year figures only.

Tools Of Financial Analysis

The following are the important tools of financial analysis which can be appropriately used by the financial analysts:

1. Common-size financial statements
2. Comparative financial statements
3. Trend percentages
4. Ratio analysis
5. Funds flow analysis
6. Cash flow analysis

Common-Size Financial Statements:

In this type of statements, figures in the original financial statements are converted into percentages in relation to a common base. The common base may be sales in the case of income statements (profit and loss account) and total of assets or liabilities in the case of balance sheet. For e.g. In the case of common-size income statement, sales of the traditional financial statement are taken as 100 and every other item in the income statement is converted into percentages with reference to sales. Similarly, in the case of common-size balance sheet, the total of asset/liability side will be taken as 100 and each individual asset/liability is converted into relevant percentages.

Comparative Financial Statements:

This type of financial statements are ideal for carrying out horizontal analysis. Comparative financial statements are so designed to give them perspective to the review and analysis of the various elements of profitability and financial position displayed in such statements. In these statements, figures for two or more periods are compared to find out the changes both in absolute figures and in percentages that have taken place in the latest year as compared to the previous year(s). Comparative financial statements can be prepared both for income statement and balance sheet.

Trend Percentages:

Analysis of one year figures or analysis of even two years figures will not reveal the real trend of profitability or financial stability or otherwise of any concern. To get an idea about how consistent is the performance of a concern, figures of a number of years must be analysed and compared. Here comes the role of trend percentages and the analysis which is done with the help of these percentages is called as trend analysis.

Trend analysis:

Is a useful tool for the management since it reduces the large amount of absolute data into a simple and easily readable form. The trend analysis is studied by various methods. The most popular forms of trend analysis are year to year trend change percentage and index-number trend series. The year to year trend change percentage would be meaningful and manageable where the trend for a few years, say a five year or six year period is to be analysed.

Generally trend percentage are calculated only for some important items which can be logically related with each other. For e.g. Trend ratio for sales, though shows a clear-cut increasing tendency, becomes meaningful in the real sense when it is compared with cost of goods sold which might have increased at a lower level.

Ratio Analysis:

Of all the tools of financial analysis available with a financial analyst the most important and the most widely used tool is ratio analysis. Simply stated ratio analysis is an analysis of financial statements done with the help of ratios. 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. But if both the figures are taken from profit and loss account then the resulting ratio is called as profit and loss account ratio. Composite ratio is that ratio which is calculated by taking one figure from profit and loss account and the other figure from balance sheet. A detailed discussion on ratio analysis is made available in the pages to come.

Funds Flow Analysis:

The purpose of this analysis is to go beyond and behind the information contained in the financial statements. Income statement tells the quantum of profit earned or loss suffered for a particular accounting year. Balance sheet gives the assets and liabilities position as on a particular date. But in an accounting year a number of financial transactions take place which have a bearing on the performance of the concern but which are not revealed by the financial statements. For e.g. A concern collects finance through various sources and uses them for various purposes. But these details could not be known from the traditional financial statements. Funds flow analysis gives an opening in this respect. All the more, funds flow analysis reveals the changes in working capital position. If there is an increase in working capital what resulted in the increase and if there is a decrease in working capital what caused the decrease, etc. Will be made available through funds flow analysis.

Cash Flow Analysis:

While funds flow analysis studies the reasons for the changes in working capital by analysing the sources and application of funds, cash flow analysis pays attention to the changes in cash position that has taken place between two accounting periods. These reasons are not available in the traditional financial statements. Changes in the cash position can be analysed with the help of a statement known as cash flow statement. A cash flow statement summarises the change in cash position of the concern. Transactions which increase the cash position of the concern are labelled as 'inflows' of cash and those which decrease the cash position as 'outflows' of cash.

Meaning And Nature of Ratio Analysis

Ratio expresses numerical relationship between two numbers. In the words of Kennedy and McMullen, "the relationship of one item to another expressed in simple mathematical form is known as a ratio". Thus, the ratio is a measuring device to judge the growth, development and present condition of a concern. It plays an important role in measuring the

comparative significance of the income and position statement. Accounting ratios are expressed in the form of time, proportion, percentage, or per one rupee. Ratio analysis is not only a technique to point out relationship between two figures but also points out the devices to measure the fundamental strengths or weaknesses of a concern. As James C. Van Horne observes: "to evaluate the financial condition and performance of a firm, the financial analyst needs certain yardsticks. One of the yardsticks frequently used is a ratio. The main purpose of ratio analysis is to measure past performance and project future trends. It is also used for inter-firm and intra-firm comparison as a measure of comparative productivity. The significance of the various components of financial statements can be judged only by ratio analysis. The financial analyst x-rays the financial conditions of a concern by the use of various ratios and if the conditions are not found to be favourable, suitable steps can be taken to overcome the limitations. The main objectives of ratio analysis are:

- To simplify the comparative picture of financial statements.
- To assist the management in decision making.
- To gauge the profitability, solvency and efficiency of an enterprise, and
- To ascertain the rate and direction of change and future potentiality.

Classification of Ratios

Financial ratios can be broadly classified into liquidity ratios, solvency ratios, profitability ratios and efficiency ratios (also called activity ratios or asset utilization ratios). Other categories include cash flow ratios, market valuation ratios, coverage ratios, etc.

1. Liquidity Ratios

Liquidity ratios assess a business's liquidity, i.e. its ability to convert its assets to cash and pay off its obligations without any significant difficulty (i.e. delay or loss of value). Liquidity ratios are particularly useful for suppliers, employees, banks, etc. Important liquidity ratios are:

- Current ratio
- Quick ratio (also called acid-test ratio)
- Cash ratio
- Cash conversion cycle

Current ratio

Current ratio is one of the most fundamental liquidity ratios. It measures the ability of a business to repay current liabilities with current assets.

Current assets are assets that are expected to be converted to cash within normal operating cycle, or one year. Examples of current assets include cash and cash equivalents, marketable securities, short-term investments, accounts receivable, short-term portion of notes receivable, inventories and short-term prepayments.

Current liabilities are obligations that require settlement within normal operating cycle or next 12 months. Examples of current liabilities include accounts payable, salaries and wages payable, current tax payable, sales tax payable, accrued expenses, etc.

Formula

Current ratio is calculated using the following formula:

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

Quick ratio

Quick ratio (also known as asset test ratio) is a liquidity ratio which measures the dollars of liquid current assets available per dollar of current liabilities. Liquid current assets are current assets which can be quickly converted to cash without any significant decrease in their value. Liquid current assets typically include cash, marketable securities and receivables. Quick ratio is expressed as a number instead of a percentage.

Formula

Quick ratio is calculated by dividing liquid current assets by total current liabilities. Liquid current assets include cash, marketable securities and receivables.

The following is the most common formula used to calculate quick ratio:

$$\text{Quick Ratio} = \frac{\text{Cash} + \text{Marketable Securities} + \text{Receivables}}{\text{Current Liabilities}}$$

Cash includes cash in hand and cash at bank.

Marketable securities are those securities/investments which can be easily converted to cash, i.e. within a short period of time at a negligible, if any, decrease in its value. Examples include government treasury bills, shares listed on a stock exchange, etc.

Receivables include accounts receivable, notes receivable, etc.

Cash ratio

Cash ratio is the ratio of cash and cash equivalents of a company to its current liabilities. It is an extreme liquidity ratio since only cash and cash equivalents are compared with the current liabilities. It measures the ability of a business to repay its current liabilities by only using its cash and cash equivalents and nothing else.

Formula

Cash ratio is calculated using the following formula:
$$\text{Cash Ratio} = \frac{\text{Cash} + \text{Cash Equivalents}}{\text{Current Liabilities}}$$

Cash equivalents are assets which can be converted into cash quickly whereas current liabilities are those liabilities which are to be settled within 12 months or the business cycle.

Interpretation

A cash ratio of 1.00 and above means that the business will be able to pay all its current liabilities in immediate short term. Therefore, creditors usually prefer high cash ratio. But businesses usually do not plan to keep their cash and cash equivalent at level with their current liabilities because they can use a portion of idle cash to generate profits. This means that a normal value of cash ratio is somewhere below 1.00.

Cash conversion cycle

Cash conversion cycle is an efficiency ratio which measures the number of days for which a company's cash is tied up in inventories and accounts receivable. It is aimed at assessing how effectively a company is managing its working capital.

A typical business purchases raw materials (mostly on credit), converts them to finished products, sell those products (mostly on credit), recovers cash from customers and reuses the cash to purchase raw materials for further production and so on.

We defined cash conversion cycle as the time for which cash is tied up in working capital (i.e. inventories and receivables). The days for which cash is tied up in receivables is measured by days' sales outstanding (DSO) and the number of days it takes to sell inventories is measured by days' inventories outstanding (DIO). The sum of these two ratios is the company's operating cycle. However, since raw materials consumed in production of inventories is purchased on credit, and hence paid after the relevant raw materials have been used in production, the actual days for which cash is tied up in inventories equals days it takes to sell inventories minus days for which the amount payable against those raw materials remained outstanding, i.e. days payable outstanding (DPO).

The following timeline shows the relationship between operating cycle, cash conversion cycle, DSO, DIO and DPO:

Formula

$$\text{Cash Conversion Cycle} = \text{DSO} + \text{DIO} - \text{DPO}$$

Where,

DSO is days sales outstanding = $\text{Average Accounts Receivable} \times 365 \div \text{Credit Sales}$

DIO is days inventory outstanding = $\text{Average Inventories} \times 365 \div \text{Cost of Goods Sold}$

DPO is days payables outstanding = $\text{Average Accounts Payable} \times 365 \div \text{Cost of Goods Sold}$

Alternatively, it can also be calculated using the following formula if we know the operating

cycle:

Cash conversion cycle = operating cycle – DPO

The figures for credit sales, cost of goods sold, average accounts receivable, average inventories and average accounts payable can be obtained from the company's financial statements.

Analysis

Cash conversion cycle is an important ratio, particularly for companies that carry significant inventories and have large receivables, because it highlights how effectively the company is managing its working capital.

2. Solvency Ratios

Solvency ratios assess the long-term financial viability of a business i.e. its ability to pay off its long-term obligations such as bank loans, bonds payable, etc. Information about solvency is critical for banks, employees, owners, bond holders, institutional investors, government, etc. Key solvency ratios are:

- Debt ratio
- Debt to equity ratio
- Debt to capital ratio
- Times interest earned ratio
- Fixed charge coverage ratio
- Equity multiplier

Debt ratio

Debt ratio (also known as debt to assets ratio) is a ratio which measures debt level of a business as a percentage of its total assets. It is calculated by dividing total debt of a business by its total assets.

Debt ratio finds out the percentage of total assets that are financed by debt and helps in assessing whether it is sustainable or not. If the percentage is too high, it might indicate that it is too difficult for the business to pay off its debts and continue operations.

Formula

Debt ratio is calculated using the following formula:

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

Total debt equals long-term debt and short-term debt. It is not equivalent to total liabilities because it excludes non-debt liabilities such as accounts payable, salaries payable, etc.

Total assets include both current assets and non-current assets.

Sometimes, debt ratio is calculated based on the total liabilities instead of total debt.
Analysis

Debt ratio is a measure of a business's financial risk, the risk that the business' total assets may not be sufficient to pay off its debts and interest thereon. Since not being able to pay off debts and interest payments may result in a business being wound up, debt ratio is a critical indicator of long-term financial sustainability of a business.

While a very low debt ratio is good in the sense that the company's assets are sufficient to meet its obligations, it may indicate underutilization of a major source of finance which may result in restricted growth. A very high debt ratio indicates high risk for both debt-holders and equity investors. Due to the high risk, the company may not be able to obtain finance at good terms or may not be able to raise any more money at all.

Debt-to-Equity Ratio

Debt-to-Equity ratio is the ratio of total liabilities of a business to its shareholders' equity. It is a leverage ratio and it measures the degree to which the assets of the business are financed by the debts and the shareholders' equity of a business.

Formula

Debt-to-equity ratio is calculated using the following formula:

$$\text{Debt-to-Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Shareholders' Equity}}$$

Both total liabilities and shareholders' equity figures in the above formula can be obtained from the balance sheet of a business. A variation of the above formula uses only the interest bearing long-term liabilities in the numerator.

Analysis

Lower values of debt-to-equity ratio are favorable indicating less risk. Higher debt-to-equity ratio is unfavorable because it means that the business relies more on external lenders thus it is at higher risk, especially at higher interest rates. A debt-to-equity ratio of 1.00 means that half of the assets of a business are financed by debts and half by shareholders' equity. A value higher than 1.00 means that more assets are financed by debt than those financed by money of shareholders' and vice versa.

An increasing trend in of debt-to-equity ratio is also alarming because it means that the percentage of assets of a business which are financed by the debts is increasing.

Debt-to-Capital Ratio

Debt-to-capital ratio is a solvency ratio that measures the proportion of interest-bearing debt to the sum of interest-bearing debt and shareholders' equity.

Interest-bearing debt includes bonds payable, bank loans, notes payable, etc. Non-interest bearing debt includes trade payable, accrued expenses, etc.

The debt-to-capital ratio is a refinement of the debt-to-assets ratio. It measures how much of the capital employed (i.e. the resources on which the company pays a cost) is debt. Higher debt included in the capital employed means higher risk of insolvency.

Formula

$$\text{Debt-to-Capital Ratio} = \frac{\text{Interest-bearing Debt}}{\text{Interest-bearing Debt} + \text{Shareholders' Equity}}$$

Fixed charge coverage

Fixed charge coverage is a solvency ratio that measures whether earnings before interest, taxes and lease payments are sufficient to cover the interest and lease payments. It is calculated by dividing the sum of earnings before interest and taxes and lease payments by the sum of interest payments and lease payments.

Fixed charge coverage ratio is very similar to interest coverage ratio. The only difference is that fixed charge coverage ratio takes into account the annual obligations on account of lease payments too (in addition to interest payments).

The higher the ratio, the better is the solvency situation of the company. The ratio is best used together with other solvency ratios such debt ratio, financial leverage ratio, etc.

Formula

$$\text{Fixed Charge Coverage} = \frac{\text{EBIT} + \text{Lease Payments other than Interest Portion}}{\text{Interest Payments} + \text{Lease Payments}}$$

Profitability Ratios

Profitability ratios measure the ability of a business to earn profit for its owners. While liquidity ratios and solvency ratios explain the financial position of a business, profitability ratios and efficiency ratios communicate the financial performance of a business. Important profitability ratios include:

- net profit margin
- gross profit margin
- operating profit margin
- return on assets

- return on capital employed
- return on equity
- earnings per share

Other ratios related to profitability that are used by investors to assess the stock market performance of a business include:

- price to earnings (P/E) ratio
- price to book (P/B) ratio
- Dividend payout ratio
- Dividend yield ratio
- Retention ratio

Net profit margin

Net profit margin (also called profit margin) is the most basic profitability ratio that measures the percentage of net income of an entity to its net sales. It represents the proportion of sales that is left over after all relevant expenses have been adjusted.

Net profit margin is used to compare profitability of competitors in the same industry. It can also be used to determine the profitability potential of different industries. While companies in some industries are able to generate high net profit margin, other industries offer very narrow margins. It depends on the extent of competition, elasticity of demand, production differentiation, etc. of the relevant product or market.

Return on equity and return on assets are other relevant ratios that measure the relationship of net income with shareholders' equity and total assets respectively.

Formula

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}$$

Net Sales = Gross Sales – Sales Tax – Discounts – Sales Returns

Gross profit margin

Gross margin ratio is the ratio of gross profit of a business to its revenue. It is a profitability ratio measuring what proportion of revenue is converted into gross profit (i.e. revenue less cost of goods sold).

Formula

Gross margin is calculated as follows:

$$\text{Gross Margin} = \frac{\text{Gross Profit}}{\text{Revenue}}$$

Gross profit and revenue figures are obtained from the income statement of a business. Alternatively, gross profit can be calculated by subtracting cost of goods sold from revenue. Thus gross margin formula may be restated as:

$$\text{Gross Margin} = \frac{\text{Revenue} - \text{Cost of Goods Sold}}{\text{Revenue}}$$

Analysis

Gross margin ratio measures profitability. Higher values indicate that more cents are earned per dollar of revenue which is favorable because more profit will be available to cover non-production costs. But gross margin ratio analysis may mean different things for different kinds of businesses. For example, in case of a large manufacturer, gross margin measures the efficiency of production process. For small retailers it gives an impression of pricing strategy of the business. In this case higher gross margin ratio means that the retailer charges higher markup on goods sold.

Operating profit margin

Operating margin ratio or return on sales ratio is the ratio of operating income of a business to its revenue. It is profitability ratio showing operating income as a percentage of revenue.

Formula

Operating margin ratio is calculated by the following formula:

$$\text{Operating Margin} = \text{Operating Income} / \text{Revenue}$$

Operating income is same as earnings before interest and tax (EBIT). Both operating income and revenue figures can be obtained from the income statement of a business.

Analysis

Operating margin ratio of 9% means that a net profit of \$0.09 is made on each dollar of sales. Thus a higher value of operating margin ratio is favorable which indicates that more proportion of revenue is converted to operating income. An increase in operating margin ratio overtime means that the profitability is improving. It is also important to compare the gross margin ratio of a business to the average gross profit margin of the industry. In general, a business which is more efficient in controlling its overall costs will have higher operating margin ratio.

Return on assets

Return on assets is the ratio of annual net income to average total assets of a business during a financial year. It measures efficiency of the business in using its assets to generate net income. It is a profitability ratio.

Formula

The formula to calculate return on assets is:

$$\text{ROA} = \frac{\text{Annual Net Income}}{\text{Average Total Assets}}$$

Net income is the after tax income. It can be found on income statement. Average total assets are calculated by dividing the sum of total assets at the beginning and at the end of the financial year by 2. Total assets at the beginning and at the end of the year can be obtained from year ending balance sheets of two consecutive financial years.

Analysis

Return on assets indicates the number of cents earned on each dollar of assets. Thus higher values of return on assets show that business is more profitable. This ratio should be only used to compare companies in the same industry. The reason for this is that companies in some industries are most asset-insensitive i.e. they need expensive plant and equipment to generate income compared to others. Their ROA will naturally be lower than the ROA of companies which are low asset-insensitive. An increasing trend of ROA indicates that the profitability of the company is improving. Conversely, a decreasing trend means that profitability is deteriorating.

Return on capital employed

Return on capital employed (ROCE) is the ratio of net operating profit of a company to its capital employed. It measures the profitability of a company by expressing its operating profit as a percentage of its capital employed. Capital employed is the sum of stockholders' equity and long-term finance. Alternatively, capital employed can be calculated as the difference between total assets and current liabilities.

The formula to calculate return on capital employed is:

$$\text{ROCE} = \frac{\text{Net Operating Profit}}{\text{Capital Employed}}$$

A more accurate value can be calculated by using average capital employed which is the sum of average long-term finance and average stockholders' equity.

Some analysts use earnings before interest and tax (EBIT) instead of net profit while calculating return on capital employed.

Since ROCE includes long-term finance in the calculation, therefore it is more comprehensive test of profitability as compared to return on equity (ROE).

Analysis

A higher value of return on capital employed is favorable indicating that the company

generates more earnings per dollar of capital employed. A lower value of ROCE indicates lower profitability. A company having less assets but same profit as its competitors will have higher value of return on capital employed and thus higher profitability.

Return on equity

Return on equity (also called return on shareholders equity) is the ratio of net income of a business during a year to its average shareholders' equity during that year. It is a measure of profitability of shareholders' investments. It shows net income as a percentage of shareholder equity.

Formula

The formula to calculate return on equity is:

$$\text{ROE} = \frac{\text{Annual Net Income}}{\text{Average Stockholders' Equity}}$$

Net income is the after tax income whereas average shareholders' equity is calculated by dividing the sum of shareholders' equity at the beginning and at the end of the year by 2. The net income figure is obtained from income statement and the shareholders' equity is found on balance sheet. You will need year ending balance sheets of two consecutive financial years to find average shareholders' equity.

Analysis

Return on equity is an important measure of the profitability of a company. Higher values are generally favorable meaning that the company is efficient in generating income on new investment. Investors should compare the ROE of different companies and also check the trend in ROE over time. However, relying solely on ROE for investment decisions is not safe. It can be artificially influenced by the management, for example, when debt financing is used to reduce share capital there will be an increase in ROE even if income remains constant.

Earnings per share

Earnings per share (EPS) is a profitability indicator which shows dollars of net income earned by a company in a particular period per share of its common stock (also called ordinary shares). Earnings per share is calculated by dividing net income for a period attributable to common stock owners by the weighted average number of common shares outstanding during the period.

EPS is a very important profitability ratio, particularly for shareholders of a company, because it is a direct measure of dollars earned per share. Accounting standards (such as IAS 33 in IFRS framework and ASC 260 in US GAAP) require companies that have securities that are publically traded or which are in process of issuing publically tradable securities, to report EPS figures on the face of their income statement.

Analysis

In analyzing profitability of different companies, total net income figures alone are not very useful because they are dependent on size of the company. EPS standardizes earnings with reference to number of shares outstanding. However, EPS alone too is not very useful because different companies have different number of shares, some companies opt to have more number of ordinary shares while others prefer to have less. For example, a company may go for a 2-for-1 stock split to double the number of its ordinary shares, without having zero effect on its market capitalization i.e. its value. EPS is used as an input in other very important indicators of profitability and investment performance, such as price-to-earnings (P/E) ratio which compares EPS with price per share of common stock.

EPS is defined as net income attributable to each share of a company's common stock (or ordinary shares). Common stock or ordinary shares is the class of share capital which represents the right to ultimate ownership of the company. There are other classes of share capital: such as preferred stock, etc., which do not share in the residual interest of the company. Hence, we subtract the claim of preferred stockholders from net income to arrive at the net income attributable to common stock.

Since the number of shares of common stock of a company fluctuate during any particular period because companies continuously issues new shares, go for stock splits, issue stock dividends and buy back shares, etc., per share figure for EPS is calculated based on weighted average number of common shares outstanding.

EPS comes in two flavors: basic EPS and diluted EPS. Diluted EPS is a worst-case EPS which calculates the net income attributable to each share of common stock under the assumption that all such financial instruments of a company which can be converted to common stock are indeed converted.

Formula

EPS is calculated using the following formula:

$$\text{Earnings per Share (EPS)} = \frac{\text{Net Income} - \text{Preferred dividends}}{\text{Weighted Average Number of Common Shares Outstanding}}$$

Weighted average number of shares is calculated by time-weighted the number of shares of common stock. For example, if Company A has 1,000 shares on 1 January 2015, issues 500 additional shares on 1 July 2015 and does not change its number of shares in the remaining six months of 2015, its weighted average number of shares would be 1,250 $[1,000 \times 6/12 + 1,500 \times 6/12]$. 1,000 shares remained outstanding for 6 months, i.e. from 1 January 2015 to 30 June 2015. But for the next six months, i.e. from 1 July 2015 to 31 December 2015, the number of shares increased from 1,000 to 1,500 so they are also

weighted for 6 months. Where a company undergoes a stock split or issues a stock dividend such that its number of shares increases, the change is included in calculation of weighted average number of shares as if it occurred at the beginning of the period.

OTHER RATIOS

Price/Earnings or P/E ratio

Price/Earnings or P/E ratio is the ratio of a company's share price to its earnings per share. It tells whether the share price of a company is fairly valued, undervalued or overvalued.

Formula $P/E \text{ Ratio} = \text{Current Share Price} / \text{Earnings per Share}$

Current share price is obtained from secondary markets like NYSE, NASDAQ, etc. while EPS is calculated as (net income minus preferred dividends)/weighted average number of shares outstanding.

Price to book ratio

Price to book ratio (also called market to book ratio) is a relative valuation statistic which measures the proportion of the current market price of a share of a company's common stock to the book value per share of the company. Price to book value tells whether investors in general value the company above, at or below the face value of the company's assets as they appear in its financial reports.

Market value of a share is determined by the average opinion of the investors about the company. Book value on the other hand, is determined using accounting principles. There are a number of factors that are not captured by accounting information, for example, value of a company's brands, reputation, growth potential, etc. Such factors create divergence between the two figures and make price to book ratio a useful tool for finding investor feeling about a company's future outlook.

Investors who specialize in buying companies whose current market prices are suppressed place significant emphasis on price to book ratio. They buy companies with low price to book ratio but good return on equity and sell them when the market adjusts its opinion about the company's true worth. Price to book ratio can also be used to find out how much a company is worth by comparing its book value to the average price to book value of the industry or competitors.

Formula $\text{Price to Book Ratio} = \text{Current Share Price} / \text{Book Value per Share}$

Book value per share can be calculated using the following formula:

$\text{Book Value per Share} = \text{Total Shareholders' Equity} / \text{Total Number of Shares}$

Outstanding

P/B ratio can also be calculated using the following formula:

Price to Book Ratio = Current Market Capitalization / Total Shareholders' Equity

Dividend payout ratio

Dividend payout ratio is the percentage of a company's earnings that it pays out to investors in the form of dividends. It is calculated by dividing dividends paid during a period by net earnings for that period.

Dividend payout ratio is reciprocal of retention ratio (or plowback period) which measures the percentage of earnings a company reinvests in projects to generate future growth.

Dividend payout ratio is an important indicator of a company's performance from an investor's point of view.

Formula

$$\text{Dividend Payout Ratio} = \frac{\text{Dividends Paid}}{\text{Net Income}} = \frac{\text{Dividend per Share}}{\text{Earnings per Share}}$$

Analysis

People invest in a company expecting a return on their investment which comes from two sources: capital gains and dividends. The return from these two sources is inter-related. A high dividend payout ratio means that the company is reinvesting less earnings in future projects, which in turn means less capital gains in future periods. Similarly, low payout ratio today may result in higher capital gains in future.

Some investors prefer companies that provide high potential for capital gains while others prefer companies that pay high dividends. Dividend payout ratio helps each class of investors identify which companies to invest in.

Dividend payout ratio also provides an indication of a company's future growth potential. For investors that are interested in high growth companies, a high dividend payout ratio may not be a good sign.

Dividend yield ratio

Dividend yield is the ratio of dividend paid per share by a company to its current share price. It is a measure of dollars of dividends received by investors per hundred dollars of their investments in the stock.

Dividends are one of the two sources for return equity shareholders receive on their investment in a company's stock, the other being capital gains. Dividend yield measures the percentage return on a particular stock that has resulted from the company's dividend payments.

Formula

Dividend yield is calculated by dividing dividends paid by a company during a period by the total current market value of the company's outstanding stock.

$$\text{Dividend Yield} = \frac{\text{Total Dividend Payments}}{\text{Total Market Capitalization}} = \frac{\text{Dividend Per Share}}{\text{Current Share Price}}$$

Dividend per share information can be obtained from the company's financial statements. Alternatively, it can be calculated by dividing total dividend payments by the total number of shares.

Analysis

Dividend yield is a measure of investor return that has come from dividend payments. While dividend payout ratio compares the amount of dividend paid by a company to the company's earnings for the period, dividend yield ratio provides a comparison of amount of dividend to investment needed to purchase the shares.

A company might be paying out a relatively high, say 50%, of its earnings to investors, but if the dividend payments are too low as compared to its current share price, the investors who prefer dividends over capital gains might not be attracted by even the high payout ratio.

Dividend yield should be analyzed in the context of the company's industry and any share buybacks. A fast growing company might not be paying any dividends resulting in a zero dividend yield, but it might be generating high capital gains for investors. On the other hand, a company in a mature industry may generate a decent dividend yield for its investors but it may not have very high future growth potential.

Retention ratio

Retention ratio (also known as plowback ratio) is the percentage of a company's earnings retained and reinvested by the company. Retention ratio is the opposite of payout ratio.

Equity shareholders invest in a company expecting payback in the form of dividends and capital gains. A company's board of directors takes its dividend policy decisions i.e. decisions about the extent and timings of dividend payments. If the company has surplus cash, the board may decide to pay a higher dividend resulting in lower retention rate. But if they believe more profitable investment opportunities are available and that the company may generate higher future earnings by availing those opportunities, the board may elect to pay less dividends or do not pay dividends at all, and instead invest the money in future projects, in which case the company will have higher retention ratio (and lower payout ratio).

Formula

Retention ratio is calculated by dividing earnings retained during the period by total earnings for

the period. Earnings retained during a period equals total earnings for the period less total dividend payments during the period.

$$\text{Retention Ratio} = \frac{\text{Earnings Retained}}{\text{dividends per share}} = \frac{1 - \text{total dividends}}{\text{Total Earnings}} = \frac{1 - \text{EPS}}{\text{Total earnings}}$$

Retention ratio can also be calculated as 1 minus payout ratio.

$$\text{Retention ratio} = 1 - \text{Payout Ratio}$$

Analysis

Higher retention ratio of a company suggests that it may generate higher growth in future periods resulting in higher share price and potential capital gain. A lower retention ratio means that the company's management is not so confident about future profitability and has elected to pay back cash to the investors.

Retention ratio and future growth potential are so much linked that future sustainable growth rate is calculated as a product of retention ratio and return on equity of the company.

3. Activity Ratios

Activity ratios assess the efficiency of operations of a business. For example, these ratios attempt to find out how effectively the business is converting inventories into sales and sales into cash, or how it is utilizing its fixed assets and working capital, etc. Key activity ratios are:

- inventory turnover ratio
- days sales in inventory
- receivables turnover ratio
- days sales outstanding
- payables turnover ratio
- days payable outstanding
- fixed asset turnover ratio
- working capital turnover ratio

Inventory turnover ratio

Inventory turnover is an efficiency ratio which calculates the number of times per period a business sells and replaces its entire batch of inventories. It is the ratio of cost of goods sold by a business during an accounting period to the average inventories of the business during the

period.

Dividing the total cost of inventories sold during a period (which equals cost of goods sold) by the cost of average inventories balance maintained by a business gives us dollars of sales made per dollar of cash tied up in inventories.

Formula

Inventory turnover ratio is calculated using the following formula:

Inventory Turnover = Cost of Goods Sold / Average Inventories

Cost of goods sold = Beginning Inventories + Cost of Goods Manufactured – Ending Inventories

Cost of goods sold figure is reported on the income statement. Average Inventories =
Beginning Inventories + Ending Inventories / 2

The values of beginning and ending inventories appear on a business' balance sheets at the start and at the end of the accounting period.

Alternatively, inventory turnover can be calculated based on the closing inventories balance where the opening inventories balance is not available or where the inventories balance has not changed significantly over the period.

Inventory turnover ratio is also an input in calculation of days inventories outstanding (DIO).

Analysis

Inventory turnover ratio is used to assess how efficiently a business is managing its inventories.

In general, a high inventory turnover indicates efficient operations. A low inventory turnover compared to the industry average and competitors means poor inventories management. It may

be an indication of either a slow-down in demand or over-stocking of inventories. Overstocking poses risk of obsolescence and results in increased inventory holding costs.

Days sales in inventory

Days' inventory on hand (also called days' sales in inventory or simply days of inventory) is an accounting ratio which measures the number of days a company takes to sell its average balance of inventory. It is also an estimate of the number of days for which the average balance of inventory will be sufficient. Days' sales in inventory ratio is very similar to inventory turnover ratio and both measure the efficiency of a business in managing its inventory.

Formula

Days' inventory on hand is usually calculated by dividing the number of days in a period by inventory turnover ratio for the period as shown in the following formula:

Days of Inventory = Number of Days in the Period / Inventory Turnover for the Period

Thus, if we have inventory turnover ratio for the year, we can calculate days' inventory on hand by dividing number of days in a year i.e. 365 by inventory turnover.

If we substitute inventory turnover as "cost of goods sold ÷ average inventory" in the above formula and simplify the equation, we get:

$$\text{Days of Inventory} = \frac{\text{Average Inventory} \times \text{Number of Days in the Period}}{\text{Cost of Goods Sold}}$$

Analysis

Since inventory carrying costs take significant investment, a business must try to reduce the level of inventory. Lower level of inventory will result in lower days' inventory on hand ratio. Therefore lower values of this ratio are generally favorable and higher values are unfavorable. However, inventory must be kept at safe level so that no sales are lost due to stock-outs. Thus low value of days of inventory ratio of a company which finds it difficult to satisfy demand is not favorable.

Days' sales in inventory varies significantly between different industries. For example, business which sell perishable goods such as fruits and vegetables have very low values of days' sales in inventory whereas companies selling non-perishable goods such as cars have high values of days of inventory.

Receivables turnover ratio

Accounts receivable turnover is the ratio of net credit sales of a business to its average accounts receivable during a given period, usually a year. It is an activity ratio which estimates the number of times a business collects its average accounts receivable balance during a period.

Formula

Accounts receivable turnover is calculated using the following formula: Receivables

$$\text{Turnover} = \frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}}$$

We can obtain the net credit sales figure from the income statement of a company. Average accounts receivable figure may be calculated simply by dividing the sum of beginning and ending accounts receivable by 2. The beginning and ending accounts receivable can be found on the balance sheets of the first and the last day of the accounting period.

Accounts receivable turnover is usually calculated on annual basis, however for the purpose of creating trends, it is more meaningful to calculate it on monthly or quarterly basis.

Analysis

Accounts receivable turnover measures the efficiency of a business in collecting its credit sales. Generally a high value of accounts receivable turnover is favorable and lower figure may indicate inefficiency in collecting outstanding sales. Increase in accounts receivable turnover

overtime generally indicates improvement in the process of cash collection on credit sales.

However, a normal level of receivables turnover is different for different industries. Also, very high values of this ratio may not be favourable, if achieved by extremely strict credit terms since such policies may repel potential buyers.

Days sales outstanding

Days' sales outstanding ratio (also called average collection period or days' sales in receivables) is used to measure the average number of days a business takes to collect its trade receivables after they have been created. It is an activity ratio and gives information about the efficiency of sales collection activities.

Formula

Days Sales Outstanding is calculated using following formula:

$$\text{DSO} = \frac{\text{Accounts Receivable}}{\text{Credit Sales}} \times \text{Number of Days}$$

If possible, use the average accounts receivable during the period.

Another formula which uses the accounts receivable turnover is:

$$\text{DSO} = \frac{\text{Number of Days in the Period}}{\text{Accounts Receivable Turnover}}$$

Analysis

Since it is profitable to convert sales into cash quickly, which means that a lower value of Days Sales Outstanding is favorable whereas a higher value is unfavorable. However it is more meaningful to create monthly or weekly trend of DSO. Any significant increase in the trend is unfavorable and indicates inefficiency in credit sales collection.

Payables turnover ratio

Accounts payable turnover is the ratio of net credit purchases of a business to its average accounts payable during the period. It measures short term liquidity of business since it shows how many times during a period, an amount equal to average accounts payable is paid to suppliers by a business.

Formula

Accounts payable turnover is usually calculated as:

$$\text{Payables Turnover} = \frac{\text{Net Credit Purchases}}{\text{Average Accounts Payable}}$$

To calculate average accounts payable, divide the sum of accounts payable at the beginning and at the end of the period by 2. Net credit purchases figure in the denominator is not easily discoverable since such information is not usually available in financial statements. It is to be search for in the annual report of the company. Sometimes cost of goods sold is used in the denominator instead of credit purchases.

Analysis

Accounts payable turnover is a measure of short-term liquidity. A higher value indicates that the business was able to repay its suppliers quickly. Thus higher value of accounts payable turnover is favorable. This ratio can be of great importance to suppliers since they are interested in getting paid early for their supplies. Other things equal, a supplier should prefer to sell to a company with higher accounts payable turnover ratio.

Days payable outstanding

Days payables outstanding (DPO) is the average number of days in which a company pays its suppliers. It is also called number of days of payables.

In general, a low DPO highlights good working capital management because the

company is availing early payment discounts. However, the DPO should be corroborated by other ratios, particularly the liquidity ratios. When a company's liquidity position is good, a high days payables outstanding most likely tells that the company is delaying payments to its creditors till the last possible date to shorten its cash conversion cycle. It highlights good working capital management. However, if the liquidity situation of the company is not good, a high DPO suggests that the company is facing problems paying its suppliers.

Formula

Days Payables Outstanding = Number of Days in a Period / Payables Turnover for the Period

Since, Payables Turnover = Purchases / Average Trade Payables

$$\text{Days Payables Outstanding} = \frac{\text{Number of Days in a Period} \times \text{Average Trade Payables}}{\text{Purchases}}$$

If the period is a year:

Days Payables Outstanding for a Year = 365 × average trade payables / Annual Purchases

If figure for purchases is not available, it is calculated as:

Purchases = Cost of Goods Sold + Closing Inventory – Opening Inventory

In some situations where opening and closing inventories are immaterial, cost of goods sold can be used instead of purchases.

Fixed asset turnover ratio

Fixed assets turnover ratio is an activity ratio that measures how successfully a company is utilizing its fixed assets in generating revenue. It calculates the dollars of revenue earned per one dollar of investment in fixed assets.

A higher fixed asset turnover ratio is generally better. However, there might be situations when a high fixed asset turnover ratio might not necessarily mean efficient use of fixed assets as explained in the example.

Formula

Fixed Assets Turnover Ratio = Net Revenue / Average Fixed Assets

Net Revenue = Gross Revenue – sales returns

Average Fixed Assets = Opening Balance of Fixed Assets + Ending Balance of Fixed Assets / 2

Working capital turnover ratio

Working capital turnover ratio is an activity ratio that measures dollars of revenue generated per dollar of investment in working capital. Working capital is defined as the amount by which current assets exceed current liabilities.

A higher working capital turnover ratio is better. It means that the company is utilizing its working capital more efficiently i.e. generating more revenue using less investment.

Formula

Working Capital Turnover Ratio = Revenue / Average Working Capital

Working Capital = Current Assets – Current Liabilities

Average Working Capital = Opening Working Capital + Closing Working Capital / 2

Advantages of Ratio Analysis:

Ratio analysis is widely used as a powerful tool of financial statement analysis. It establishes the numerical or quantitative relationship between two figures of a financial statement to ascertain strengths and weaknesses of a firm as well as its current financial position and historical performance. It helps various interested parties to make an evaluation of certain aspect of a firm's performance.

The following are the principal advantages of ratio analysis:

1. Forecasting and Planning:

The trend in costs, sales, profits and other facts can be known by computing ratios of relevant accounting figures of last few years. This trend analysis with the help of ratios may be useful for forecasting and planning future business activities.

2. Budgeting:

Budget is an estimate of future activities on the basis of past experience. Accounting ratios help to estimate budgeted figures. For example, sales budget may be prepared with the help of analysis of past sales.

3. Measurement of Operating Efficiency:

Ratio analysis indicates the degree of efficiency in the management and utilisation of its assets. Different activity ratios indicate the operational efficiency. In fact, solvency of a firm depends upon the sales revenues generated by utilizing its assets.

4. Communication:

Ratios are effective means of communication and play a vital role in informing the position of and progress made by the business concern to the owners or other parties.

5. Control of Performance and Cost:

Ratios may also be used for control of performances of the different divisions or departments of an undertaking as well as control of costs.

6. Inter-firm Comparison:

Comparison of performance of two or more firms reveals efficient and inefficient firms, thereby enabling the inefficient firms to adopt suitable measures for improving their efficiency. The best way of inter-firm comparison is to compare the relevant ratios of the organisation with the average ratios of the industry.

7. Indication of Liquidity Position:

Ratio analysis helps to assess the liquidity position i.e., short-term debt paying ability of a firm. Liquidity ratios indicate the ability of the firm to pay and help in credit analysis by banks, creditors and other suppliers of short-term loans.

8. Indication of Long-term Solvency Position:

Ratio analysis is also used to assess the long-term debt-paying capacity of a firm. Long-term solvency position of a borrower is a prime concern to the long-term creditors, security analysts and the present and potential owners of a business. It is measured by the leverage/capital structure and profitability ratios which indicate the earning power and operating efficiency. Ratio analysis shows the strength and weakness of a firm in this respect.

9. Indication of Overall Profitability:

The management is always concerned with the overall profitability of the firm. They want to know whether the firm has the ability to meet its short-term as well as long-term obligations to its creditors, to ensure a reasonable return to its owners and secure optimum utilisation of the assets of the firm. This is possible if all the ratios are considered together.

10. Signal of Corporate Sickness:

A company is sick when it fails to generate profit on a continuous basis and suffers a severe liquidity crisis. Proper ratio analysis can give signal of corporate sickness in advance so that timely measures can be taken to prevent the occurrence of such sickness.

11. Aid to Decision-making:

Ratio analysis helps to take decisions like whether to supply goods on credit to a firm, whether bank loans will be made available etc.

12. Simplification of Financial Statements:

Ratio analysis makes it easy to grasp the relationship between various items and helps in understanding the financial statements.

Limitations of Ratio Analysis:

The technique of ratio analysis is a very useful device for making a study of the financial health of a firm. But it has some limitations which must not be lost sight of before undertaking such analysis.

Some of these limitations are:

1. Limitations of Financial Statements:

Ratios are calculated from the information recorded in the financial statements. But financial statements suffer from a number of limitations and may, therefore, affect the quality of ratio analysis.

2. Historical Information:

Financial statements provide historical information. They do not reflect current conditions. Hence, it is not useful in predicting the future.

3. Different Accounting Policies:

Different accounting policies regarding valuation of inventories, charging depreciation etc. make the accounting data and accounting ratios of two firms non-comparable.

4. Lack of Standard of Comparison:

No fixed standards can be laid down for ideal ratios. For example, current ratio is said to be ideal if current assets are twice the current liabilities. But this conclusion may not be justifiable in case of those concerns which have adequate arrangements with their bankers for providing funds when they require, it may be perfectly ideal if current assets are equal to or slightly more than current liabilities.

5. Quantitative Analysis:

Ratios are tools of quantitative analysis only and qualitative factors are ignored while computing the ratios. For example, a high current ratio may not necessarily mean sound liquid position when current assets include a large inventory consisting of mostly obsolete items.

6. Window-Dressing:

The term 'window-dressing' means presenting the financial statements in such a way to show a better position than what it actually is. If, for instance, low rate of depreciation is charged, an item of revenue expense is treated as capital expenditure etc. the position of the concern may be made to appear in the balance sheet much better than what it is. Ratios computed from such balance sheet cannot be used for scanning the financial position of the business.

7. Changes in Price Level:

Fixed assets show the position statement at cost only. Hence, it does not reflect the changes in price level. Thus, it makes comparison difficult.

8. Causal Relationship Must:

Proper care should be taken to study only such figures as have a cause-and-effect relationship; otherwise ratios will only be misleading.

9. Ratios Account for one Variable:

Since ratios account for only one variable, they cannot always give correct picture since several other variables such Government policy, economic conditions, availability of resources etc. should be kept in mind while interpreting ratios.

10. Seasonal Factors Affect Financial Data:

Proper care must be taken when interpreting accounting ratios calculated for seasonal business. For example, an umbrella company maintains high inventory during rainy season and for the rest of year its inventory level becomes 25% of the seasonal inventory level. Hence, liquidity ratios and inventory turnover ratio will give biased picture.

BANK RECONCILIATION

A company's cash balance at bank and its cash balance according to its accounting records usually do not match. This is due to the fact that, at any particular date, checks may be outstanding, deposits may be in transit to the bank, errors may have occurred etc. Therefore companies have to carry out bank reconciliation process which prepares a statement accounting for the difference between the cash balance in company's cash account and the cash balance according to its bank statement.

Following are the transactions which usually appear in company's records but not in the bank statement:

Deposits in Transit: Deposits which have been sent by the company to the bank but have not been received by the bank at proper time before the issuance of bank statement.

Checks Outstanding: Checks which have been issued by the company but were not presented or cleared before the issuance of bank statement.

Following are the transactions which usually appear in bank statement but not in company's cash account:

Service Charges: Service charges may have been deducted by the bank. Such charges are usually not known to the company before the issuance of bank statement.

Interest Income: If any interest income has been earned by the company on its bank account, it is not usually entered in company's cash account before the issuance of bank statement.

NSF Checks: NSF stands for "not sufficient funds". These are the checks deposited by the company in bank account but the bank is unable to receive payment on those checks due to insufficient funds in the payer's account.

Bank Reconciliation Statement.

A schedule showing the items of difference between the bank statement and the bank column of Cash Book is known as Bank Reconciliation Statement.

Causes of Differences in Cash Book and Pass Book

- (A) Transactions recorded in Cash Book but not in Pass Book.
- (B) Transactions recorded in Pass Book but not in Cash Book.
- (C) Others transactions errors.

(A) Transactions recorded in Cash Book but not in Pass Book

- (i) Cheques issued but not presented for payment in the bank.
- (ii) Cheques deposited or paid into the bank for collection but not yet credited by bank.
- (iii) Cheques deposited but dishonored.
- (iv) Wrongly Debit or credit entered.

(B) Transactions recorded in Pass Book but not in Cash Book

- (i) Interest allowed by the Bank
- (ii) Interest on overdraft, bank charges and commission etc. charges by Bank.
- (iii) Direct deposit by the customers into Bank.
- (iv) Interest, dividend etc. collected by the Bank.
- (v) Direct payment made by the Bank on behalf of customer as per standing instruction.

(C) Other transactions

- (i) Error in totaling or balancing of Cash Book.
- (ii) Transactions recorded twice in Cash Book.
- (iii) Transactions recorded twice in Pass Book.
- (iv) Error of recording by wrong amount.

(v) Error of recording in wrong side like Debit instead of credit and vice-versa.

Need and importance

- It helps in locating and rectifying the errors or omissions committed either by the firm or by the bank.
- Customer becomes sure of the correctness of the bank balance shown by the cash book.
- Facilitates the preparation of amended or revised Cash Book
- Reduces the chances of fraud by the staff of the firm or bank.
- Helps in keeping a track of the cheques deposited for collection.

Procedure of Preparing Bank Reconciliation Statement (BRS)

- A Bank Reconciliation Statement is prepared when we get the duly completed Pass Book from the Bank.
- (1) First of all tally the Debit side entries of the cash book with the Credit side entries of the Pass Book and vice versa.
- (2) Tick the items appearing in both the books.
- (3) Unticked items will be the points of differences.
- (4) A BRS is then prepared by taking either the balance as per Cash Book or Pass Book as a starting point.

Important Points

- (1) If the Starting point is Cash Book Balance then the ending point will be Pass Book Balance.
- (2) If the starting point is Pass Book Balance then the ending point will be the Balance as per Cash Book.

3) Debit Balance as per Cash Book or Credit Balance as per Pass Book, means that the firm has that much amount of deposit at the bank (also called favourable balance) write the amount under (+) items.

(4) Credit Balance as per Cash Book or Debit Balance as per Pass Book, means that this much amount has seen withdrawn in excess of deposit (also called overdraft or unfavorable balance) write the amount under (-) items.

Method of Preparing BRS Starting with the Balance/overdraft as per Bank Column of Cash Book.

Bank Reconciliation Statement as on.....

Particulars	+ ITEM	- ITEM
Balance as per Cash Book		
Add :- Items Credit in Pass Book but not recorded in Cash Book.		
Less : - Items debit in Cash Book but not recorded in Pass Book.		
Less : Item debit in Pass Book but not recorded in Cash Book		
Add: Items credit in Cash Book but not recorded in Pass Book		
Total	P	M
Balance as per Pass Book (P — M) =		

Note

If total of (+) Items is more than the total of (-) items then Difference is Credit Balance or favourable balance as per Pass Book.

Where as if the(-)total is more than the (+) items total then Difference is Debit Balance or overdraft as per Pass Book.

If BRS is started with Balance as per Cash Book then ending point is Balance as per Pass Book and Vice-Versa.

Debit balance of Cash Book means favourable balance or(+) Balance

Debit balance of Pass Book means unfavorable balance or (-)balance.

Credit balance of Pass Book means favourable balance or(+) balance

Credit Balance of cash Book Means unfavourable balance or (-) Balance.

Ready Reference Items which increase the Pass Book Balance or decreases the Cash Book Balance

- (1) Cheques issued but not yet presented.
- (2) Credits made by the bank for Interest.
- (3) Amount directly deposited by the customers in our bank A/c. (4) Interest and dividend collected by the bank. (5) Cheques paid into the bank but omitted to be recorded in the Cash Book.

Items which, decreases the Pass Book Balance or increase the Cash Book Balance

- (1) Cheques sent to the bank for collection but not yet credited by the - bank.
- (2) Cheques paid into the bank but dishonoured.
- (3) Direct payments made by the bank
- (4) Bank charges, commission etc. debited by the bank.
- (5) Cheques issued but omitted to be recorded in the Cash Book.

Example 1: Balance as per Cash Book is given Prepare Bank Reconciliation statement as on 31st July 2016

- (1) Dr. Balance as per Cash Book is ₹ 20,000 as on 31st Jul 2016.
- (2) Cheques for ₹ 5,000 were deposited into the Bank in the month of July but only Cheques for ₹ 1,000 were credited by bank till 31st July 2016
- (3) Cheques issued for ₹ 33,000 in July, out of which a cheque for ₹ 13,800 was presented for payment on 3rd August, 2016.
- (4) Bank charged ₹ 150 as Bank charges and credited interest of ₹ 400.
- (5) A Customer directly deposited ₹ 2,500 in firm's bank A/C.
- (6) Bank paid the insurance Premium of ₹ 1,200 as per standing instruction on 25.7.2016.

Solution:

Bank Reconciling Statement as on 31st July 2016

<i>Particulars</i>		<i>+ Item (Rs.)</i>	<i>- Item (Rs.)</i>
(1)	Balance as per Cash Book.	20,000	
(2)	Cheques deposited but not yet collected by the bank (5,000-1,000)	-	4,000
(3)	Cheques issued but not yet Present for payment	13,800	-
(4)	(a) Bank. Charges	-	150
	(b) Interest credited by the bank	400	-
(5)	Directly deposited by the customers not recorded in the Cash Book	2,500	-
(6)	Insurance Premium paid by the bank not recorded in Cash Book.		1,200
	Total	36,700	5,350
	Balance as per Pass Book (36,700-5,350)	31,350	

Explanation

1. Balance as per Cash Book means favourable Balance, hence (+) Item. If nothing (i.e. Debit or Credit) is written the Balance given, it is treated as favourable.

2. Cheques were deposited into the bank for ₹5,000 but credited by the bank for ₹1,000 in the month of July, implies that cheques for ₹4,000 (5,000-1,000) are entered in the Cash Book but not in the Pass Book Increasing the Cash Book Balance by ₹4,000 as compared to Pass Book. Hence to get pass Book Balance from the Cash Book ₹4,000 will have to be deducted.

3. Cheques issued but not presented for payment till 31st July is for ₹13800 which is entered on the credit side of Cash Book as compared to Pass Book (Cash book Balance is less by ₹ 13.800 as compared to Pass Book Item)

4. (a) Bank charges of ₹ 150 entered in the Pass Book will decrease the Balance of Pass Book. To reach Pass Book Balance from Cash Book Balance, this item has to be deducted i.e. minus item.

(b) Interest credited by the Bank ₹ 400 interest in Pass Book Increases the, balance of Pass Book, hence to reach the Balance from cash book and this item is to be added to (+) item.

5. Direct deposit by a customer ₹2,500 Increase the Pass Book Balance plus item.

6. Payment made by the bank for insurance premium decreases the Pass Book Balance Minus Item.

7. Plus items total ₹36,700 is more than Minus item total ₹5,350 by ₹31,350 Hence the difference of ₹31,350 will be (+) item i.e. Favourable Balance or Cr. balance as per Pass Book.

Example 2: When overdraft as per Cash Book is given

(1) Overdraft as per Cash Book is ₹40,500 on 30th June 2016.

- (2) Cheques deposited but not yet collected? 12,000.
- (3) Cheques issued but not yet presented for payment of ?2,800.
- (4) Bank Charges of Rs. 50 and Interest on overdraft of Rs. 250 are charged by the bank.
- (5) A customer directly deposited Rs. 1,200 into the Bank.
- (6) Insurance Premium of Rs. 1,500 is paid by the bank as per standing instructions

Prepare Bank Reconciliations Statement for the month of June 2016.

Bank Reconciliations Statement as on 30th June 2016

<i>Particulars</i>	+Items (Rs.)	- Items (Rs.)
(1) Overdraft as per Cash Book*.	-	40,500
(2) Cheques deposited but not yet collected	-	12,000
(3) Cheques issued but not yet Presented for payment	2,800	-
(4) (a) Bank Charges	-	50
(b) Interest on overdraft charged	-	250
(5) Directly deposited by a customer in the bank.	1,200	-
(6) Insurance Premium paid by the bank not entered — in Cash Book.	-	1,500
Total	4,000	54,300
Overdraft as per Pass Book 54,300-4,000		50,300

Overdraft means unfavorable balance or Negative Balance Hence put it under (-ive) items.
Explanation for all other items is similar as example 1 except the following.

- Item No. 4 (b)- Interest on overdraft decreases the Pass Book Balance hence it is to be deducted from Cash Book Balance to reach at Pass Book Balance (- item)
- This time the total of (-) items Rs. 54,300 is more than the total (+) items? 50,300 by? 4,000 by
- At the end (+) item and (-) item are totalled
 - If total of (+) items is more than the total of (-) items Difference is favourable Balance or Debit Balance as per Cash Book.
 - Where as if the total of (-) items is more than the total of (+) items. Difference is unfavourable or overdraft as per Cash Book.

READY REFERENCE

Items which increases the Cash Book Balance or decreases the Pass Book Balance

- (1) Cheques deposited into the bank but dishonoured.
- (2) Cheque sent for collection but not yet collected.
- (3) Direct Payments made by the bank.
- (4) Bank charges, commission etc. debited by the bank.
- (5) Cheques issued but omitted to be recorded in the Cash Book.

Items which decreases the Cash Book Balance or increase the Pass Book Balance

- (1) Cheques issued but not yet presented.
- (2) Credits made by the bank for interest.
- (3) Amount directly deposited by the customers into the Bank.
- (4) Interest and dividend collected by the Bank.
- (5) Cheques paid into the bank but omitted to be recorded in the Cash Book.

Examples 3 : Balance as per Pass Book is given

Given (1) Balance as per Pass Book is Rs. 70,000 Point No. (2) to (6) are same as given in example (1) Prepare Bank Reconciliation Statement as on July 31.2016

Solution: Bank Reconciliation Statement as on 31st July 2016

<i>Particulars</i>		<i>+ Items (Rs.)</i>	<i>- Items (Rs.)</i>
(1)	Balance as per Pass Book (Cr).	70,000	—
(2)	Cheques deposited but not yet collected by the Bank (5,000-1,000).	4,000	-
(3)	Cheques issued but not yet Presented for payment		13,800
(4)	(a) Bank Charges	150	-
	(b) Interest allowed by Bank.	-	400
(5)	Directly deposited by the customer, not recorded in the Cash Book.	-	2,500
(6)	Insurance Premium paid by the Bank, not recorded in Cash Book.	1,200	-
	Total	75,350	16,700
	Balance as per Cash Book (75,350-16,700)	58,650	

Important Points:

Starting and Ending points are reversed compared to Example No. 1 Hence (+) items (-) items are interchanged.

Favourable balance whether of Cash Book or Pass Book is always a (+) items.

If (+) items total is more than (-) items total then the difference in the two totals is always a favourable Balance

Where as if + items total is less than the (-) items total then the difference in the two totals is overdraft.

Example 4 : Overdraft as per Pass book is Rs. 45,000 Rest of the contents (points 2 to 6) are same as given example No.2 Prepare Bank Reconciliation Statement as on June 30.2016

Bank Reconciliations Statement as on 30th June 2016

<i>Particulars</i>	<i>-1-Item (Rs.)</i>	<i>-Items (Rs.)</i>
(1) Over draft as per Pass Book.	-	45000
(2) Cheques deposited but not yet collected	12,000	-
(3) Cheques issued but not yet presented for payment	-	2,800
(4) (a) bank Charges not entered in Cash Book	50	-
(b) Interest on overdraft charged by the bank	250	-
(5) Directly deposited by a customer in the Bank	-	1,200
(6) Insurance Premium paid by the Bank	1,500	-
Total	13,800	49,000
Overdraft as per Cash Book (49,000-13,800)	-	35,200

Important Points

Overdraft whether as per Cash Book or Pass Book is always a (-) items.

Starting and Ending points are interchanged as compared to Example No. 2 hence (+) items and (-) are also interchanged.

Here (-) items total is more as compared to (+) items total, therefore, the difference in the two balance is a negative items i.e. overdraft as per Cash Book.

Amended Cash Book Method Introduction : So far we have studied the preparation of Bank Reconciliation Statement simply by reconciling the causes of differences between the Cash Book and Pass Book. In actual practice adjustments are done in the Cash Book by comparing the Bank column of Cash Book with the Bank Statement and after that, B.R. Statement is prepared. It is called Amended Cash Book Method.

Procedure

(1) Adjusted Cash book is prepared starting with the Balance of the Cash Book given in the question.

(2) All errors that have been committed in the Cash Book will have to be rectified by passing adjusting entries in the Cash Book.

Usual General Errors are

- Overcasting or Under casting of Debit/Credit Column of Cash-Book.
- Cheques deposited or Issued but omitted to be entered in the Cash Book.
- Incorrect amount (if any) entered in the Cash Book.
- Entries on the correct side or in the wrong column of Cash Book.
- Any amount recorded twice in the Cash Book.

(3) Certain amounts for which Bank has debited our A/c will be recorded on the Credit side of

Cash Book. Such items are

- (a) Interest charged by the bank on overdraft, etc.
- (b) Debits made by the bank for the bank charges, commission etc.
- (c) Direct payments made by the Bank on behalf of the A/c holder
- (d) Cheques sent for collection but dishonoured.

(4) Cash Book is then balanced : and the new Balance of the Cash book is taken as the starting point for preparing the B.R. Statement.

Important: It should be noted that the following items must not be recorded in the Amended Cash Book.

Cheques deposited into the Bank but not yet credited by the Bank.

Cheques Issued but yet not presented for payment.

Any wrong Entry in pass Book.

Example: The cash Book of Mr. Sharma showed a balance, of ₹ 3,560 as on 31st Dec. 2015 at the bank where as Pass Book showed a balance of ₹ 4,230. Comparison of the Cash Book and Pass Book revealed the following:

- (1) The Bank has debited Mr. Sharma With ₹ 460. the annual premium of his life Policy according to his standing instructions and Rs. 20 as Bank charges.
- (2) Mr. Sharma paid into the Bank cheques totalling ₹ 3,100 on Dec. 26, 2015 of which those for ₹ 2,500 were collected in December. One cheque for ₹ 200 was returned dishonored on 2nd Jan. 2016
- (3) The Bank has credited Mr. Sharma by ₹ 1,600. the proceeds of a bill.
- (4) Cash collected, on 31 st Dec. 2015 totaling ₹ 850 was entered in the Cash Book in the Bank column on the same date but banked on 2.1.2016
- (5) Mr. Sharma issued cheques totalling ₹ 2,300 in the month of Dec. out of which cheques for ₹ 1,000 have not been presented for payment for payment till 31 st Dec.

SOL:

Receipt side	Payment side	
<i>Particulars</i>	<i>+Items (Rs.)</i>	<i>- Items (Rs.)</i>
(1) Balance as per Adjusted Cash Book (Dr.)	4,680	-
(2) Cheques paid into the Bank but not Credited by Dec. 31, 2013 (3,100-2,500)	-	600
(3) Cash collected entered in the Cash Book but not banked.		850
(4) Cheques issued but not presented till date	1,000	-
Total	5,680	1,450
Balance as per Pass Book (5,680-1,450)	4,230	

UNIT - 4

FINANCIAL STATEMENT ANALYSIS II

Analysis of Financial Statements II: *Funds Flow Statement:* Meaning, Concept of Gross and Net Working Capital, Preparation of Schedule of Changes in Working Capital, Preparation of Funds Flow Statement and its analysis;

Cash Flow Statement: Various cash and non-cash transactions, flow of cash, difference between cash flow and fund flow, preparation of Cash Flow Statement and its analysis.

Objectives:

After reading this lesson, the reader should be able to

Understand the concept of funds and flow.

Evaluate the changes in working capital in an organization.

Ascertain the sources and uses of funds from a given financial statement.

Prepare fund flow statement.

Understand the concepts of cash and cash flow.

Understand the cash flow analysis.

Prepare cash flow statement.

Fund Flow Statement

Meaning of Fund Flow Statement:

A fund flow statement is a statement in summary form that indicates changes in terms of financial position between two different balance sheet dates showing clearly the different sources from which funds are obtained and uses to which funds are put.

It summarizes the financing and investing activities of the enterprise during an accounting period.

By depicting all inflows and outflows of fund, the statement shows their net impact on working capital of the firm.

If the total of inflows is greater than the outflows, the excess goes to increase in working capital. If there is deficit of funds during a particular accounting period, the working capital is impaired. So fund flow statement is an important tool for working capital management.

Some definitions of financial experts are given for the clear conception of fund flow statement:

According to R. N. Anthony:

“The funds flow statement describes the sources from which additional funds were derived and the uses to which these funds were put.”

Roy A. Fouke defines fund flow statement as “a statement of sources and application of funds is a technical device designed to analyse the changes in the financial condition of a business enterprise between two dates.”

Thus, the fund flow statement reveals the volume of financial transactions and explains the flow of funds taking place within a business during a particular period of time and its effect on the net working capital. It is not a substitute for either the Profit and Loss Account or the Balance Sheet, but it is a useful supplement to them.

It describes the sources from which funds are obtained and the uses of these funds, in a condensed form.

Importance of Fund Flow Statement:

The importance of fund flow statement may be summarised:

1. Analyses Financial Statements:

Balance Sheet and Profit and Loss Account do not reveal the changes in the financial position of an enterprise. Fund flow analysis shows the changes in the financial position between two balance sheet dates. It provides details of inflow and outflow of funds i.e., sources and application of funds during a particular period.

Hence it is a significant tool in the hands of the management for analysing the past, and for planning the future. They can infer the reasons for imbalances in the uses of funds in the past and take corrective measures for the future.

2. Answers Various Financial Questions:

Fund flow statement helps us to answers various financial questions such as:

- (a) How much fund flowed into the business?
- (b) How much of these funds were provided by the operations?
- (c) What are the other sources of funds?
- (d) How were these funds used?
- (e) Why was there less/more amount of net working capital at the end of the period than at the beginning?
- (f) Why were the dividends not larger?

(g) How was the purchase of fixed assets financed?

(h) Where have the net profits gone?

(i) How were the loans repaid?

3. Rational Dividend Policy:

Sometimes it may happen that a firm, instead of having sufficient profit, cannot pay dividend due to inadequate working capital. In such circumstances, fund flow statement shows the working capital position of a firm and helps the management to take policy decisions on dividend etc.

4. Proper Allocation of Resources:

Financial resources are always limited. So it is the duty of the management to make its proper use. A projected fund flow statement enables the management to take proper decision regarding allocation of limited financial resources among different projects on priority basis.

5. Guide to Future Course of Action:

The future needs of the fund for various purposes can be known well in advance from the projected fund flow statement. Accordingly, timely action may be taken to explore various avenues of fund.

6. Proper Managing of Working Capital:

It helps the management to know whether working capital has been effectively used to the maximum extent in business operations or not. It depicts the surplus or deficit in working capital than required. This helps the management to use the surplus working capital profitably or to locate the resources of additional working capital in case of scarcity.

7. Guide to Investors:

It helps the investors to know whether the funds have been used properly by the company. The lenders can make an idea regarding the creditworthiness of the company and decide whether to lend money to the company or not.

8. Evaluation of Performance:

Fund flow statement helps the management in judging the financial and operating performance of the company.

Limitations of Fund Flow Statement:

Despite its various advantages, the fund flow statement suffers from certain limitations:

1. Historical Nature:

The information used for the preparation of the fund flow statement is essentially historical in nature. It does not estimate the sources and application of funds for the near future.

2. Structural Changes Not Disclosed:

The fund flow statement does not disclose the structural changes in financial relationship in a firm. In other words, it does not reveal shifts among items making up the current assets and current liabilities. It does not tell us whether any loss of working capital has unduly weakened the financial position or not.

3. Not Foolproof:

The fund flow statement is prepared from the data provided in the balance sheet and profit and loss account. Hence, the defects in financial statements will be carried over to the fund flow statement also.

4. Ignores Non-Fund Items:

As fund flow statement ignores non-fund items, it becomes a crude device compared to income statement and balance sheet.

5. Not Relevant:

A study of changes in cash (i.e., cash flow statement) is more relevant than a study of changes in funds for the purpose of managerial decision-making.

General Rules:

We know, working capital (WC) = Current Assets (CA) – Current Liabilities (CL) or, $WC = CA - CL$

From the above equation, we may deduce

(i) An increase in CA or a decrease in CL – Causes an increase in WC

(ii) A decrease in CA or an increase in CL – Causes a decrease in WC

(iii) A simultaneous increase in CA and CL or a simultaneous decrease in CA and CL— will have no effect on WC.

A flow of funds takes place only if a transaction involves one current account (CA or CL) and one Non-current account (NCA or NCL).

From above the following general rules can be formed:

(i) Transactions which involve only current accounts (CA or CL) do not result in a flow of funds.

(ii) Transactions which involve only Non-current accounts (NCA or NCL) do not result in a flow of funds.

(iii) Transactions which involve one current account (CA or CL) and one Non-current account (NCA or NCL) results in a flow of funds.

Preparation of Fund Flow Statement:

Generally, two comparative balance sheets—one at the beginning and the other at the end of the period—are used for preparing a fund flow statement. In addition, a summarised income statement comprising non-fund or ‘non-operating’ items and a statement of retained earnings or at least material information from these statements are required in order to find out fund from operations.

Additional information regarding change in non-current accounts like plant and machinery, building, share capital, debentures etc., if available, will sharpen the firms financial profile as revealed by the fund flow statement.

The fund flow analysis involves the preparation of two statements:

(a) Statement or Schedule of Changes in Working Capital and

(b) Statement of Sources and Application of funds.

1. Statement or Schedule of Changes in Working Capital:

The primary purpose of a fund flow statement is to explain the net change in working capital, it will be better to prepare first the schedule of changes in working capital before preparing a fund flow statement.

The Schedule or Statement of changes in working capital is a statement that compares the change in the amount of current assets and current liabilities on two balance sheet dates and highlights its impact on working capital.

The format of this statement is:

Schedule of Changes in Working Capital

Particulars	Previous Year Rs.	Current Year Rs.	Effect on Working Capital	
			Increase (+) Rs. Rs.	Decrease (-) Rs. Rs.
Current Assets				
Cash in hand	***	***		
Cash at Bank	***	***		
Bills Receivable	***	***		
Sundry Debtors	***	***		
Closing Stock	***	***		
Short-term Investments	***	***		
Prepaid Expenses	***	***		
Other Current Assets	***	***		
Total [A]	***	***		
Current Liabilities				
Bills Payable	***	***		
Sundry Creditors	***	***		
Outstanding Expenses	***	***		
Bank Overdraft	***	***		
Short-term Loan taken	***	***		
Proposed Dividend ⁽¹⁾	***	***		
Provision for Taxation ⁽¹⁾	***	***		
Other Current Liabilities	***	***		
Total [B]	***	***		
Working Capital [A – B]	***	***		
Net Increase/Decrease in working capital	***	***	***	***

Note (1) : May or may not be treated as current liability. This matter has been discussed subsequently.

To analyse the effect of working capital as a result of change in current assets and current liabilities, the following general rules should be considered :

Nature of Transactions

1. Increase in Current Assets
2. Decrease in Current Assets
3. Increase in Current Liabilities
4. Decrease in Current Liabilities

Effect on Working Capital

- Increase in Working Capital (+)
- Decrease in Working Capital (-)
- Decrease in Working Capital (-)
- Increase in Working Capital (+)

2. Fund Flow Statement:

After preparing the schedule of changes in working capital, the next step is to prepare the Fund Flow Statement to find out the different sources and applications of funds. While preparing this statement the emphasis is given on the changes in the fixed assets and fixed liabilities. The statement may be prepared either in 'T form' or in 'Vertical form'.

A proforma of each of them is given:

T form
Fund Flow Statement for the year ended.....

Sources of Funds	Rs.	Application of Funds	Rs.
Trading Profit or Fund from Operations (1)	* * *	Trading Loss or Fund lost in Operations(1)	* * *
Issue of Share Capital	* * *	Redemption of Pref. Share	* * *
Issue of Debentures	* * *	Redemption of Debentures	* * *
Raising of Long-term Loans	* * *	Repayment of Long-term Loans	* * *
Receipts from Partly Paid-up shares Called-up	* * *	Purchase of Fixed Assets	* * *
Sale of Fixed Assets/ Investments	* * *	Purchase of Long-term Investment	* * *
Non-trading Receipts	* * *	Payment of Dividend	* * *
		Payment of Tax	* * *

(e.g., dividend etc.)	***	Net Increase in Working Capital ⁽²⁾	***
Net Decrease in Working Capital ⁽²⁾	***		***
	***		***

**Vertical form
Fund Flow Statement for the year ended.....**

	Rs.
Sources of Funds	
Trading Profit or Fund from Operations ⁽¹⁾	***
Issue of Share Capital	***
Issue of Debentures	***
Raising of Long-term Loans	***
Receipts from partly paid-up shares, called-up	***
Sale of Fixed Assets and Investments	***
Non-trading Receipts, such as dividends received	***
Net Decrease in Working Capital ⁽²⁾	***
Total	***
Application of Funds	
Trading Loss or Funds Lost in operations ⁽¹⁾	***
Redemption of Preference Share Capital	***
Redemption of Debentures	***
Re-payment of Long-term Loans	***
Purchase of Fixed Assets	***
Purchase of Long-term Investment	***
Payment of Dividend	***
Payment of Tax	***
Net Increase in Working Capital ⁽²⁾	***
Total	***

NOTE:

- (1) Either of the two will appear in the Fund Flow Statement.
- (2) Either of the two will appear in the Fund Flow Statement.
- (3) Payment of dividend and tax will appear as an application of funds only when these items are appropriation of profits and not current liabilities.

<i>Sources of Funds</i>	<i>Uses of Funds</i>
1. Issue of Fresh Shares	1. Redemption of Preference Shares
2. Issue of Debentures	2. Redemption of Debentures
3. New Loans	3. Repayment of Loans
4. Sale of Fixed Assets	4. Purchase of Fixed Assets
5. Non-trading Income	5. Loss from Operations
6. Profits from Operation	6. Payment of Dividends etc.

CASH FLOW STATEMENT:**Meaning of Cash Flow Statements:**

Cash Flow Statement is a statement which describes the inflows (sources) and outflows (uses) of cash and cash equivalents in an enterprise during a specified period of time. Such a statement enumerates net effects of various business transactions on cash and its equivalents and takes into account receipts and disbursements of cash.

A cash flow statement summarizes the causes of changes in cash position of a business enterprise between dates of two balance sheets. According to AS-3 (Revised), an enterprise should prepare a cash flow Statement and should present it for each period for which financial statements are prepared.

The terms cash, cash equivalents and cash flows are used in this statement with the following meanings:

1. Cash comprises cash on hand and demand deposits with banks.
2. Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes.

For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of change in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short-maturity, of say, three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents: for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).

3. Cash flows are inflows and outflows of cash and cash equivalents. Flow of cash is said to have taken place when any transaction makes changes in the amount of cash and cash equivalents available before happening of the transaction. If the effect of transaction results in the increase of cash and its equivalents, it is called an inflow (source) and if it results in the decrease of total cash, it is known as outflow (use) of cash.

Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Classification of Cash Flows:

According to AS-3 (Revised), the cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

Thus, cash flows are classified into three main categories:

1. Cash flows from operating activities.

2. Cash flows from investing activities.

3. Cash flows from financing activities.

1. Cash Flows from Operating Activities:

Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities. The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans, and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss.

Examples of cash flows from operating activities are:

- (a) Cash receipts from the sale of goods and the rendering of services;
- (b) Cash receipts from royalties, fees, commissions, and other revenue;
- (c) Cash payments to suppliers of goods and services;
- (d) Cash payments to and on behalf of employees;

- (e) Cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
- (f) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
- (g) Cash receipts and payments relating to futures contracts, forward contracts, option contracts, and swap contracts when the contracts are held for dealing or trading purposes.

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

2. Cash Flows from Investing Activities:

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Examples of cash flows arising from investing activities are:

- (a) Cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalized research & development costs and self constructed fixed assets;
- (b) Cash receipts from disposal of fixed assets (including intangibles);
- (c) Cash payments to acquire shares, warrants, or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(d) Cash receipts from disposal of shares, warrants, or debt instruments of other enterprises and interests in joint venture (other than receipts from those instruments considered to be cash equivalents¹ and those held for dealing or trading purposes);

(e) Cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);

(f) Cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);

(g) Cash payments for futures contracts, forward contracts, option contracts, and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) Cash receipts from futures contracts, forward contracts, option contracts, and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

3. Cash Flows from Financing Activities:

Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise.

Examples of cash flows arising from financing activities are:

(a) Cash proceeds from issuing shares or other similar instruments:

(b) Cash proceeds from issuing debentures, loans, notes, bonds, and other short-or long-term borrowings; and

(c) Cash repayments of amounts borrowed such as redemption of debentures, bonds, preference shares.

Limitations of Cash Flow Statement:

Despite a number of uses, cash flow statements suffer from the following limitations:

(i) As cash flow statement is based on cash basis of accounting, it ignores the basic accounting concept of accrual basis.

(ii) Some people feel that as working capital is a wider concept of funds, a funds flow statement provides a more complete picture than cash flow statement.

(iii) Cash flow statement is not suitable for judging the profitability of a firm as non-cash charges are ignored while calculating cash flows from operating activities.

(iv) A cash flow statement is not a substitute of an income statement it is complementary to an income statement. Net cash flow does not mean the net income of a firm.

(v) A cash flow statement is also not a substitute of funds flow statement which provides information relating to the causes that lead to increase or decrease in working capital.

(vi) A comparative study of cash flow statements may give misleading results.

Format of Cash Flow Statement:

A S – 3 (Revised) has not provided any specific format for preparing a cash flow statement. However, an idea of the suggested format can be inferred from the illustrations appearing in the

appendices to the accounting standard. The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

A widely used format of cash flow statement (Direct Method) is given below:

Cash Flow Statement (for the year ended)		
	₹	₹
Cash Flows From Operating Activities		
Either		
Cash receipts from customers	xxx	
Cash paid to suppliers and employees	(xxx)	
Cash generated from operations	xxx	
Income-tax paid	(xxx)	
Cash flow before extraordinary items	xxx	
Extraordinary items	xxx	
Net cash from (used in) Operating activities		xxx
Or		
Net profit before tax and extraordinary items	xxx	
Adjustments for non-cash and non-operating items (List of individual items such as depreciation, foreign exchange loss, loss on sale of fixed assets, interest income, dividend income, interest expense etc.)	xxx	
Operating profit before working capital changes	xxx	
Adjustments for changes in current assets and current liabilities (List of individual items)	xxx	
Cash generated from (used in) operations before tax	xxx	
Income tax paid	xxx	
Cash flow before extraordinary items	xxx	
Extraordinary items (such as refund of tax)	xxx	
Net cash from (used in) operating activities		xxx
Cash Flows From Investing Activities		
Individual items of cash inflows and outflows from financing activities (such as purchase/sale of fixed assets, purchase or sale of investments, interest received, dividend received etc.)	xxx	
Net Cash from (used in) investing activities		xxx
Cash Flows From Financing Activities		
Individual items of cash inflows and outflows from financing activities (such as) proceeds from issue of shares, long-term borrowings, repayments of long- term borrowings, interest paid, dividend paid etc.)	xxx	
Net cash from (used in) financing activities	xxx	
Net Increase (Decrease) in cash and cash equivalents		xxx
Cash and cash equivalents at the beginning of the period		xxx
Cash and cash equivalents at the end of the period		xxx

Format of Cash Flow Statement (Indirect Method) :

Cash Flow Statement (for the year ended)	
XYZ Ltd.	₹
A. Cash Flow From Operating Activities	
Net Profit/Loss before tax and extraordinary items	
Adjustments for :	
Depreciation	
Gain/Loss on sale of fixed assets	
Foreign exchange	
Miscellaneous expenditure written off	
Investment income	
Interest	
Dividend	
Operating profit before working capital changes	
Adjustments for :	
Trade and other receivables	

Inventories	
Trade Payables	
Cash generated from operations	
Interest paid	
Direct taxes paid	
Cash flow before items	
Extraordinary items	
<i>Net Cash from Operating Activities</i>	
B. Cash Flow From Investing Activities	
Purchase of fixed assets	
Sales of fixed assets	
Purchase of investments	
Sale of investments	
Interest received	
Dividend received	
<i>Net Cash from/used in investing activities</i>	
C. Cash Flow From Financing Activities	
Proceeds from issue of share capital	
Proceeds from long-term borrowings/banks	
Payment of long-term borrowings	
Dividend paid	
<i>Net Cash from /used in financing activities</i>	
Net Increase/Decrease in Cash and Cash Equivalents	
Cash and Cash Equivalents as at (Opening Balance)	
Cash and Cash Equivalents as at (Closing Balance)	

Key Words

Working Capital: working capital is that part of capital used for the purposes of day-to-day operations of a business.

Fund: fund refers to the long term capital used for financing current assets.

It can be ascertained by finding the difference between current assets and current liabilities.

Flow of funds: flow refers to transactions which change the size of fund in an organisation. The flow transactions are divided into uses and sources.

While the former refers to those transactions which reduce the funds, the latter increases the size of fund.

Cash: cash refers to cash and bank balances.

Cash Flow: cash flow refers to the actual movement of cash in and out of an organisation.

UNIT - V**ACCOUNTING STANDARDS AND IFRS AND EMERGING ISSUES IN ACCOUNTING**

Accounting Standards and IFRS: Need for accounting standards - IFRS and proposed changes in Indian Accounting Standards. **Emerging issues in Accounting:** Corporate Governance and clause 49 of the listing agreement, Human Resource Accounting, Forensic Accounting, Window Dressing- Sustainability Reporting. **Fundamentals of Taxation:** Overview of Heads of Income, deductions u/s 80C, Income Tax Rates and Returns – For Individuals only (Only Theory)

Concept of Accounting Standards:

We know that Generally Accepted Accounting Principles (GAAP) aims at bringing uniformity and comparability in the financial statements. It can be seen that at many places, GAAP permits a variety of alternative accounting treatments for the same item. For example, different methods for valuation of stock give different results in financial statements.

Such practices sometimes can misguide intended users in taking decision relating to their field. Keeping in view the problems faced by many users of accounting, a need for the development of common accounting standards was aroused.

For this purpose, the Institute of Chartered Accountants of India (ICAI), which is also a member of International Accounting Standards Committee (IASC), had constituted Accounting Standard Board (ASB) in the year 1977. ASB identified the areas in which uniformity in accounting was required. After detailed research and discussions, it prepared and submitted a draft to the ICAI. After proper examination, ICAI finalized them and notified for its use in financial statements.

Meaning of Accounting Standards:

Accounting standards are the written statements consisting of rules and guidelines, issued by the accounting institutions, for the preparation of uniform and consistent financial statements and also for other disclosures affecting the different users of accounting information.

Accounting standards lay down the terms and conditions of accounting policies and practices by way of codes, guidelines and adjustments for making the interpretation of the items appearing in the financial statements easy and even their treatment in the books of account.

Nature of Accounting Standards:

On the basis of forgoing discussion we can say that accounting standards are guide, dictator, service provider and harmonizer in the field of accounting process.

(i) Serve as a guide to the accountants:

Accounting standards serve the accountants as a guide in the accounting process. They provide basis on which accounts are prepared. For example, they provide the method of valuation of inventories.

(ii) Act as a dictator:

Accounting standards act as a dictator in the field of accounting. Like a dictator, in some areas accountants have no choice of their own but to opt for practices other than those stated in the accounting standards. For example, Cash Flow Statement should be prepared in the format prescribed by accounting standard.

(iii) Serve as a service provider:

Accounting standards comprise the scope of accounting by defining certain terms, presenting the accounting issues, specifying standards, explaining numerous disclosures and implementation date. Thus, accounting standards are descriptive in nature and serve as a service provider.

(iv) Act as a harmonizer:

Accounting standards are not biased and bring uniformity in accounting methods. They remove the effect of diverse accounting practices and policies. On many occasions, accounting standards develop and provide solutions to specific accounting issues. It is thus clear that whenever there is any conflict on accounting issues, accounting standards act as harmonizer and facilitate solutions for accountants.

Objectives of Accounting Standards:

In earlier days, accounting was just used for recording business transactions of financial nature. Its main emphasis now lies on providing accounting information in the process of decision making.

For the following purposes, accounting standards are needed:

(i) For bringing uniformity in accounting methods:

Accounting standards are required to bring uniformity in accounting methods by proposing standard treatments to the accounting issue. For example, AS-6(Revised) states the methods for depreciation accounting.

(ii) For improving the reliability of the financial statements:

Accounting is a language of business. There are many users of the information provided by accountants who take various decisions relating to their field just on the basis of information contained in financial statements. In this connection, it is necessary that the financial statements should show true and fair view of the business concern. Accounting standards when used give a sense of faith and reliability to various users.

They also help the potential users of the information contained in the financial statements by disclosure norms which make it easy even for a layman to interpret the data. Accounting standards provide a concrete theory base to the process of accounting. They provide uniformity in accounting which makes the financial statements of different business units, for different years comparable and again facilitate decision making.

(iii) Simplify the accounting information:

Accounting standards prevent the users from reaching any misleading conclusions and make the financial data simpler for everyone. For example, AS-3 (Revised) clearly classifies the flows of cash in terms of 'operating activities', 'investing activities' and 'financing activities'.

(iv) Prevents frauds and manipulations:

Accounting standards prevent manipulation of data by the management and others. By codifying the accounting methods, frauds and manipulations can be minimized.

(v) Helps auditors:

Accounting standards lay down the terms and conditions for accounting policies and practices by way of codes, guidelines and adjustments for making and interpreting the items appearing in the financial statements. Thus, these terms, policies and guidelines etc. become the basis for auditing the books of accounts.

ACCOUNTING STANDARDS

- AS 1 Disclosure of Accounting Policies

- AS 2 Valuation of Inventories
- AS 3 Cash Flow Statements
- AS 4 Contingencies and Events Occurring After Balance Sheet Date
- AS 5 Net profit or Loss for the period, Prior Period Items and Changes in Accounting Policies
- AS 7 Construction Contracts
- AS 9 Revenue Recognition
- AS 10 Property, Plant and Equipment
- AS 11 The Effects of Changes in Foreign Exchange Rates
- AS 12 Government Grants
- AS 13 Accounting for Investments
- AS 14 Accounting for Amalgamations
- AS 15 Employee Benefits
- AS 16 Borrowing Costs
- AS 17 Segment Reporting
- AS 18 Related Party Disclosures
- AS 19 Leases
- AS 20 Earnings Per Share
- AS 21 Consolidated Financial Statements
- AS 22 Accounting for Taxes on Income
- AS 23 Accounting for Investments in Associates
- AS 24 Discontinuing Operations
- AS 25 Interim Financial Reporting
- AS 26 Intangible Assets
- AS 27 Financial Reporting of Interests in Joint Ventures
- AS 28 Impairment of Assets
- AS 29 Provisions, Contingent Liabilities and Contingent Assets

International Financial reporting Standards (IFRS)

- ∅ IFRS is a core set of accounting practices used across the globe
- ∅ It is a global framework and guidance for preparing the financial statements
- ∅ Global presentation of financial statements should conform to IFRS terminology
- ∅ Useful for companies having foreign subsidiaries
- ∅ It will stimulate flow of global capital and competition

HUMAN RESOURCE ACCOUNTING

Human resource accounting is recording and identification of human cost . It includes calculation and recording the cost of recruiting , selection , training and developments of employees .

DEFINITIONS

“Human Resource Accounting is the process of identifying and measuring data about human resources and communicating this information to interested parties.”

- American Accounting Society Committee on HRA

“Human Resource Accounting is an attempt to identify and report investments made in human resources of an organisation that are presently not accounted for in conventional accounting practice. Basically it is an information system that tells the management what changes over time are occurring to the human resource in the business.”

- Woodruff

“A term used to describe a variety of proposals that seek to report and emphasize the importance of human resources – knowledgeable, trained and loyal employees in a company earning process and total assets.”

- Davidson and Roman L Weel

“Human resource accounting is the measurement of the cost and value of the people for the organisation.”

- Eric Flamholtz of university of California, Los Angeles

Explanation of human resource accounting :-

Under HRA , organization deals with employees as assets and shows in balance sheet .

Method of calculating the value of human assets

There are many method for maintaining accounting under this system and also calculate human resource value with following ways .:-

I) Historical cost method

Under this method , we calculate the value of human assets on the basis of historical transaction with employees on the basis of wages and salaries . His value is directly charges on the total cost of finished product and all managerial staff salaries are shown in profit and loss account only. There is no extra account is made under this method .

2. Present value method of future earning

Under this method , we can calculate the value of employee with following formula

Value of employee =

Employee's annual earning up to retirement / (retirement age + discount) power(t+r)

= \$ 1000000 / (60+10) power 60 age+10rate

3. Cost benefit method

Under this method we can calculate total estimated benefit which is given by employee to organization and then we calculate the total value of benefits which is give by co. to employee and its difference is surplus which is real value of human resource asset .

4. Way of showing HR in balance sheet under total cost method

Balance sheet

Liability side

HR capital \$ 4000000

Assets side

HR asset \$ 4000000

☀ **Benefits of HRA**

There are many benefits of HRA accounting which can be explain in following way.

1. HRA provides the information of total cost of human assets which can use for calculating their benefits for business by comparing it with the benefits provided by employees.
2. HRA is top work in the field of accounting because in accounting , we includes all physical assets and intangible assets but before making of HRA accounting we are ignoring a very important asset and its name is human being who works in any company or industry.
3. Human resource accounting is very important where human element is more important than any other factor of production or services. For instance education sector is top sector who human resource accounting must be used for maintaining the accounts of education department .

Demerits of Human resource accounting

1. Calculation the value of human resources is not so easy because it is most difficult to calculate the value of the quality of any person. What worth will be of honesty, morality, benevolence and generosity? But these moral values are so important for developing any company from bottom point.
2. Jealousy to see the high value of other employee can decrease the efficiency of any employee because he can think why my price is sow low and other employee's price is so high.
3. From human resource accounting, we can not get short period benefits like general historical accounting system.
4. Indian company law 1956 , Indian Income tax law 1961 and other legal laws are no rule for showing human resource assets in the balance sheet .

Something new about human resource accounting

- In 1891 , first William patty calculate the value of human resource in the form of money

- Lev and Schwartz (1971) is the first person who discover above formula of value of employee.
- Most popular book of human resource accounting is Human Resource Accounting: Past, Present and Future which is written by Caplan, Edwin H. and Landekich, Stephen

INDIA

As far as the statutory requirements go, the Companies Act, 1956 does not demand furnishing of HRA related information in the financial statements of the companies. The Institute of Chartered Accountants of India too, has not been able to bring any definitive standard or measurement in the reporting of human resources costs. While qualitative pronouncements regarding the importance of Human Resources is often made by the chairmen, in the AGM, quantitative information about their contribution is rarely recorded or communicated. There are a few organizations, however, that do recognize the value of their human resources, and furnish the related information in their annual reports. In India, some of these companies are : Infosys, Bharat Heavy Electricals Ltd (BHEL); the Steel Authority of India Ltd. (SAIL), the Minerals and Metals Trading Corporation of India Ltd. (MMTC), the Southern Petrochemicals Industries Corporation of India (SPIC), the Associated Cement Companies Ltd, Madras Refineries Ltd. , the Hindustan Zinc Ltd. , Engineers India Ltd, the Oil and Natural Gas Commission, Oil India Ltd., the Cement Corporation of India Ltd. etc.

Clause 49 to listing agreement - Corporate governance

Corporate governance There are certain requirements mentioned in Clause 49 of listing agreement which a listed company needs to follow. To have a quick review of those important requirement, summary is given below.

1. Rights of shareholders and role of stakeholders: Company should seek to protect the rights of shareholders and should facilitate them so that they can exercise their rights. Shareholders should be part of any decision of fundamental change and should have right of voting in general meetings. They should be allowed to effectively participate in key corporate governance decisions, to questions to board, put up agenda items on general meeting, made clear on voting procedure, and their grievances (including violation of their rights) should be addressed including protection to Minority shareholders. Voting process should be easy and not a costly affair. Company should give timely and sufficient information to shareholders about general meetings like time, place and agenda. Company should inform rights which each class of shareholders possesses before they invest including if any class of holders has disproportionate rights. Company should give equitable treatment to all shareholders including monitory and foreign shareholders who are under same series. Mechanism to avoid insider trading should be in place. There should be mechanism for employee participation and timely sharing of information so that participation in corporate governance can be made. Whistleblower policy should be in place.

2. Disclosure and transparency: Company should disclose material matters timely including BS, P&L, and ownership and governance issues. Company should follow applicable Accounting standards in true spirit and statutory audit should be conducted by competence and independent qualified person. Sharing of information should be timely and should be accessible to all users in cost effective manner. Minutes of meetings should be maintained recording dissenting opinions.

3. Responsibility of Board: i. All members of board including KMPs to disclose any material interest in ant transaction/matter in any manner whether directly or indirectly. ii. Board and management should maintain confidentiality and transparency of information.

4. Function of the board: Review of corporate strategies, giving strategic guidance, major plans of action, risk policy, annual budgets and business plans, setting performance parameters, maintaining transparent board nomination process, monitoring potential conflict with different stakeholders, monitoring effectiveness of governance practices, integrity of financials reporting process and internal controls, management, compliances with law, communication with stakeholders, hiring and compensating including succession plan of key executives, overseeing of major capex, acquisition, divestments, work in good faith in a responsible manner, overview process of disclosure and communication, monitoring board evaluation process, training to directors, set a corporate culture and should work in best interest of the company with high ethical standards, and should have independent judgment. Allow independent directors and committee to function properly and also intimate them their role as board members and committee member. Composition of Board: 1. At least one woman director 2. Minimum 50% of the board should be independent if chairman of the board is executive director. If chairman is non executive Director (NED) than 1/3 of the board should be independent. If chairman is non executive but is a promoter or related to promoter or to any person one level below board, than 1/2 of the board should be independent.

5. Independent directors: He is a person who:

- Is a person of 21 years or more
- who possesses integrity and relevant expertise in board's view
- is neither executive director nor a nominee director
- is not related to any of promoter/director of company (including of holding, subsidiary(subs), and associate).
- Who is not and was not a promoter of the company (including of holding, subs and associate) at any point of time.
- Apart from receiving sitting fee/directors remuneration, he does not have or had any time any material pecuniary relationship with company, holding, subs or associate or their promoter/directors in current year and previous two years.
- Same requirement applies for his relative also if they have such transactions with the company amounting to 2% or more of gross turnover or income or Rs. 50 lacs whichever is lower.
- Along with his relatives does not hold 2% or more of voting power or his relative does not have or have been in following positions in any of the preceding 3 financial years immediately preceding the financial year in which he is proposed to be appointed..
- employee or KMP of company (co.), holding, subs or associate
- employee, partner, proprietor of a CA, cost audit, co secretary firm, of co. holding, subs or associate or
- Employee, partner, proprietor of a

legal or consulting firm who has transaction of 10% or more of the firm with co. holding, subs or associate. • Is or his relative is not a material supplier, customer, service provider, lessor or lessee of the company • Is or his relative is not a director of CEO of Non profit organization which receive 25% or more of receipts from company or its relatives. • A person shall not serve as an Independent director of more than 7 listed entities (3 listed entities if he is whole time director (WTD) in any listed entity). • Formal letter of appointment should be issued and terms and conditions of appointment should be posted on website of the company. • Nomination committee should lay down evaluation criteria of Independent Directors (IDs) and also mention in AR. Evaluation is done by board excluding ID being evaluated. Evaluation becomes basis whether to extend the term or not. • There has to be at least one meeting in a year of ONLY IDs. IDs should review performance of board, chairperson and Non independent Directors (NIDs), and should also assess whether flow of information was adequate with ref to time, quality and quantity between management and board. • Company should make familiarization programme for IDs so that they can have idea of business model of company, nature and risk appetite. Also disclose on website and link in AR.

6. Non-executive Directors' compensation and disclosures: Any fees, compensation should be approved by board and have prior approval of shareholders. Sitting fee to NED does not required prior approval if it is within limits of co act. IDs does not entitle for stock options.

7. Other provision of committee and code of conduct i. Board shall meet at least 4 times in a year with maximum gap between two meetings of 120days. Minimum information to be made available to board is in Annex X to the listing agreement. ii. A director shall not be a member of more than 10 committees and at the same time he can not act as chairman in more than 5 committees. He needs to update to board regularly about his membership in different committees or boards. iii. Board should review compliance report prepared by company including action taken on non compliance if any. iv. If an ID resigns or is removed by board and his position is not fulfilled before , than his position should be filled immediately within 3 months or next board meeting which ever is earlier. v. A succession plan of Board and senior management should be in place. vi. There has to be a written code of conduct for Board and senior management which should be posted on website. AR should have declaration of CEO of compliance of code of

conduct by all concerned. Code of conduct should specify duties of IDs. vii. IDs should be made responsible for acts or omission of companies which were in his knowledge. viii. Company should have whistle blower policy and also safeguard to persons who avail such mechanism. Such policy should be on website as well as AR.

8. Audit committee (AC): i. Composition, quorum and meetings ii. There has to be a qualified and independent AC with terms of reference (TOR). iii. AC should have minimum 3 directors with 2/3 of them independent. Chairman should be ID and should present at AGM. iv. Directors should be financially literate at least one of them should have Accounting or financial management expertise. v. AC may invite finance head or other executives including internal and statutory auditors to present in meeting. Company secretary to act as secretary to meeting. vi. AC should meet at least 4 times in a year with maximum gap of 4 months. Quorum is 2 independent directors with minimum 1/3 of AC. vii. AC can investigate any matter within its TOR and can seek information from any employee and can take legal or professional advice from outsider as and when required.

9. Role of AC i. Oversight of financial reporting process and ensure disclosure of financial information which is reliable and credible. ii. Recommending appointment, remuneration, terms of appointment and approval of payment for any other service of statutory auditors. Appointment of CFO or finance head. iii. Review with management of annual along with audit report before submission to board with particular reference to - Matters to be included in board report (Directors responsibility statement) - Change in accounting policy, qualification of auditors and explanation thereto, significant estimate judgment by management, significant audit findings and resulting adjustment in books , RPT disclosure , compliance requirement related to financial statements - Review of any substantial defaults in payment of debt/deposits including creditors and dividend. - Review of effectiveness of whistleblower mechanism, - Review with management uses /application of fund raised from IPO and deviation if any. - Review with management of performance, independence (statutory auditors) and effectiveness of internal and statutory auditors and review of internal audit function, evaluation of internal financial control and risks management system. - Discuss with statutory and internal auditors before audit for nature and scope and post audit on their findings and concerns including suspected frauds and

inform to board. - Scrutiny of inter corporate loan and investments, valuation of assets or business AC must review following: Management Discussion Analysis, financial status and performance, significant RPT,MRL, letter of internal control weakness issued by statutory auditors, Internal audit report and appointment/ terms appointment/removal of internal auditors , quarterly financials before they are submitted to board.

10. Nomination and Remuneration Committee i. Board should appoint such committee of non executive directors (NEDs) which should have minimum 3 directors with 1/3 of them independent. Chairman of committee should be ID. Chairman of the company may be appointed as member of committee but can not chair the meeting. ii. Role of the committee is to formulation of criteria for evaluation of performance of Board and IDs, qualification, independence and attribute of a director and recommend to board a policy for remuneration of Directors, KMP and employees. iii. Identifying a person who can be appointed in senior management or as Director. Recommending to board their appointment and removal and evaluation criteria in AR.

11. Subsidiary company i. At least one ID of holding company should be on the board of Material non listed Indian subsidiary co. ii. AC should review Financial statements of subs specially investments made by unlisted subs iii. Minutes of the board meeting of unlisted subs should be placed in board meeting of holding company and all significant transaction entered by such subs should be brought to notice of board of holding co. iv. Should formulate policy of identifying material subs and such policy should be on company website with link in AR. v. A subs is material, if investment in subs is more than 20% of consol Networth or if subs has generated 20% or more of consol income as per latest audited consol financial statements. vi. An company can not loose control over a material subs by way of divestment without shareholder approval except where divestment is court approved. vii. If a material subs sells, leases or disposes assets of more than 20% of its assets, than it requires special resolution of holding company's shareholders unless done under court approval.

12. Risk management: 1. Company should frame procedure to inform board about risk assessment and minimization procedure and board should frame risk management plan. 2. Company should make risk management committee and board should define role and

responsibilities of committee which should have majority of members from board specially chairperson of committee.

13. Related party transactions (RPT): i. Related party as defined in companies act 2(76) or under Accounting standards. ii. Company should have policy on materiality of RPT and dealing with them. iii. A transaction is considered material if a transaction to be entered together with previous similar transaction if any entered during the year exceeds 10% of total Turnover of the company as per consol audited financials of previous year. iv. All RPT required prior approval of AC however AC may grant omnibus approval also subject to following: v. AC should set criteria of such omnibus approval and that can be for only transactions of repetitive in nature. Such omnibus approval's need and interest of company should be established. vi. Such omnibus approval should specify: name of related party, nature of transactions, time period, max amount, indicative price, current price and other information. If such need can not be foreseen and such details are not available than omnibus approval can be for Max Rs 1 cr per transaction. vii. AC should review every quarter transactions entered against such omnibus approval and such approval can be valid for max one year from the date of approval. viii. Companies act states that all RPT which are (i) between Company and its WOS or (ii) transactions which are in ordinary course of business which are at arms length, such transactions does not require board approval. ix. The transactions which are not with WOS, which are not at arms length or which are not in ordinary course of business, those transactions require prior approval of board. If value of transactions excess certain limit than additionally approval of shareholders is also required.

14. Other disclosures i. All RPT should be disclosed in compliance report on corporate governance. ii. Policy of RPT should be disclosed on website and link in AR. iii. If company has not followed accounting standard than management should give explanations. iv. All pecuniary transactions with NED should be disclosed in AR. Complete details of remuneration paid to all directors including fixed and variable component should be disclosed. v. It should disclose criteria for remuneration to NEDs, no of shares and convertible instrument held by them. NEDs are also required to disclose their holding before appointment. vi. Management discussion analysis (MDA) should be part of AR. MDA contains details about past performance, out look, industry, SWOT analysis, adequacy of internal control system and other developments. vii.

Senior management should disclose to board their conflict or potential conflict to material financial and commercial transactions. viii. Code of conduct of BOD and senior management should be disclosed on website.

15. Shareholders: i. When a director is appointed or re appointed shareholder should be provided with his resume, places where he is director or in committees, and shareholding of NEDs. Disclosure of relationship with other directors. ii. Qly results and presentations sent to analyst should be on website and also with stock exchanges where it is listed. iii. Stakeholders' relationship committee should be formed with chairman as NED. Process of share transfer should be smooth. iv. When money is raised through IPO a quarterly report of uses and application of such funds should be presented to AC. Company should also disclose if any money is used in other than specified purpose for which it was raised till all money is utilized.

16. CEO/CFO certification: i. CEO/MD/Manager or WTD and CFO should certify to board that they have reviewed financials statements and they represent true and fair view and not misleading. ii. No fraud, illegal transactions. They have evaluated effectiveness of internal control systems. iii. They have informed to AC and auditors about significant changes in accounting polices, frauds and where employees are involved,.

17. Report on corporate governance: There has to be separate section in AR on Corporate governance and its compliances. Company should submit to respective stock exchanges compliance report on corporate governance within 15 days from close of the quarter. Company should obtain certificate from auditors or from practicing company secretary about compliance of corporate governance and this certificate should also be attached with Directors report. Non mandatory requirements which are given in Annexure VIII of clause 49 may be implemented by company.

Inflation Accounting

Inflation

Since we started understanding things around us, we all used to listen from our Grandparents about the things and articles especially Gold & Ghee being cheaper in their times.

That time we used to think that why the things were cheaper in our Grandparents' time and why had they started becoming costlier. So this question would keep us puzzled.

But now as we have grown in our knowledge and understanding, we have come to know about the phenomenon of Inflation which in layman's language is known as the state of rising pricing or the falling value of money was the greatest reason behind this.

Now emerges the question that what exactly is the Inflation?

Inflation is a global phenomenon in present day times. There is hardly any country in the capitalist world today which is not afflicted by the spectre of inflation.

Different economists have defined inflation in different words like Prof. Crowther has defined inflation "as a state in which the value of money is falling, i.e., prices are rising." In the words of Prof. Paul Einzig, "Inflation is that state of disequilibrium in which an expansion of purchasing power tends to cause or is the effect of an increase of the price level." Both the definition have emphasized on the rising prices of the goods.

The basic factors behind the inflation are either the rising demand or the shortening of supply due to any reason.

Effect of Inflation on Business

The impact of inflation on business can be bifurcated into two parts like

1. Impact on costs and revenue
2. Impact on assets and liabilities

As far as impact of inflation on costs and revenues is concerned, definitely both will rise but whether they result into extraordinary profits will be determined by that how much opening stock was available at old prices with the company and how much later the demand for increasing wages is entertained by the company.

In case of monetary assets and liabilities, a company will lose in case of being creditor and gain in case of being debtor in real terms.

If we talk about other assets like building, land and other securities, the company will be having holding gains in monetary terms but may have neutral impact in real terms due to the rise in prices on the one hand but fall in value of money on the other.

Inflation Accounting and its significance

The impact of inflation comes in the form of rising prices of output and assets. As the financial accounts are kept on Historical cost basis, so they don't take into consideration the impact of rise in the prices of assets and output. This may sometimes result into the overstated profits, under priced assets and misleading picture of Business etc.

So, the financial statements prepared under historical accounting are generally proved to be statements of historical facts and do not reflect the current worth of business. This deprives the users of accounts like management, shareholders, and creditors etc. to have a right picture of business to make appropriate decisions.

Hence, this leads towards the need for Inflation Accounting. **Inflation accounting** is a term describing a range of accounting systems designed to correct problems arising from historical cost accounting in the presence of inflation.

The significance of inflation accounting emerges from the inherent limitations of the historical cost accounting system. Following are the limitations of historical accounting:

1. Historical accounts do not consider the unrealised holding gains arising from the rise in the monetary value of the assets due to inflation.
2. The objective of charging depreciation is to spread the cost of the asset over its useful life and make reserve for its replacement in the future. But it does not take into account the impact of inflation over the replacement cost which may result into the inadequate charge of depreciation.
3. Under historical accounting, inventories acquired at old prices are matched against revenues expressed at current prices. In the period of inflation, this may lead to the overstatement of profits due mixing up of holding gains and operating gains.
4. Future earnings are not easily projected from historical earnings.

History of Inflation Accounting

In the last few years, inflation accounting has been adopted as a supplementary financial statement in the United States and the United Kingdom. This comes after more than 50 years of debate about methods of adjusting financial accounts for inflation.

Accountants in the United Kingdom and the United States have discussed the effect of inflation on financial statements since the early 1900s, beginning with index number theory and purchasing power. Irving Fisher's 1911 book *The Purchasing Power of Money* was used as a source by Henry W. Sweeney in his 1936 book *Stabilized Accounting*, which was about Constant Purchasing Power Accounting. This model by Sweeney was used by The American Institute of Certified Public Accountants for their 1963 research study (ARS6) *Reporting the Financial Effects of Price-Level Changes*, and later used by the Accounting Principles Board (USA), the Financial Standards Board (USA), and the Accounting Standards Steering Committee (UK). Sweeney advocated using a price index that covers everything in the gross national

product. In March 1979, the Financial Accounting Standards Board (FASB) wrote Constant Dollar Accounting, which advocated using the Consumer Price Index for All Urban Consumers (CPI-U) to adjust accounts because it is calculated every month.

During the Great Depression, some corporations restated their financial statements to reflect inflation. At times during the past 50 years standard-setting organizations have encouraged companies to supplement cost-based financial statements with price-level adjusted statements. During a period of high inflation in the 1970s, the FASB was reviewing a draft proposal for price-level adjusted statements when the Securities and Exchange Commission (SEC) issued ASR 190, which required approximately 1,000 of the largest US corporations to provide supplemental information based on replacement cost. The FASB withdrew the draft proposal.

Still to cater to the needs of an Inflation Accounting, the IASB came out with an Accounting Standard known as IAS 29.

Techniques of Inflation Accounting

To measure the impact of inflation on financial statements, following are the techniques used:

Current Purchasing Power (CPP) Method

Under this method of adjusting accounts to price changes, all items in the financial statements are restated in terms of a constant unit of money i.e. in terms of general purchasing power. For measuring changes in the price level and incorporating the changes in the financial statements we use General Price Index, which may be considered to be a barometer meant for the purpose. The index is used to convert the values of various items in the Balance Sheet and Profit and Loss Account. This method takes into account the changes in the general purchasing power of money and ignores the actual rise or fall in the price of the given item. CPP method involves the refurbishing of historical figures at current purchasing power. For this purpose, historical figures are converted into value of purchasing power at the end of the period. Two index numbers are required: one showing the general price level at the end of the period and the other reflecting the same at the date of the transaction.

Profit under this method is an increase in the value of the net asset over a period, all valuations being made in terms of current purchasing power.

Current Cost Accounting (CCA) Method

The Current Cost Accounting is an alternative to the Current Purchasing Power Method. The CCA method matches current revenues with the current cost of the resources which are consumed in earning them.

Changes in the general price level are measured by Index Numbers. Specific price change occurs if price of a particular asset changes without any general price change. Under this method, asset are valued at current cost which is the cost at which asset can be replaced as on a date.

While the Current Purchasing Power (CPP) method is known as the General Price Level approach, the Current Cost Accounting (CCA) method is known as Specific Price Level approach or Replacement Cost Accounting.

Limitations of Inflation Accounting

Though Inflation Accounting is more practical approach for the true reflection of financial status of the company, there are certain limitations which are not allowing this to be a popular system of accounting. Following are the limitations:

1. Change in the price level is a continuous process.
2. This system makes the calculations a tedious task because of too many conversions and calculations.
3. This system has not been given preference by tax authorities.

Conclusion

Every person on this earth has been affected by Inflation, some positively but most of the people negatively because the Inflation leads to the erosion of general purchasing power. The Inflation spares none and it equally influences the Businesses like the people.

Historical cost accounting does not take into account the changes in the rise in the value of assets and its impact on Balance Sheet and P&L Account due to inflation and does not reflect the real worth of the business which is very required for effective decision making.

Inflation Accounting has removed this drawback by providing methods for adjusting the figure according to General or Specific Price levels.

Despite a right method of presenting financial statements, Inflation Accounting is still not widely prevalent due to certain limitations. But with more research and development of accounting software in this field, there is no doubt that Inflation adjusted accounting is the future of Financial Accounting.

Window dressing

Window dressing is actions taken to improve the appearance of a company's financial statements. Window dressing is particularly common when a business has a large number of shareholders, so that management can give the appearance of a well-run company to investors who probably do not have much day-to-day contact with the business. It may also be used when a company wants to impress a lender in order to qualify for a loan. If a business is closely held, the owners are usually better informed about company results, so there is no reason for anyone to apply window dressing to the financial statements.

Examples of window dressing are:

- **Cash.** Postpone paying suppliers, so that the period-end cash balance appears higher than it should be.
- **Accounts receivable.** Record an unusually low bad debt expense, so that the accounts receivable (and therefore the current ratio) figure looks better than is really the case.
- **Fixed assets.** Sell off those fixed assets with large amounts of accumulated depreciation associated with them, so the net book value of the remaining assets appears to indicate a relatively new cluster of assets.
- **Revenue.** Offer customers an early shipment discount, thereby accelerating revenues from a future period into the current period.
- **Depreciation.** Switch from accelerated depreciation to straight-line depreciation in order to reduce the amount of depreciation charged to expense in the current period. The mid-month convention can also be used to further delay expense recognition.
- **Expenses.** Withhold supplier invoices, so that they are recorded in a later period.

These actions are taken shortly before the end of an accounting period.

The window dressing concept is also used by fund managers, who replace poorly-performing securities with higher-performing ones just before the end of a reporting period, to give the appearance of having a robust set of investments.

The entire concept of window dressing is clearly unethical, since it is misleading. Also, it merely robs results from a future period in order to make the current period look better, so it is extremely short-term in nature.

Window dressing is a set of actions or manipulations with financial or other information in financial documents (financial statements, reports, etc.) to make this information look more attractive to its users. Even though window dressing can occur at any time, it is commonly used at the end of a period.

Window dressing can be used by companies and mutual funds.

A company can use window dressing when preparing financial statements to improve the appearance of its performance or liquidity. In this case, window dressing may consist of changing asset depreciation or valuation policies, making short-term borrowings, or engaging in sales and leaseback transactions at the end of a period. By doing so, management embellishes the company's results or liquidity and obtains some benefits.

Other examples of window dressing by companies may include advertising, selling, and marketing. In these cases, window dressing occurs when positive characteristics of products or services are a little exaggerated to increase demand for them while negative characteristics are not mentioned or kept hidden.

Mutual funds use window dressing when preparing periodic (quarterly, yearly) reports. Window dressing by mutual funds consists of selling underperforming stocks and buying well-performing stocks near the reporting period end. This practice makes a fund portfolio look more profitable and thus more attractive to its (prospective) clients.

Reasons and beneficiaries of window dressing

In most cases, beneficiaries of window dressing are those who use this practice, i.e., companies and mutual fund managers. In many cases, managers' remuneration (i.e., salaries and bonuses) depend on how well their companies or mutual funds performed; so there is a direct interest in making financial results or liquidity look better than they really are.

Refer to the table below to see specific reasons for window dressing:

Illustration 1: Reasons for window dressing

Beneficiary	Reason	Window dressing Action	Who is misled
Company	To obtain funding (to borrow money)	Increase profits and liquidity ratios	Borrowers (banks, other financial institutions)
	To reduce tax payments	Decrease profits by increasing expenses	Government
	To smooth financial data (sales, expenses, accounts receivable, etc.)	Record sales or purchases in an inappropriate period; give large discounts to debtors for payments received before period end	Owners
	To hide some problems (liquidity, profitability, poor management decisions)	Increase cash account balance at the period end; increase useful life of fixed assets	Owners
Mutual Fund	To improve fund portfolio structure	Buy more well-performing stocks and selling nonperforming ones	Investors
	To increase portfolio value	Buy additional well-performing stocks at a higher price	Investors

Is window dressing legal?

Generally, window dressing is considered to be an unethical practice because it involves deception and advancement of management's interests instead of interests of information users (i.e., owners, investors, government).

From the legal point of view window dressing isn't illegal, but in some cases it can be so. Window dressing can be an illegal or fraudulent action if it contradicts the law or accounting standards. Some well-known examples of illegal window dressing practices relate to Enron, Peregrine Systems, WorldCom, and Xerox.

Company's window dressing example

Let us look at an example of window dressing used by a company's management. Assume the company has its accounting year ending on Dec. 31, 2017.

At Dec. 27, 2017, the balance in the cash account is \$2,000. Before the end of the year the company must pay \$3,000 for the services it received during the year. Paying this obligation will negatively impact the company's liquidity, so it decides to do some window dressing. The company postpones the payment of \$3,000 till Jan. 4, 2018, by negotiating the payment terms with the vendor. The company also decides to sell a fixed asset for \$4,000 cash. Refer to the extract of the balance sheet below to see how these two actions of window dressing impacted the company's financial position:

ABC Company		
Extract of Balance Sheet as of Dec. 31, 2017		
	WITHOUT	AFTER
	Applying window dressing	Applying window dressing
Assets		
Current assets:		
Cash and cash equivalents	(1,000)	6,000
Accounts receivable	5,000	5,000
Inventories	9,000	9,000
Total current assets	13,000	20,000

Note that the cash and cash equivalents changed from a negative balance of \$1,000 (which would need to be presented in the liabilities section of the balance sheet) to a positive balance of \$6,000.

Mutual fund's window dressing example

Now let us look at an example of window dressing used by a mutual fund. Assume the mutual fund is preparing its quarterly report with a list of holdings as of June 30, 20X0. On June 27,

20X0, the fund's portfolio contains an investment in Company ABC, whose performance has been decreasing. The fund's portfolio also includes investments in Company XYX1, Company XYX2, and Company XYX3, whose stock prices have increased by 20%, 5% and 8%, respectively, during the quarter.

The fund managers decide to use window dressing to reduce the impact of falling stock prices of Company ABC. For this purpose the fund managers sell their holding in Company ABC and buy additional stocks of Company XYZ1 on June 28, 20X0. After these transactions, the fund's portfolio does not include nonperforming stocks of Company ABC and includes more stocks of well-performing Company XYZ1. This makes the portfolio structure and performance more appealing in the eyes of fund clients.

How to spot window dressing

The ability to compare and attentiveness to detail can help recognize window dressing in a company or mutual fund's reporting.

When analyzing overall management performance, business owners and shareholders should review all financial statements (i.e., balance sheet, income statement, statement of cash flows, and statement of changes in equity) and any additional available information to determine whether:

- A positive cash balance is a result of short-term borrowing or non-operating activities (refer to the statement of cash flows to see which activities generated cash)
- There is an abnormal increase or decrease in any balances
- The company's policies were changed during the period
- Strong sales are accompanied by increases in accounts payable

When choosing a mutual fund, an investor should compare the year-end reports with the quarterly reports side by side to determine whether:

- The portfolio consists of only the most popular investments without any nonperforming investment
- There are abnormal period-end selling or purchase transactions
- The portfolio is diversified
- The portfolio structure and investment style are supported

WAYS OF WINDOW DRESSING:

(i) Creation of Secret Reserves:

The building up of secret reserve is an important and the most popular way in the hands of accountants the financial statements are prepared and presented in such a way that they are not able to bring them to an open eye. Creation of secret reserves is fashionable and many a time is applauded.

Secret reserve is also known as unpublished reserve. This unpublished reserve can be created as under:

1. Under statement of assets can be done by charging more than reasonable or allowable depreciation.
2. Creation of more provisions for bad debts or discounts on debtors than expected bad debts or discount on debtors.
3. Over statement of liabilities along with understatement of owner claim.
4. Treatment of contingent liabilities as actual liabilities on the liability side of balance sheet.

(ii) Under and Over Valuation of Inventories:

Inventories are the most important part of current assets of an organisation. Valuation of inventories do effect the estimation of working capital of an organisation. Accountants now a day's do the valuation of their inventories as desired by top officials.

Undervaluation of inventory in hand at the end of the accounting period means lowering down the profits and vice a versa. Sometimes obsolete stocks are shown at some values which actually they do not have, so as to improve current ratio of the concern.

1. Under valuation of opening inventories will show rise in profits.
2. Over valuation of opening inventories will lower down the profits.

Under valuation of closing inventories will lower down the profits.

4. Over valuation of closing inventories will show rise in profits.
5. Inclusion of dead or worthless stock will improve current ratio of the concern.

(iii) Methods of Depreciation:

It is in practice to show fixed assets at their acquisition costs irrespective of their market values. Application of the method of depreciation is again in the hands of an accountant. Choice of an appropriate method of depreciation may help the accountant in creative accounting or window dressing.

Shifting of one method to another by creating a need is another device in the hands of an accountant. In a way, financial statement particularly balance sheet presents an artificial view as created by an accountant.

(iv) Creation of Provisions:

The convention of conservatism provides a safeguard against the overstatement of profits. This convention says those never anticipate profits but create provision for losses. The purpose of this doctrine is to ensure that an accountant adopts a cautious approach while preparing income statement.

Now a days accountants use this convention as a way to create income statement on the whims of the owners. By creating excess provisions accountants can lower down profits to reduce tax burden and to lower down the rate of dividends and vice-versa.

(v) Abuses of accounting Concepts and Conventions:

Accounting being a language of a business has evolved certain basic principles, conventions and concepts for practising the accountancy. These concepts, and conventions have been developed with the passage of time to help accountants to understand and apply them while preparing and constructing their financial statements.

These conventions are being abused by some of the accountants for creative accounting for instance.

Convention of conservatism is being misused by the accountants for creating secret reserves by the help of following ways:

- (i) Excessive provision of bad debts, discounts on debtors
- (ii) By charging excess depreciation on fixed assets
- (iii) By amortizing excess on intangible assets
- (iv) Artificial fall in value of shares caused by suppressed profits

(vi) Unrealistic Assumptions:

Financial statements are prepared or constructed by accountants on basic unrealistic assumption like stable monetary unit who can imagine the validity of stable monetary unit in the periods of violently changing prices. No doubt this assumption is much far from reality.

Creative accountants enjoy such basic unrealistic assumptions for manipulation of accounts. Gradual erosion in the purchasing power of monetary units such as rupee or dollar do effect the preparation of accounts. How these accounts expressed in monetary unit which is losing its power can reflect a true and fair view of the affairs of an organisation?

(vii) Off balance sheet financing:

When debt financing is not shown on the face of balance sheet that is called off balance sheet financing. This method of Window Dressing is used to mislead the investors. Generally investors use to calculate gearing ratios to assess financial position of a corporate unit.

(viii) Creating Special Purpose Vehicle:

Sometimes a special purpose vehicle is created for a particular financial transaction. That is also by creating special purpose entity.

Means to Check Window Dressing:

1. Verification and Valuation of Assets:

Verification of assets would help to guard against improper increase of values or creation of those assets which actually do not exist. This is primary and important responsibility of management accountants. The modern function of management accountant is not only to verify but to protect the assets also verification further includes valuation of assets.

Generally valuation of assets will involve following points for consideration:

- (i) Acquisition cost of asset
- (ii) Life of the asset
- (iii) Depreciation and method of depreciation to be applied
- (iv) Scrap value at the end of the life of asset
- (v) Provisions for contingencies
- (vi) Basis of Valuation

Management accountant has to keep in mind which basis of the valuation is being followed since asset can be valued at realizable values or replacement cost. He should ensure that the method of valuation conforms to the principles on which assets are being valued.

In examining the intangible assets like goodwill patents, brands etc. some points he has to keep in mind that what was the basis for valuation at the time of their origin, adequacy of the amortization procedure, consistency followed in recording such assets. Nowadays intangible assets like brands are gaining importance and are subject to correct or realistic valuation. Management accountants are to ensure their accurate valuation as some of them may be un-saleable.

2. Verification and Valuation of Inventories:

Verification and valuation of inventories is another mean available to check window dressing. Inclusion of obsolete stock or dead stock may cheat the user of the financial statements. Valuation of stocks may be done on the FIFO system or LIFO system, market price or average price. Choice of the method may lead to understatement or overstatement of stocks. However a General principle of market price or cost price whichever is lower followed by accountants. But valuation of stock is another tool in the hands of creative accountants to put glamour to the balance sheet.

3. Verification of provisions:

Generally provisions are created to meet losses or to meet a specific contingency for instance provision for bad debts, discount on debtors, etc. An excessive provision for bad and doubtful debts will lower the income shown in profit and loss account. A trend can be framed so as to put a check on this malpractice. More over creation of provisions is subjective in nature. More conservative accountant will create more provision and vice versa.

4. Verification of Capital and Revenue Items:

A distinction between capital and revenue item is very important from the point of view of calculating the correct profit or loss of a business concern. Window dressing can be done by shifting any capital expenditure from balance sheet to income statement so as to lowering down the profits and vice & versa.

A check is also required to determine whether revenue item is deferred revenue or not. Deferred revenue expenditure is basically a revenue item but the benefit of which will extend beyond the period in which it is incurred.

Reasons for need of window dressing:

1. Window Dressing is done for enhancing liquidity position of the corporate unit.
2. Window Dressing is done for showcase stable profitability of the company.
3. Window Dressing is done for reducing tax liability of the corporate unit.
4. Window Dressing is done to attract more investors.
5. Window Dressing is done to reassure money lenders.
6. Window Dressing sometime is done to ward off take-over bids.
7. Window Dressing is also done to influence market prices of shares of the company.
8. Window Dressing is needed sometimes for hiding poor managerial decisions.

9. Window Dressing is done to satisfy major investors because they feel concerned with desired rate of return.

10. Window Dressing is done for achieving sales and profit targets.

Window Dressing of Income Statement: A creative accountant can prepare an attractive income statement of an inefficient business firm in such a way that lapse on the part of management can be concealed.

Following are the ways of window dressing in Income Statement:

1. Under and over valuation of inventories.
2. Excess/less creation of provision of Bad debts and Discount on Debtors.
3. Excess/Less Depreciation on Fixed assets.
4. Excess/less amortization of fictitious assets.
5. Creation of General Reserve.
6. Showing capital expenditure as a revenue expenditure in income statement.

Window Dressing of Balance Sheet: Balance sheet being a static statement shows financial position and condition of an organisation on a particular date. This statement does not depict the position of the whole accounting period.

Clever accountant can create a balance sheet on the whims of owner in following ways:

1. Under or over valuation of closing stock.
2. Inclusion of obsolete or dead stock.
3. Excess slow moving debtors by adopting liberal credit policies.
4. Showing long term items as short term so as to improve liquidity ratios.
5. Window dressing of portfolios maintained by the firms.
6. Utilization of reserves for issuing bonus shares.

Concept of Inflation Accounting:

Inflation normally refers to the increasing trend in general price levels. In economic sense it refers to a state in which the purchasing power of money goes down or conversely there is more

money in circulation than is justified by goods and services. Inflation has come to stay as a standing feature in the economy of almost all countries of the world.

The general weakness of the traditional accounting system is that it fails to reflect the price level changes in the financial statements as it is based on historical cost. The American Institute of Certified Public Accountants defines the Inflation accounting as a system of accounting, which purports to record as a built-in mechanism, all economic events in terms of current cost.

It is a system of accounting like traditional accounting. It is a method designed to show the effect of changing costs and prices on affairs of a business unit during the course of relative accounting period. But the difference lies in the process of matching cost against revenue.

While the cost in the traditional accounting refers to historical cost, in inflation accounting it represents the cost that prevails at the time of reporting. The inflation accounting has an inbuilt and automatic mechanism to match the cost and revenue at current values.

Salient Features:

From the above definition, the salient features of Inflation accounting may be listed as follows:

1. The inflation accounting has an inbuilt and automatic recording procedure.
- . The unit of measurement is not stable like traditional or historical accounting.
3. It takes into consideration all the elements of financial statements for reporting.
4. The realization principle is not rigidly followed, particularly in the case of recording fixed assets and long-term loans.

Need for Inflation Accounting:

In the traditional accounting, assets are shown in the financial statements year after year on the basis of acquisition prices or at historical cost. During the inflationary period, historical-cost based depreciation would be highly insufficient to replace the existing assets at current costs. Items like depreciation, cost of goods sold, and inventory are understated and the profit figure and financial position of the business units are highly distorted.

Current revenues for the period are not properly matched with current cost of operation. Hence, the problems created by price changes in the historical- cost based accounts necessitate some methods to take care of inflation into the accounting system.

Methods of Accounting for Changing Prices:

International accounting bodies have suggested a number of methods for measuring the impact of changing prices on the profitability and financial position of the business units. However, no single method has gained universal acceptance.

Noteworthy among the various methods the following are the generally accepted methods of accounting for price level changes: Current Purchasing Power Method [CPP method]. Current Cost Accounting Method [CCA method]. Hybrid method [a Mixture of CPP and CCA methods].

(1) Current Purchasing Power (CPP) Method:

The CPP method [also termed as Constant rupee method] attempts to restate all items in the financial statements in terms of units of equal purchasing power. It seeks to eliminate the effects of changes in the general price levels or in the value of money itself. Money as a measuring rod is somewhat defective, because its value keeps on changing due to inflation or deflation.

The CPP method basically attempts to remove the distortions in financial statements, which arise due to change in the value of rupee. For this purpose, any approved price index depicting the changes in the purchasing power of rupee is used to convert the various items of the financial statements.

For example, an asset purchased in 2000 for Rs.5, 000 would be valued in 2005 based on the change in the general price index in 2005 as compared to that in 2000. Suppose the general price index was 200 in 2000 and it was 300 in 2005.

The asset would be valued at Rs.7,500 [i.e., Rs.5,000 x 300/200], It implies that the current purchasing power of a sum of Rs. 5,000 spent in 2000 is equivalent to Rs.7 500 in 2005. That is, the purchasing power of rupee in 2005 is 1.5 times [300/200] more than that in 2000.

It is important to note that under CPP method only the changes in the general purchasing power of money is relevant and not the value of individual asset. For example a particular asset has become cheaper over the period of time as against the increase in the general price index. In such a case, the value of such an asset will be raised in accordance with the general price index.

Steps involved in CPP method:

Conversion Factor: For converting historical rupees into equivalent uniform rupees [current purchasing prices] as at the date of balance sheet an index depicting the changes in the power of rupee is required.

This is done through a conversion factor, which is calculated as follows:

$$\text{Conversion Factor} = \frac{\text{Price Index at the date of conversion}}{\text{Price at the date of transaction}}$$

For this purpose most broad-based retail or consumer price is used. And in case of transactions occurring throughout a period, an average price index of the period is used. Such transactions include items like sales, purchase of goods, payment of expenses, etc. The average price index may be calculated by taking the average of the opening and end of the period price index numbers.

Example 1:

A company purchased a plant on 1-1-2005 for a sum of Rs.45 000. The consumer price index on that date was 125 and it was 250 at the end of the year. Restate the value of the plant as per CPP method as on 31st December 2005.

Solution:

$$\text{Conversion Factor} = \frac{\text{Price index as on 31-12-2005}}{\text{Price as on 1-1-2005}} = \frac{250}{125} = 2$$

Value of the Plant on 31st December 2005 after conversion = Value of the plant on 1 – 1 – 2005 x Conversion Factor = Rs. 45 000 x 2 = Rs. 90 000.

Distinction between Monetary and Non-monetary items:

The CPP method distinguishes between monetary items and non-monetary items for converting the figures.

Monetary items are those items whose amounts are fixed by contract or otherwise they remain constant in terms of monetary units [rupees, dollars, etc.]. The changes in price levels do not affect their values. Examples of monetary assets and liabilities are cash, debtors, creditors, debentures, outstanding expenses, preference share capital, etc.

During the period of inflation, the holder of monetary assets loses general purchasing power since their claims against the firm remain fixed irrespective of any changes in the general price levels.

Conversely the holder of monetary liabilities gains since he is to pay the same amount due in rupees of lower purchasing power. The CPP method suggests the computations of purchasing power gains or loss made by a firm on holding the net monetary items.

Non-monetary items are those items that cannot be stated in fixed monetary amounts. They include tangible assets such as buildings, plant and machinery, inventories for sale, etc. In other words non-monetary items do not carry a fixed value like monetary items. Under CPP method all such items are to be restated to represent the current purchasing power.

For example, a machinery costing Rs.25 000 in 1996 may sell for Rs.35 000 today though it has been used. This may be due to change in the general price level. The equity capital is a non-monetary item since the equity shareholders have residual claim on the company's net assets.

Computation of Monetary Gain or Loss:

The changes in purchasing power affect both monetary and non-monetary items of the financial statements. In case of monetary assets and monetary liabilities, the firm receives or pays the amounts fixed as per the terms of contract, but it loses or gains in terms of real purchasing power.

Such monetary gain or loss should be computed separately and shown as a separate item in the restated income statement in order to find out the overall profit or loss under CPP method.

Example 2:

From the following data, compute the net monetary gain or loss as per CPP method:

Monetary Items	1 - 1 - 2005	31 - 12 - 2005
Cash	Rs. 5,000	Rs.10,000
Debtors	20,000	25,000
Creditors	15,000	20,000
Public Deposits	20,000	20,000
Consumer price index numbers are:		
On 1 - 1 - 2005	—	100
On 31 - 12 - 2005	—	150
Average for the year	—	120

Solution:

[A] Impact of changes of general price levels on liabilities:	Rs.
Monetary liabilities on 1 - 1 - 2005	Rs.35 000
Value of liabilities at current prices [Rs.35 000 × 150/100]	52,500
Value of additional liabilities at current prices [Rs.40 000 - 35 000] × 150/120	<u>6,250</u>
	58,750
Less: Value as per closing balance sheet	<u>40,000</u>
Resultant monetary gain on holding liabilities	<u>18,750</u>

[B] Impact of changes of general price levels on monetary assets:

Value of monetary assets on 1 – 1 – 2005	Rs.25 000	
Value at current prices on 31 – 12 – 2005 [Rs.25 000 x 150/100]		37,500
Additions at current prices [Rs.35,000 – 25,000] x [150/120]		<u>12,500</u>
		50,000
Value of assets as per closing balance sheet		<u>35,000</u>
Resultant monetary loss on holding monetary assets		<u>15,000</u>
Net monetary gain [A – B] [Rs.18,750 – 15,000]		<u>3,750</u>

Note:

The conversion factors for the opening balances of assets and liabilities have been computed by dividing the year-end price index by opening price index, [i.e., 150/100]. And for additions made during the year, it has been calculated by dividing the year-end price index by average price index, [i.e., 150/120].

Adjustment for Cost of Sales and Inventories:

For the purpose of restatement of the Cost of sales and Inventories under CPP method, the cost flow pattern of [i.e., First in First out or Last in First out] should be kept in mind. Under the First in First out assumption, the inventories purchased first are issued to production or to customers. Later purchases remain in stock.

Similarly under the last in First out assumption, the inventories purchased are issued first and the earlier purchases remain in stock. These cost flow pattern should be kept in mind while using the index numbers for computing conversion factors. Under FIFO method, the cost of sales normally includes the entire opening stock and current purchases less closing stock.

Closing stock comprises entirely current purchases and sometimes part of opening stock. In case of LIFO, the cost of sales includes current purchases only and closing stock comprises opening stock and sometimes part of current purchases.

For the purpose of restatement of historical figures in terms of current values, the following price indices are used:

[i] Purchases of the previous year: Average indices for the relevant years.

[ii] Current Purchases: Average index of the year.

[iii] Opening stock: Index at the beginning of the year.

Example 3:

[B] Impact of changes of general price levels on monetary assets:		
Value of monetary assets on 1 – 1 – 2005	Rs.25 000	
Value at current prices on 31 – 12 – 2005 [Rs.25 000 x 150/100]		37,500
Additions at current prices [Rs.35,000 – 25,000] x [150/120]		<u>12,500</u>
		50,000
Value of assets as per closing balance sheet		<u>35,000</u>
Resultant monetary loss on holding monetary assets		<u>15,000</u>
Net monetary gain [A – B] [Rs.18,750 – 15,000]		<u>3,750</u>

Method Solution:**FIFO Method:****Values of Cost of Sales and Inventories:**

	Historical Cost Basis Rs.	Conversion Factor	CPP Method Rs.
Opening Stock	20,000	1.6 [240/150]	32,000
Add: Purchases	<u>60,000</u>	1.33 [240/180]	<u>80,000</u>
	80,000		1,12,000
Less: Closing Stock	<u>24,000</u>	1.33 [240/180]	<u>32,000</u>
Cost of Sales	<u>56,000</u>		<u>80,000</u>

LIFO Method

Values of Cost of Sales and Inventories

	Historical Cost Basis Rs.	Conversion Factor	CPP Method Rs.
Opening Stock	20,000	1.6 [240/150]	32,000
Add: Purchases	<u>60,000</u>	1.33 [240/180]	<u>80,000</u>
	80,000		1,12,000
Less: Closing Stock:			
Opening stock	20,000	1.6 [240/150]	32,000
Current Purchases	<u>4,000</u> <u>24,000</u>	1.33 [240/180]	<u>5,333</u> <u>37,333</u>
Cost of Sales	<u>56,000</u>		<u>74,667</u>

Determination of Profit:

There are two approaches to determine the profit under CPP method. They are [a] Net Change Method and [b] Restatement of Income Method.

Net Change Method:

This approach is based on normal accounting concept that profit is equal to change in equity during an accounting period. Opening balance sheet based on historical cost is converted into CPP balance sheet by using index numbers.

Monetary items should be converted and the net monetary gain or loss is shown. Equity capital is also converted. The difference in the balance sheet is taken as reserves. When equity is not converted, then the difference in the balance sheet is taken as equity.

Income Method:

Under this method the historical profit and loss account is restated in CPP terms. All the items of Income Statement are converted into CPP values on the following basis:

- [a] Sales and operating expenses are restated at the average index applicable for the year.
- [b] Cost of sales is converted as per the cost flow assumption as explained above.
- [c] Net gain or loss on monetary items will have to be determined and shown separately in the restated income statement.
- [d] Fixed assets and their depreciation are converted on the basis of the indices prevailing at the dates of purchase of such assets.
- [e] Taxes and dividends paid are converted on the basis of indices prevailing at the dates of payment.

Limitations of CPP Method:

The index numbers are statistical averages and the CPP method is based on indices. Hence, it would be very difficult to apply with precision to individual firms.

There are various price indices, which characterize different price situations. Hence, it would be a difficult task to select a suitable price index.

The method deals with changes in the general price level and not with the changes in prices of individual firms. However, the only relationship is that the individual prices move with the general price index to some extent.

Hence, a large number of accountants, economists, and Government authorities do not favor this method.

(2) Current Cost Accounting [CCA] Method:

Because of the limitations of CPP method, the Sandilands Committee recommended the current cost accounting system as a method for correcting the deficiencies of historical cost accounting. The Accounting Committee of U.K has issued a Statement of Standard Accounting Practice 16 [SSAP – 16] relating to CCA method. Main Features of CCA method

Money remains to be the unit of measurement. The items of the financial statements are restated in terms of current value of that item and in terms of general purchasing power of money. Assets and liabilities are at their current value to the business. Similarly the profits are computed on the basis of current values of the various items to the business.

This requires carrying out the following adjustments:

Revaluation Adjustment,

Depreciation Adjustment,

Cost of Sales Adjustment [COSA] and

Monetary Working Capital Adjustment

Methodology:

Revaluation Adjustment:

Fixed assets are shown in the balance sheet at their values to the business. The value to the business of an asset refers to the opportunity loss to the business if were deprived of such assets. In this context, it is pertinent to understand the gross and net replacement costs. The gross replacement cost of an asset is the cost to be incurred at the date of valuation to obtain a similar asset for replacement.

For example:

If an asset purchased on 1 – 1 – 2005 for Rs. 50,000 costs Rs. 80,000 on 31 – 12 – 2005, then the gross replacement cost on 31 – 12 – 2005 would be Rs.80,000. Net replacement cost refers to the unexpired service potential of that part of gross current replacement cost.

For example, a machine costing Rs. 80,000 has a life of eight years with zero scrap value and it has been used for three years. If the machine can be purchased now for Rs.80,000 then the net replacement cost of the asset would be Rs.70,000 i.e., the current price of the machine less depreciation for three years.

Plant and machinery, Motor vehicles, Office equipment, Fixtures and fittings, Ships and Aircrafts, etc., are normally valued at their net current replacement cost. Land and buildings occupied by the owner himself should be shown in the balance sheet at their value to the business, which will comprise the market value for existing use plus estimated acquisition cost.

If the open market is not available, then the net replacement cost of the buildings and open market value of land for its existing use plus the estimated acquisition cost should be taken as their value to the business. Long-term investments should also be shown in the balance sheet at their value to the business.

Quoted investments should be valued at their unit market value and unquoted investments are valued on the basis of the current cost net worth of the company. Inventories should be valued at power of the current replacement cost as on the date of the balance sheet and the net realizable value.

Depreciation Adjustment:

The profit and loss account should be charged for depreciation with an amount equal to the value of fixed assets consumed during the period. When the fixed assets are valued on the basis of their net current replacement cost, the depreciation charge should be based on such cost. The depreciation charge may be computed either on the basis of total replacement cost of the asset or on average net current cost of assets.

Average current cost may be computed as follows:

$$\frac{\text{Current cost at the beginning of the year} + \text{Current cost at the end of the year}}{2}$$

The current depreciation charge is obtained by apportioning the average net replacement cost over the expected remaining useful life of the fixed assets as at the beginning of the period.

When the fixed assets are revalued every year there will also be shortfall of depreciation representing the effect of price rise during the period. This shortfall is called backlog depreciation, which should be charged either to general reserves or against the related revaluation surplus on the fixed assets. The need for adjustment of backlog depreciation will arise whenever a depreciating asset is revalued.

Example 4:

Vicky ltd. purchased new equipment on 1 – 1 – 2002 for Rs. 80,000 and its expected life was 10 years without any scrap value. On 1 – 1 -2005 a similar new equipment costed Rs. 30,000 and on 31 – 12 – 2005 Rs.40,000. What would be the depreciation charge for the year 2005 assuming that there is no change in the estimated life of the equipment.

Solution

Depreciation charge under CCA method

$$\frac{\text{Current value at the beginning} + \text{Current value at the end}}{2 \times \text{Expected life}}$$

$$= \frac{\text{Rs.30,000} + \text{Rs.40,000}}{2 \times 10} = \text{Rs. 3,500}$$

Example 5

On 1 – 1 – 2002 firm purchased equipment for a sum of Rs.5 00 000 and its expected life was 10 years without any scrap value. The price indices for the asset were as follows:

1 – 1 – 2002	100
1 – 1 – 2005	150
31 – 12 – 2005	180

Compute the depreciation adjustment for the year 2005 under CCA method charging depreciation on straight-line basis.

Solution**Statement showing the value and depreciation of the Equipment**

Particulars	1 – 1 – 2005		31 – 12 – 2005	
	Historical Cost [Rs.]	Current Cost [Rs.]	Historical Cost [Rs.]	Current Cost [Rs.]
Cost	5,00,000	7,50,000	5,00,000	9,00,000
Less: Depreciation [3/4 yrs.]	<u>1,50,000</u>	<u>2,25,000</u>	<u>2,00,000</u>	<u>3,60,000</u>
Net Cost	<u>3,50,000</u>	<u>5,25,000</u>	<u>3,00,000</u>	<u>5,40,000</u>

i Depreciation adjustment for 2005 based on Current Replacement value

Depreciation at 10% on Current Cost Rs.9 00 000	Rs.90,000
Less: Depreciation charged for 2005 as per HCA	<u>50,000</u>
Depreciation Adjustment	<u>40,000</u>

Cost of Sales Adjustment [COSA]:

This adjustment is made in order to determine the current cost operating profit. COSA represents the difference between value to the business and the historical cost of stock consumed in the period. The amount of sales is the current revenue and requires no adjustment in its figure.

Such as raw materials consumed or finished goods sold items. Which enter into the calculation of cost of sales, have to be taken at the present value at which they would be replaced or consumed or sold. The difference in values is called as COSA, which is debited to the Profit and loss account and credited to Current Cost Account Reserve.

Example 6:

Determine the value of Cost of Sales Adjustment from the data given below:

Opening stock on 1 – 1 – 2005	Rs.12 000
Closing stock on 31 – 12 – 2005	16 000
Index number on 1 – 1 – 2005 [Io]	160
Index number on 31 – 12 – 2005 [Ic]	200
Average index number for the year [Ia]	190

Solution

$$\begin{aligned} \text{Cost of Sales Adjustment} &= \text{Closing stock [CS]} - \text{Opening stock [OS]} - \text{Ia [CS/ Ic - OS/ Io]} \\ &= [\text{Rs.16,000} - 12,000] - 190 [\text{16,000/200} - \text{12,000/160}] \end{aligned}$$

$$= \text{Rs. 4,000} - 190 [80 - 75]$$

$$= \text{Rs. 3,050}$$

Monetary Working Capital Adjustment [MWCA]:

The rising prices create the need for the additional working capital for efficient and profitable operation of the firm. The concept of monetary working capital refers to the excess of accounts receivables and unexpired expenses over accounts payables and accruals. Current cost accounting ensures that the impact of changing prices on working capital is taken care of through MWCA.

This adjustment is to be carried out while computing current cost of operating profit by charging profit and loss account with any increase in net additional working capital owing to changing price levels and crediting the CCA Reserve. This adjustment is required only for price level changes and not for any increase in volume of business. The following formula may be used for calculating MWCA.

$$\text{MWCA} = C - O - Ia [C/Ic - O/Io]$$

Where C = Closing monetary working capital
 O = Opening monetary working capital
 Ia = Average price index
 Io = Opening price index
 Ic = Closing price index

Example 7

From the following information as per historical cost accounting, carry out Monetary Working Capital Adjustment under CCA method:

	Opening balance Rs.	Closing balance Rs.
Accounts Receivables	18,000	21,000
Accounts Payables	10,000	12,000
Price Index	175	205
Average Price Index		190

Solution

$$\text{MWCA} = C - O - Ia [C/Ic - O/Io]$$

Opening monetary working capital [O] = Rs.18 000 – 10 000 = Rs.8 000

Closing monetary working capital [C] = Rs.21 000 – 12 000 = Rs.9 000

$$\text{MWCA} = \text{Rs.9 000} - 8 000 - 190 [9000/205 - 8000/175]$$

$$= \text{Rs.1 000} - 190 [43.9 - 45.7]$$

$$= \text{Rs.1 000} + 342 = \text{RS.1 342}$$

Gearing Adjustment:

Gearing is the ratio of debt capital to shareholder's funds. When fixed assets and working capital are partially financed by debt capital the amount of debt remains the same because of repayment agreement. The price level changes do not affect this liability of the business. Thus, the shareholders enjoy the benefits in the period of rising prices.

During the declining prices the reverse experience takes place. The entire net income goes to shareholders. However, in the calculation of operating profit, the existence of borrowing is ignored.

Hence, the profits attributable to shareholders would be understated [or where prices fall overstated] if the whole of depreciation, COSA, and MWCA were charged or credited to profit and loss account. The total of these adjustments [Depreciation, COSA, and MWCA] are proportionately abated through gearing adjustment [gearing ratio].

The gearing adjustment is calculated by the application of the following formula:

$$\text{Gearing Adjustment [Gearing ratio]} = \frac{D}{D + S} \times S$$

Where D = average net debt S = average share holders interest

In the calculation of net borrowing, cash or any other monetary asset not included in MWCA should be deducted from the total borrowing. It would be apt to use average gearing ratio for gearing adjustment.

The calculated amount of gearing adjustment will be debited to Current Cost account Reserve and credited to Profit and Loss Account. In other words the shareholders' share will be charged to profit and loss account and credited to current cost account reserve.

Example 8:

Following information relate to Rashmi & Co., Ltd.	Opening [Rs.]	Closing [Rs.]
[a] The net borrowing debentures and deferred taxation	2,80,000	2,80,000
Creditors	40,000	28,000
Bank Overdraft	1,20,000	92,000
Taxation	30,000	28,000
Cash	<u>[80,000]</u>	<u>[1,20,000]</u>
Total	<u>3,90,000</u>	<u>3,08,000</u>
[b] Share capital and Reserves from Current Cost Balance Sheet	7,41,600	9,41,000
Proposed dividend	<u>10,000</u>	<u>12,000</u>
Total Shareholders interest	<u>7,51,600</u>	<u>9,53,000</u>
[c] Current cost adjustment:		
Depreciation		34,000
Fixed assets disposal		36,000
COSA		32,400
MWCA		<u>22,400</u>
		<u>1,24,800</u>

Calculate the Gearing Adjustment Ratio and the Current Cost Adjustment after abating for gearing adjustment.

Solution:

$$\text{Gearing Adjustment Ratio} = \frac{D}{D+S} \times 100$$

$$\text{Average net borrowing [D]} = [\text{Rs.}3\ 90\ 000 + \text{Rs.}3\ 08\ 000]/2 = \text{Rs.}3\ 49\ 000$$

$$\text{Average Shareholders funds [S]} = [\text{Rs.}7\ 51\ 600 + \text{Rs.}9\ 53\ 000]/2 = \text{Rs.}8\ 52\ 300$$

$$\text{Average total funds employed [D + S]} = [\text{Rs.}3\ 49\ 000 + \text{Rs.}8\ 52\ 300] = \text{Rs.}12\ 01\ 300$$

$$\text{Gearing Adjustment Ratio} = \frac{D}{D+S} \times 100 = \frac{\text{Rs. } 3,49,000}{\text{Rs. } 12,01,300} \times 100 = 29.05\%$$

Total current cost adjustment	Rs.1,24,800
Less: Gearing adjustment [29.05% of the above]	<u>36,254</u>
Current cost reserve after adjustment	<u>88,546</u>

Advantages of CCA Method:

1. Computation of depreciation based on the fixed assets current value [or value to the business] provides a realistic measure of the resources used in a period.
2. Assets are shown at their current values in the balance sheet.
3. It clearly differentiates the gains from operations from the gains from holding assets.
4. Cost of sales adjustment enables the entity to maintain its value in real terms.
5. Computation of monetary gains and losses highlights the effect of holding monetary items.
6. The introduction of appropriation account brings together revaluation surplus and current cost profit together. It helps management in devising dividend policies realistically.
7. Both management and users of accounts are provided with realistic information relating to value of assets, costs and profit.

Deficiencies in CCA Method:

1. Treatment of backlog depreciation is not proper. Charging against the current cost accounting reserve, which is a capital reserve, provides for backlog depreciation. The proper method would be to charge against revenue reserve available for dividend. This will enable the management to make available the funds for replacement of assets. Further it fails to provide adequate funds for replacements of new types of assets.
2. This method ignores materiality factor. If a particular adjustment is not necessary for a company, it cannot ignore such adjustment. Further the valuation process is subject to the discretion and personal judgment of the managers than the ascertainment of historical cost.

3. This method ignores purchasing power gains and losses on the monetary items of the firm. It takes into account such gains and losses in nature of cost of holding monetary assets and liabilities during a period of changing price levels. In fact such companies would gain or lose very much in terms of purchasing power on the items during the inflationary periods.

4. This method is based on uniform accounting practices, which are not true in actual practice. The accounting practices and maintaining of books differ from firm to firm. Hence, the information available for valuation purposes may not be adequate and real. Because of these deficiencies, many accountants feel that this method may not have adequate capacity to depict the true financial position of the business during the periods of price level changes.

5. The CCA method fails to provide for the gearing adjustment with regard to fixed assets and inventories. They are also financed partly by borrowings. Hence, it is pertinent to subject these assets to gearing adjustment.

(3) Hybrid Method:

Hybrid method combines some of the features of CPP method and CCA method. According to this method, the relevant adjustments are made with reference to specific indices in the place of general index as in the case of CPP method.

In addition, the purchasing power gains and losses on monetary items are also taken into consideration. Combining of the two methods as a compromise formula brings both the benefits and limitations of both CPP and CCA methods. It is still in the evolutionary stage and not suitable for practical application.

Illustration 1:

On 1 – 1 – 2005 a company purchased equipment for Rs.45 000. The price index on that date was at 150. Restate the value of the equipment as per CPP method on 31 – 12 – 2005 when the price index was at 200.

Solution:

$$\text{Conversion Factor} = \frac{\text{Price index at the date of conversion}}{\text{Price index at the date of purchase}} = \frac{200}{150} = \frac{4}{3}$$

$$\begin{aligned} \text{Value of equipment on 31 - 12 - 2005 as per CPP method} \\ &= \text{Existing value} \times \text{Conversion Factor} \\ &= \text{Rs.45 000} \times \left[\frac{4}{3}\right] = \text{Rs.60 000} \end{aligned}$$

Illustration 2:

Mr. Ram purchased shares in HLL Ltd., for Rs. 10 000 in 1991 when the index of the general price levels stood at 110. At the end of 1994 the market price of the shares was Rs.8 000 and the index was 132. In 1995, the market price of the shares was Rs.9 000 and the index was 145.2.

- [i] Calculate the CPP value of the shares in 1994 and in 1995.
- [ii] Under CPP accounting, what gain or loss would be shown in respect of shares?
- [iii] What was the real gain or loss in purchasing power in respect of the shares during 1995?

Solution:

$$\text{[i] CPP value of the shares at the end of 1994} = \frac{\text{Rs.10 000} \times 132}{110} = \text{Rs.12,000}$$

$$\text{CPP value at the end of 1995} = \frac{\text{Rs.10,000} \times 145.2}{110} = \text{Rs.13,200}$$

[ii] Determination of accounting gain or loss

	1994	1995
CPP value	Rs. 12,000	13,200
Less: Purchase price	<u>10,000</u>	<u>10,000</u>
Accounting loss	<u>2,000</u>	<u>3,200</u>

[iii] Determination of actual loss in purchasing power

	1994	1995
CPP value	Rs.12,000	13,200
Less: Market price	<u>8,000</u>	<u>9,000</u>
Loss in purchasing power	<u>4,000</u>	<u>4,200</u>

Illustration 3: From the data given below, compute the net monetary gain or loss as at 31 - 12 - 2005:

	1 - 1 - 2005	31 - 12 - 2005
Cash	Rs. 10,000	Rs. 20,000
Accounts Receivables	40,000	50,000
Sundry creditors	30,000	40,000
Debentures	40,000	40,000
Retail price index numbers	200	300
Average price index for the year 240		

Illustration 3: From the data given below, compute the net monetary gain or loss as at 31 - 12 - 2005:

	1 - 1 - 2005	31 - 12 - 2005
Cash	Rs. 10,000	Rs. 20,000
Accounts Receivables	40,000	50,000
Sundry creditors	30,000	40,000
Debentures	40,000	40,000
Retail price index numbers	200	300
Average price index for the year 240		

Solution:

Statement showing monetary gain/loss on account of Price level changes		
CPP value of Monetary liabilities on 1 – 1 – 2005	Rs. 1,05,000	
[Rs.70 000 × 1.5]		
CPP value of increase in monetary liabilities during 2005		
[Rs.10 000 × 1.25]	<u>12,500</u>	
CPP value of monetary liabilities on 31 – 12 – 2005	1,17,500	
Less: Monetary liabilities on 31 – 12 – 2005 as per balance sheet	<u>80,000</u>	
Gain on holding Monetary liabilities		Rs. 37,500
CPP value of monetary assets as on 1 – 1 – 2005		Rs. 75,000
[Rs.50 000 × 1.5]		
CPP value of increase in monetary assets during 2005		
[Rs.20 000 × 1.25]	<u>25,000</u>	
CPP value of monetary assets on 31 – 12 – 2005		1,00,000
Less: Book value as on 31 – 12 – 2005		<u>70,000</u>
Loss on holding monetary assets		Rs. <u>30,000</u>
Net gain on monetary items		<u>7,500</u>

Working Notes:**Computation of conversion factors:****Working Notes:**

Computation of conversion factors:

For monetary items as on 1 – 1 – 2005: $300/200 = 1.5$

For monetary items as on 31 – 12 – 2005: $300/240 = 1.25$

Increase in monetary items: as on 1 – 1 – 2005 as on 31 – 12 – 2005 Increase during 2005

	Rs.	Rs.	Rs.
Monetary Assets	50,000	70,000	20,000
Monetary Liabilities	70,000	80,000	10,000

Illustration 4:

Following information has been extracted from the books a Limited Company:

Monetary assets Rs.30 000; monetary liabilities Rs. 16,500

The price index at the time of monetary item were created was 200 and now it stands at 260. Assuming that there has been no change in the amount of assets and liabilities, ascertain the general purchasing power gain or loss.

Solution:

CPP value of monetary assets = [Rs. 30,000 × 260] / 200 =Rs. 39,000	
Less: Actual book value	<u>30,000</u>
[A] Loss on holding monetary assets	<u>9,000</u>
CPP value of monetary liabilities = [Rs.16 500 × 260] / 200 = Rs. 21,450	
Less: Actual book value	<u>16,500</u>
[B] Gain on holding monetary liabilities	<u>4,950</u>
Net general purchasing power loss [A – B]	<u>4,050</u>

Illustration 5:

On 1 – 1 – 2005 a firm had cash at bank balance of Rs. 40,000. On that date the consumer price index was 200.

During the period ended 31 – 12 – 2005 the receipts and payments were as follows:

Receipts	Rs.	Price Index	Payments	Rs.	Price index
1 – 5 – 2005 Sales	21 000	210	10 – 6 – 2005 Costs	43 000	215
18 – 9 – 2005 Sales	69 000	230	1 – 8 – 2005 Plant	40 000	225
			15 – 12 – 2005 Costs	30 000	240

Ascertain the profit or loss on account of price changes at the year-end when the price index was 240.

Solution:

Statement showing the profit or loss on account of price level changes during the year ended 31 – 12 – 2005.

	Historical Cost [Rs.]	Conversion Factor	CPP value [Rs.]
1 – 1 – 2005 Bank balance	40,000	240/200	48,000
Receipts:			
1 – 5 – 2005 Sales	21,000	240/210	24,000
18 – 9 – 2005 Sales	<u>69,000</u>	<u>240/230</u>	<u>72,000</u>
Total bank balance [A]	<u>1,30,000</u>		<u>1,44,000</u>
Payments:			
10 – 6 – 2005 Costs	43,000	240/215	48,000
1 – 8 – 2005 Plant	42,750	240/225	45,600
15 – 12 – 2005 Costs	<u>30,000</u>	<u>240/240</u>	<u>30,000</u>
Total Payments [B]	<u>1,15,750</u>		<u>1,23,600</u>
31 – 12 – 2005 Bank balance [A – B]	<u>14,250</u>		<u>20,400</u>

The constant rupee [CPP] value of the closing bank balance should have been Rs.20 400 whereas the actual balance is only Rs. 17 000. Hence, the difference in value of Rs.6 150 [Rs.20 400 – 14 250] represents the loss on account of price changes.

Illustration 6:

Mr. Ram purchased shares at a cost of Rs.1 80 000 on 9th February 2005 when the price index stood at 300. On 31st December 2005 the index had moved to 345 and the market value of the investment was Rs.1 96 000. Find out the profit or loss on the investment as per CPP basis.

Solution:

31 – 12 – 2005 Cost of shares as per CPP basis [Rs. 1,80,000 × 345/300]	=Rs. 2 07,000
Less: Market value of the shares	<u>1,96,000</u>
Loss on the value of the investment	<u>11,000</u>

Illustration 7: From the following information given on historical cost basis, restate the cost of goods sold according to HCA and CPP methods assuming that the firm is using LIFO method for pricing its inventories:

	Rs.
Inventories on 1 – 1 – 2005	2,400
Purchases during the year 2005	28,000
Inventories on 31 – 12 – 2005	6,800

The price index in the beginning of the year was 200 while at the end of 2005 it was 360. The closing inventory consists of purchases of purchases made when the price index was 330. The purchases were made uniformly during the year.

Solution:

	HCA method	Conversion Factor	CPP method
	Rs.		Rs.
1 – 1 – 2005 Inventory	2,400	360/200 [1.8]	4,320
Purchases during 2005	<u>28,000</u>	360/280	<u>36,000</u>
Goods available for sale	30,400		40,320
31 – 12 – 2005 Inventory	<u>6,800</u>	2,400 × 1.8	4,320
		<u>4 400 × 360/330</u>	<u>4 800</u>
Cost of goods sold during 2005	<u>23,600</u>		<u>31,200</u>

Note: Purchases have been converted into constant rupees using average price index, 280 [i.e., 200 + 360 /2], Closing inventory includes the balance of the opening inventory.

Illustration 8:

From the following information given on historical cost basis, compute the cost of goods sold under HCA and CPP methods assuming that the firm follows FIFO method for pricing its inventories:

Inventories on 1 – 1 – 2005	Rs. 4,800
Purchases during the year 2005	Rs. 42,000
Inventories on 31 – 12 – 2005	Rs. 11,400

The general price index was 200 on 1 – 1 – 2005 and at the end of 2005 it was 360. The closing inventory consists of purchases made when the price index was 228. The purchases were made uniformly throughout the year.

Solution

	HCA method	Conversion Factor	CPP method
	Rs.		Rs.
Inventory on 1 – 1 – 2005	4,800	360/200	8,640
Purchases made during 2005	<u>42,000</u>	360/280	<u>54,000</u>
Goods available for sales	46,800		62,640
Less: Inventory on 31 – 12 – 2005	<u>11,400</u>	360/228	<u>18,000</u>
Cost of goods sold during 2005	<u>35,400</u>		<u>44,640</u>

Note:

Purchases have been converted into constant rupees using the average price index of 280.

Illustration 9:

A firm purchased a plant for Rs.5 00 000 on 1 – 1 – 2002. It has an expected life of 10 years with zero scrap value.

The price indices for the asset were as follows:

1 – 1 – 2002	200
1 – 1 – 2005	320
31 – 12 – 2005	350

The firm charged depreciation on straight-line basis. Ascertain the values of machinery on 1st January and 31st December 2005 as per HCA and CCA methods. Also calculate the amount of depreciation adjustment to be made in the account of 2005.

Solution:**Statement showing the value and depreciation of the Equipment**

Particulars	1 - 1 - 2005		31 - 12 - 2005	
	Historical Cost [Rs.]	Current Cost [Rs.]	Historical Cost [Rs.]	Current Cost [Rs.]
Cost	5,00,000	8,00,000	5,00,000	8,75,000
Less: Depreciation [3/4 yrs.]	<u>1,50,000</u>	<u>2,40,000</u>	<u>2,00,000</u>	<u>3,50,000</u>
Net Cost	<u>3,50,000</u>	<u>5,60,000</u>	<u>3,00,000</u>	<u>5,25,000</u>
Depreciation adjustment for 2005 based on Current Replacement value				
Depreciation at 10% on Current Cost Rs.8 75 000			Rs. 87,500	
Less: Depreciation charged for 2005 as per HCA			<u>50,000</u>	
Depreciation Adjustment			<u>37,500</u>	

Illustration 10:

Following information have been taken out from the books of Mac Ltd., for the year 31st December 2005:

			Rs.
Materials consumed			5,00,000
Manufacturing wages and expenses			4,00,000
Inventories as on 1 - 1 - 2005 at cost:			
Raw materials			40,000
Finished goods			1,00,000
Inventories as on 31 - 12 - 2005 at cost:			
Raw materials			60,000
Finished goods			90,000
The value of inventories to business was ascertained at	1 - 1 - 2005	31 - 12 - 2005	
			Rs. Rs.
Raw materials			48,000 70,000
Finished goods			1,10,000 1,00,000

Price of materials rose during the year steadily by 20% and manufacturing wages and expenses by 16%. Ascertain the adjustments required for the above under CCA method.

Solution:

Statement showing adjustment for value of inventories to business and Cost of Sales adjustment for the year ended 31 - 12 - 2005.

Adjustment for value of inventories to business:

Value of inventories to business on 31 st December 2005:		Rs.
Raw materials		70,000
Finished goods		<u>1,00,000</u>
Total		1,70,000
Book value of inventories: Raw materials	Rs. 60,000	
Finished goods	<u>90,000</u>	<u>1,50,000</u>
Increase in value [credit to CCA Reserve]		<u>20,000</u>
Cost of sales Adjustment:		
Purchases as per books of account		5,20,000
Add: 10% being half the increase in raw material prices		<u>52,000</u>
		5,72,000
Add: Raw material stock on 1 – 1 – 2005 [value to business]		<u>48,000</u>
		6,20,000
Less: Closing stock of Raw materials [adjusted for price changes]		
[Rs.60 000 x 110/120]		<u>55,000</u>
Materials consumed at prices when consumed		5,65,000
Manufacturing wages and expenses	4,00,000	
Add: 8% being half the increase in rate during 2005	<u>32,000</u>	<u>4,32,000</u>
		9,97,000
Less: book value of materials, wages and expenses		<u>9,00,000</u>
Cost of Sales Adjustment		<u>97,000</u>
Debit to Profit and loss account and Credit to CCA Reserve		

Notes:

Computation of purchases = Materials consumed + Closing stock – Opening Stock

Purchases = Rs.5 00 000 + 60 000 – 40 000 = Rs. 5, 20,000

Illustration 11:

From the following particulars calculate the Monetary Working Capital Adjustment:

	1 – 1 – 2005	31 – 12 – 2005
Inventories	Rs. 2,20,000	Rs. 2,44,000
Accounts Receivables	1,80,000	2 20,000
Cash at bank	24,000	32,000
Advances for supplies of materials	40,000	50,600
Due to suppliers	1,00,000	1,28,800

During the year 2005 the material prices increase by 15% and those of finished goods by 10%.

During the year 2005 the material prices increase by 15% and those of finished goods by 10%.

Solution:

Statement of Monetary Working Capital		
	As On 1 – 1 – 2005	As on 31 – 12 – 2005
	Rs.	Rs.
Accounts Receivables	1,80,000	2,20,000
Advances for supply of materials	<u>40,000</u>	<u>50,600</u>
	2,20,000	2,70,600
Less: Accounts Payables	<u>1,00,000</u>	<u>1,28,800</u>
Monetary Working capital [MWC]	1,20,000	1,41,800
Increase in MWC during 2005	<u>21,800</u>	

Restatement showing increase in amounts due to change in volume in terms of mid- year prices.

	As on 1 – 1 – 2005	as on 31 – 12 – 2005
	Rs.	Rs.
Accounts Receivables Rs. 1 80 000 × 105/100	1,89,000	
Rs.2 20 000 × 105/110		2,10,000
Advances for supply of materials Rs.40 000 × 107.5/100	43,000	
Rs.50 600 × 107.5/115		<u>47,300</u>
	<u>2,32,000</u>	<u>2,57,300</u>
Less: Due to suppliers Rs.1 00 000 × 107.5/100	1,07,500	
Rs.1 28 800 × 107.5/115		1,20,400
	1,24,500	1,36,900
Increase due to change in prices	<u>12,400</u>	
Increase in Monetary Working Capital – actual	Rs. 21 800	
Less: Due to increase in volume in terms of mid-year prices	<u>12 400</u>	
Increase due to change in prices – MWCA	<u>9 400</u>	

Note:

Accounts Receivables have been adjusted by change in prices of finished goods and the other two items by the change in prices of material.

Illustration 12:

From the following comparative balance sheet of Sri Ram Limited as prepared according to Current Cost Accounting Method, calculate the Gearing ratio:

Comparative Balance sheet					
Liabilities	2004 Rs.	2005 Rs.	Assets	2004 Rs.	2005 Rs.
Share Capital	1,00,000	1,00,000	Fixed Assets [net]	2,40,000	2,80,000
Revenue Reserve	50,000	60,000	Inventories	1,00,000	1,30,000
CCA Reserve	1,00,000	1,20,000	Book debts	1,60,000	1,80,000
Secured Debts	1,16,000	1,76,000	Prepaid expenses	2,000	2,000
Creditors	1,00,000	92,000	Cash	10,000	14,000
Provision for Taxation	31,000	40,000			
Proposed dividend	15,000	18,000			
	5,12,000	6,06,000		5,12,000	6,06,000

Solution**Statement of Equity and Net Borrowings**

Equity Rs.	As on 31 - 12 - 2004		Equity Rs.	As on 31 - 12 - 2005	
	Net Borrowings Rs.	Total Rs.		Net Borrowings Rs.	Total Rs.
Share capital	1,00,000	1,00,000	1,00,000	1,00,000	
Revenue Reserve	50,000	50,000	60,000	60,000	
CCA Reserve	1,00,000	1,00,000	1,20,000	1,20,000	
Proposed dividend	15,000	15,000	18,000	18,000	
Secured debts	1,16,000	1,16,000	1,76,000	1,76,000	
Provision for taxation	31,000	31,000	40,000	40,000	
Cash	[10,000]	[10,000]	[14,000]	[14,000]	
Total 2,65,000	1,37,000	4,02,000	2,98,000	2,02,000	5,00,000

$$\text{Gearing Ratio} = \frac{\text{Net Borrowings [D]}}{\text{Equity [S] + Net Borrowings [D]}} \times 100$$

$$\text{Gearing Ratio for 2004} = \frac{\text{Rs. 1,37,000}}{\text{Rs. 4,02,000}} \times 100 = 34.08\%$$

$$\text{Gearing Ratio for 2005} = \frac{\text{Rs. 2,02,000}}{\text{Rs. 5,00,000}} \times 100 = 40.4\%$$

$$\text{Average Gearing ratio} = [34.08\% + 40.4\%] / 2 = 37.24\%$$

Illustration 13:

From the following information compute the values of cost of sales as per HCA and CCA methods:

Opening stock of materials on 1 – 1 – 2005 [500 tons at Rs.60 per ton.]	Rs.30 000
Materials consumed during 2005	400 tons
Purchases during 2005	Nil
Price of materials on 1 – 1 – 2005	Rs. 70 per ton
Price of materials on 31 – 12 – 2005	Rs. 90 per ton

Solution

Historical Cost Accounting method	
Cost of sales [400 tons × 60]	Rs. 24,000
Closing stock [100 × 60]	Rs. 6,000
Current Cost Accounting method	
Cost of Sales [400 tons × 80]	Rs. 32,000
Closing Stbck [100 tone × 90]	Rs. 9,000

Cost of sales is calculated based on average price index $[70 + 90] / 2 = 80$ Rs.80. The difference in the value of closing stock will be credited to CCA Reserve. The value of closing stock will appear at Rs.9 000 in the balance sheet. The cost of sales adjustment of Rs.8 000 [i.e., Rs.32 000 – 24 000] will be charged to Profit and loss account and credited to CCA Reserve.

Sustainability reporting

Sustainability reporting enables organizations to consider their impacts of wide range of sustainability issues, enabling them to be more transparent about the risks and opportunities they face.

A sustainability report is a report published by a company or organization about the economic, environmental and social impacts caused by its everyday activities. A sustainability report also presents the organization's values and governance model, and demonstrates the link between its strategy and its commitment to a sustainable global economy.

Sustainability reporting can help organizations to measure, understand and communicate their economic, environmental, social and governance performance, and then set goals, and manage change more effectively. A sustainability report is the key platform for communicating sustainability performance and impacts – whether positive or negative.

Sustainability reporting can be considered as synonymous with other terms for non-financial reporting; triple bottom line reporting, corporate social responsibility (CSR) reporting, and more. It is also an intrinsic element of **integrated reporting**; a more recent development that combines the analysis of financial and non-financial performance.

Importance of Trust

Building and maintaining trust in businesses and governments is fundamental to achieving a sustainable economy and world. Every day, decisions are made by businesses and governments which have direct impacts on their stakeholders, such as financial institutions, labor organizations, civil society and citizens, and the level of trust they have with them. These decisions are rarely based on financial

information alone. They are based on an assessment of risk and opportunity using information on a wide variety of immediate and future issues.

The value of the sustainability reporting process is that it ensures organizations consider their impacts on these sustainability issues, and enables them to be transparent about the risks and opportunities they face. Stakeholders also play a crucial role in identifying these risks and opportunities for organizations, particularly those that are non-financial. This increased transparency leads to better decision making, which helps build and maintain trust in businesses and governments.

Who should report?

Sustainability reports are released by companies and organizations of all types, sizes and sectors, from every corner of the world.

Thousands of companies across all sectors have published reports that reference GRI's Sustainability Reporting Guidelines. Public authorities and non-profits are also big reporters. GRI's **Sustainability Disclosure Database** features all known GRI-based reports.

Major providers of sustainability reporting guidance include:

- GRI (GRI's Sustainability Reporting Standards)
- The Organisation for Economic Co-operation and Development (OECD Guidelines for Multinational Enterprises)
- The United Nations Global Compact (the Communication on Progress)
- The International Organization for Standardization (ISO 26000, International Standard for social responsibility)

FORENSIC ACCOUNTING

The integration of accounting, auditing and investigative skills yields the speciality known as Forensic Accounting.

"Forensic", according to the Webster's Dictionary means, "Belonging to, used in or suitable to courts of judicature or to public discussion and debate."

"Forensic Accounting", provides an accounting analysis that is suitable to the court which will form the basis for discussion, debate and ultimately dispute resolution.

Forensic Accounting encompasses both [Litigation Support](#) and [Investigative Accounting](#).

As Forensic Accountants, we utilize accounting, auditing and investigative skills when conducting an investigation. Equally critical is our ability to respond immediately and to communicate financial information clearly and concisely in a courtroom setting.

Forensic Accountants are trained to look beyond the numbers and deal with the business reality of the situation.

Other Terminology

Forensic Investigation

The utilization of specialized investigative skills in carrying out an inquiry conducted in such a manner that the outcome will have application to a court of law. A Forensic Investigation may be grounded in accounting, medicine, engineering or some other discipline.

Forensic Audit

An examination of evidence regarding an assertion to determine its correspondence to established criteria carried out in a manner suitable to the court. An example would be a Forensic Audit of sales records to determine the quantum of rent owing under a lease agreement, which is the subject of litigation.

Internal Audit

An audit performed by an employee who examines operational evidence to determine whether prescribed operating procedures have been followed.

External Audit

An audit performed by an auditor engaged in public practice leading to the expression of a professional opinion which lends credibility to the assertion under examination.

Need for Forensic Accounting

Given the day and age, there is no realm that is immune to dishonesty, fraudulence and oppression. Forensic Accounting challenges such acts and hence has penetrated various sectors that are infested with financial treachery. The need and demand for Forensic Accountants is increasing in the following areas[8]:

- Detection of Fraud by Employees Within an Organization

On speculations of misconduct of an employee, an organization may engage a Forensic Accountant to fish out the truth. They trace any fraud by going through the books and papers of the company as well as the activities of the employee. They also tactfully interview the accused and review evidence of assets created out of such fund embezzlement.

- Criminal Investigation

Where fraud is already established and criminal proceedings are in line, a detailed report containing financial implications made by a Forensic Accountant is of unparalleled assistance to the Police and Law society.

- Settlement For a Retiring Partner

If a retiring or otherwise outgoing partner of a firm complaint of an unjust settlement, he, with the help of a Forensic Accountant, can get assets and liabilities gauged properly and if need be, institute proceedings for resettlement.

- Cases Relating to Professional Negligence

Whenever due to the negligence of an employee, generally accepted standards of accounting and auditing are not complied with or an ethical code is breached, Forensic Accountants are called upon to quantify the extent of loss arising from such deficiency in service.

- Arbitration and Other forms of Dispute Settlement

Forensic Accountants are specially trained in alternative dispute resolution. They help the business community mend differences using tools of arbitration and mediation. Apart from that, they also help settle contract disputes, liability claims, intellectual property infringements, construction breaches etc.

- Settlement Regarding Motor Vehicle Accidents

The expertise of Forensic Accountants is useful in quantifying losses arising out of motor vehicle accidents. They are well acquainted with laws as a part of their curriculum.

- Settlement of Insurance Claims

Claims relating to – consequential loss, property loss, due to various risks, fidelity insurance are handled by a Forensic Accountant. They are also sought when policyholders wish to challenge settlement claims by insurance companies and accurately assess them as well.

- Settlement of Disputes Arising Out of Matrimony

Forensic Accountants indulge in the valuation of assets in matrimonial disputes and their function is limited to locating, tracing and evaluation of the same.

Forensic Accountants – Skills, Qualifications and Activities

As aptly put, **the Forensic Accountant is the bloodhound of book-keeping.**[9] With the steep growth in frauds, scandals and white-collar crimes as well as the outcry for accountability and transparency to establish good governance, Forensic Accountants fit the bill to help the cause and sniff out such criminal transactions.

- Primarily, Forensic Accountants are retained to **analyze, interpret, summarize and present intricate financial issues in a court of law**, in a manner that is both lucid and well supported by documentary evidence.

By virtue of their broad scope of work, they find employment in Multinational Corporations, Banks, Insurance Houses, Police Forces, Government Agencies and even Freelance.

- **One who aspires to be a Forensic Accounting expert must start working towards an Accountancy degree in the Bachelors or Masters level.** To expand their knowledge base, they may also pursue specialized certifications on Forensic Accounting and pass the Fraud examiner's Exam.

Having experience in the Law sector regarding fraud schemes, money laundering strategies, risk assessment will also help immensely, besides honing personal attributes such as excellent communicative skills, understanding of criminal psychology etc.

- **Lastly**, proficiency in operating computers and other devices makes a significant addition to entry-level Accountants.

Functions of Forensic Accountants, inter alia, Are:

- Detection of fraud in a corporate environment.
- Investigating and analyzing evidence arising out of financial foul-play.
- Developing software in order to analyze such evidence and presenting in the appropriate Court/Tribunal.
- Preparation of reports, exhibits and collections of documents.
- Assisting in legal proceedings that include testifying in courts, serving as expert witness and formulating visual aids to support trial evidence.

Keeping in mind their job description, some of the traits that a Forensic Accountant must possess are analytical aptitude, persistence and perseverance, orientation to minute details, a knack for finding loopholes, confidence, compliance to ethical codes and inquisitiveness, among others.

The crucial need to adhere to this strict pre-requisite skill-set makes Forensic Accounting a super-specialized and boutique arena.

Conclusion

Forensic Accounting in India is still vastly untrodden, rather ironically, given the persisting corruption in the country and the alarming need for honesty, accountability and transparency in the economy.

The situation in the West is different. Forensic Accounting became a globally accepted discipline as soon as the Serious Fraud Investigation Office (SFIO) was founded in America and continues to be a substantial medium of employment.

Although India might be behind the States in gaining a suitable environment for Forensic Accounting to thrive in, there is no lack of scope for it. In fact, the market is expected to be booming in the near future.

Whereas presently work of Forensic Accountants is limited to dealing with financial implications of the cases they are entrusted with and not engaging in auditing, they soon will be playing more proactive risk reduction roles against financial frauds and white-collar crimes.

OVERVIEW OF HEADS OF INCOME:

As per the Section 14 Income Tax Act,1961, there are five main income tax heads for an individual. The computation of income tax is an important part and has to be calculated according to the income of a person. For a hassle-free calculation, the income has to be classified properly so that there is no confusion regarding the same. The government has classified the sources of income under separate heads and then the income tax is computed accordingly. The provisions and rules are according to the details mentioned in the Income Tax Act

Five main Income tax heads

- Income from Salary
- Income from [House Property](#)
- Income from Profits and Gains of Profession or Business
- Income from [Capital Gains](#)
- Income from Other Sources

Income from Salary

The first head of Income Tax heads is income from salary whichThis clause essentially assimilates any remuneration, which is received by an individual in terms of services provided by him based on a contract of employment. This amount qualifies to be considered for income tax only if there is an employer-employee relationship between the payer and the payee respectively. Salary also should include the basic wages or salary, advance salary, pension, commission, gratuity, perquisites as well as the annual bonus.

Allowances: An allowance is a fixed monetary amount paid by the employer to the employee for expenses related to office work. Allowances are generally included in the salary and taxed unless there are exemptions available.

Specific tax exemptions are allowances allowed by employers as part of the salary. Some of them are.

- **Conveyance Allowance:** Up to Rs 800/- a month is exempt from tax.
- **House Rent Allowance (HRA):** Salaried individuals can claim House Rent Allowance or HRA to lower taxes who live in a rented house. This can be partially or completely exempt from taxes.

The deduction available is the minimum of the following amounts:

1. Actual HRA received
 2. 50% of [Basic salary + DA] for those living in metro cities (40% for non-metros)
 3. Actual rent paid less 10% of salary
- **Leave Travel Allowance (LTA):** LTA accounts for expenses for travel when you and your family go on leave. While this is paid to you, it is tax-free twice in a block of **4 years**.
 - **Medical Allowance:** Medical expenses to the extent of **Rs 15,000/-** per annum is tax-free. The bills can be incurred by you or your family.
 - **Perquisites: Section 17** of Income Tax Act deals with perquisites which are basically benefits in addition to normal salary to which an employee has a right by way of his employment. Examples of these are rent free accommodation or car loan. There are some perquisites that are taxable in the hands of all categories of employees, some which are taxable when the employee belongs to a specific group and some that are tax-free

Income from House Property

The second head of Income Tax heads is Income from house property, According to the Income Tax Act 1961, Sections 22 to 27 is dedicated to the provisions for the computation of the total standard income of a person from the house property or land that he or she owns. An interesting aspect is that the charge is derived out of the property or land and not on the amount of rent received. However, if the property is utilized for letting out the normal course of business, then the income from the rent will be considered.

Income from Profits of Business

The third head of Income Tax heads is Income from Profits of Business in which the computation of the total income will be attributed from the income earned from the profits of business or profession. The difference between the expenses and revenue earned will be chargeable. Here is a list of the income chargeable under the head:

- Profits earned by the assessee during the **assessment year**
- Profits on income by an organization
- Profits on sale of a certain license
- Cash received by an individual on export under a government scheme
- Profit, salary or bonus received as a result of a partnership in a firm
- Benefits received in a business

Income from Capital Gains

Capital Gains are the profits or gains earned by an assessee by selling or transferring a capital asset, which was held as an investment. Any property, which is held by an assessee for business or profession, is termed as capital gains.

Income from other sources

Any other form of income, which is not categorized in the above-mentioned clauses, can be sorted in this category. Interest income from bank deposits, lottery awards, card games, gambling or other sports awards are included in this category. These incomes are attributed in Section 56(2) of the Income Tax Act and are chargeable for income tax.

DEDUCTIONS UNDER SECTION 80C:

Under Section 80C of the Income Tax Act of 1961, a taxpayer is allowed certain deductions that allow him to lower his tax liability against his taxable income. These deductions are as per Budget 2016 and are applicable for AY 2014-15, AY 2015-16, AY 2016-17, and AY 2017-18.

Tax deductions are offered for the taxpayer to save tax and to lower the amount of tax he needs to pay. The amount varies with the type of deductions you are claiming. It could be for medical expenses, tuition fees, or donations!

These tax exemptions are offered by the Government as a type of encouragement to individuals and corporations to provide for social causes.

Tax Deductions Fall Under Section 80C of Income Tax Act:

An individual and HUFs can claim deductions under Section 80C on payments made to the following:

- Premium for Life Insurance for self, spouse, or children.
- Deferred Annuities payable by self and the Government.
- Contribution towards PPF.
- Contribution towards PFs operated by the Central Government.
- Contribution towards a Recognized PF.
- Contribution towards a Superannuation Fund.
- Subscription for a Government Deposit or Security.
- Subscription for Saving Certificates.

- Subscription to ULIP, 1971.
- Contribution towards ULIP of LIC Mutual Fund.
- Insurance company's Annuity Plans including LIC.
- Subscription to Notified units of Mutual Fund.
- Contribution to the Pension Fund of Notified units of Mutual Fund.
- National Housing Bank's Pension Fund.
- Subscribing to the Deposit Scheme of a Public Sector companies allocating long-term financing for housing.
- Tuition fees for a maximum of 2 children studying in India.
- Repayment of housing loan taken for a residential property.
- Subscription to Mutual Funds units recommended by Central Board of Direct Taxes.
- An FD from a scheduled bank with a minimum tenure of 5 years.
- NABARD notified bonds.
- Contributions to Senior Citizens Saving Scheme.
- Tax Saving 5 Year FD.

Rs.150,000 is the maximum deduction that can be claimed under Section 80C and all its subsections combined.

Subsections of Section 80C, Income Tax Act, 1961

Subsections were created to give clarity to the taxpayers regarding which deductions they are eligible for.

1: Section 80CCC

Only an individual can claim a maximum of Rs.150,000 as tax deductions under this section against payments made towards Pension Funds.

2. Section 80CCD

An individual taxpayer can claim a deduction under this section if he and his company make contributions to Central Government certified pension schemes. Both the amounts are eligible for a tax deduction if the amount does not exceed 10% of the individual taxpayer's salary.

3. Section 80CCF

Tax deduction under this section can be claimed by both an individual and HUFs on investments made in Government notified long-term Infrastructure Bonds. The maximum deduction of Rs.20, 000 can be claimed under this section.

4. Section 80CCG

Under this section only specified individuals can claim a maximum benefit of Rs.25,000 against investments made in Government notified Equity Schemes. Deduction claimed cannot be more than 50% of the invested amount.

Popular Schemes Eligible for Deductions under Section 80C

Section 80C deductions are offered to investments made in a variety of instruments. Several of these are more popular than others because of different reasons. The government too promotes a few as tax saving instruments to encourage individuals to make investments.

Income Tax Deduction on Investment in PPF and Provident Funds

- An individual can claim deductions for deposits made in PPF accounts in the name of self, spouse, and children even if major.
- HUFs can claim the deduction under the section for deposits made for any member of the family.
- The maximum deduction allowed is Rs.100,000 for AY 2014-15 and Rs.150,000 for AY 2015-16, AY 2016-17, and AY 2017-18.
- Investments in PPF earn fixed annual compound interest. For FY 2016-17, an interest of 8.1% has been declared by the Ministry of Finance.
- PPF has 15-year tenure, from which the amount cannot be withdrawn prematurely.
- Partial withdrawals equivalent to the total of the last three years contribution to the PPF account is allowed, that too after completion of a set number of years.
- You can also take a loan against the total available amount in the account.
- Contribution to **EPF** not exceeding Rs.150,000 too earns tax benefit under Section 80C. 12% of the salary is invested in EPF. Currently, it is earning an interest rate of 8.8%.!

Income Tax Deduction on Investment in NSC or National Savings Certificates

Deductions on NSC are allowed in the year of their purchase.

- A maximum investment of Rs.150,000 can be made in NSC to claim deductions under Section 80C.
- NSCs are issued by the Post Office and have a lock-in time of 5 years.
- The compound interest earned on NSC annually is taxable. For the FY 2016-17, the compound interest is calculated at 8.1% p.a.

Income Tax Deduction on Investment in Tax Saving Fixed Deposits

- These fixed deposits have a fixed tenure of 5 years and cannot be withdrawn prematurely.
- They are eligible for deductions under Section 80C for a maximum investment of Rs.150,000.
- The rate of interest offered is at the discretion of the bank, but it is usually between 7% to 9%.
- The total interest earned becomes eligible for taxation upon the FDs maturity.
- FDs give us guaranteed returns with 100% capital security.

Income Tax Deduction on Investment in Equity Based Mutual Funds or ELSS

- Equity Linked Saving Scheme gets a Tax deduction under the section for a maximum investment of Rs.150,000.
- At least 65% of the ELSS funds are invested in the equity market.
- ELSS are one of the top tax saving instruments because not only do they offer a higher rate of returns, but they have the shortest lock-in time of 3 years amongst all tax-saving schemes.
- Also, the returns on the ELSS funds held for more than a year are considered Capital Gains as and are therefore 100% tax-free!
- Investing in a diverse ELSS portfolio through SIPs is the recommended option by financial and tax planners.

Income Tax Deduction on Investment in NPS or National Pension Scheme

The pension system is the Government's effort to afford pensions on retirement to working professional and those working in the unorganized sector.

- A maximum investment of Rs.150,000 can be claimed for deduction under Section 80C.
- As per Budget 2016, an extra Rs.50,000 can be claimed under Section 80CCD(1B) if the investment made by the individual is voluntary.
- An individual can choose from the various NPS plans as per his risk endurance.

The disadvantages that NPS suffers from are:

- NPS earnings are taxable at maturity.
- There is no guarantee of earnings with NPS.

Income Tax Deduction on Investment in ULIP or Unit Linked Insurance Plans

- It is an amalgamation of investment and insurance in the equity market.
- They are also eligible for deductions on a maximum investment of Rs.150,000 under Section 80C.
- They do not offer promised returns and suffer from vagueness about where the amounts are invested and what is deducted as expenses and commission.

Income Tax Deduction on Investment in Sukanya Samriddhi Yojna

- This scheme is specifically set up for investments made for girl child by her parent or the guardian.
- The amount eligible for tax deductions cannot exceed Rs.150,000. Compound interest of 8.6% p.a. is the current rate of interest enjoyed by this scheme.
- The account matures after 21 years. Qualified withdrawal of a maximum of 50% of last year's total balance is permitted when the girl reaches 18 years of age.

[Income Tax Deduction on Investment in SCSS or Senior Citizen Saving Scheme](#)

- This scheme is for citizens over 60 or a voluntary retiree of over 55 years of age.
- A maximum investment of Rs.150,000 earns an interest of 8.6% p.a. and tax benefit under Section 80C
- It has a lock-in requirement of 5 years.

Comparing the Popular Tax Saving Instruments under section 80C:

Comparing the Popular Tax Saving Instruments under section 80C:

Tax Saving Investment options Under Section 80C	Risk Profile	Interest (in %)	Guaranteed Returns	Lock-in Time (in years)
PPF	Risk free	8.1	Yes	15
NSC	Risk free	8.1	Yes	5
Tax Saving FDs	Risk free	7 - 9 approx	Yes	5
ELSS	Equity oriented	12 - 15 approx	No	3
NPS	Equity oriented	8 - 10 approx	No	Up Till retirement
ULIP	Equity oriented	8 - 10 approx	No	5

Sukanya Samriddhi Yojna	Risk free	8.6	Yes	21
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SCSS	Risk free	8.6	Yes	5
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Payments Earning Tax Benefits under Section 80C

- Premiums paid on Life Insurance during the FY for self, spouse, and children are eligible for deductions conditioned to the fact that paid premiums should not be over 10% of the assured sum. Life Insurance premiums paid any of the family members in case of an HUF are eligible for tax deductions under Section 80C. Children include non-dependent adult children, including a married daughter.
- Tuition fees paid for a maximum of two kids studying in India is allowed for tax deductions under Section 80C. A maximum of Rs.150,000 can be given as fees for any educational institute or university, college, or school. The only condition is that the course has to be full time.
- Repayment of the principal amount of the home loan is eligible for tax deductions. The loan can be for construction or purchase of residential property. Deductions are allowed for registration fees, transfer expenses, and stamp duty.

The income tax is a percentage of income which is paid to the government by the taxpayers for the betterment of the public in general. The income tax slabs are decided by the Finance Ministry

and the same is laid out in the budget every year. The income is categorized in different groups and the groups are known as tax slabs.

The income tax rates are declared in the Budget. Every individual has to adhere to the tax rates, which depend on the annual income of the individuals. The rates are mentioned in detail below:

Tax rates for individuals below 60 years of age:

Taxable income	Tax Rate
INR 0 to INR 2,50,000	Nil
INR 2,50,000 to INR 5,00,000	5%
INR 5,00,000 to INR 10,00,000	20%
Above INR 10,00,000	30%

Tax rates for individuals above 60 years but less than 80 years of age:

Taxable income	Tax Rate
INR 0 to INR 3,00,000	Nil
INR 3,00,000 to INR 5,00,000	5%
INR 5,00,000 to INR 10,00,000	20%
Above INR 10,00,000	30%

Tax rates for individuals above 80 years of age:

Taxable income	Tax Rate
INR 0 to INR 5,00,000	Nil

INR 5,00,000 to INR 10,00,000

20%

Above INR 10,00,000

30%

Additionally, there is a surcharge of 10% in case the total income exceeds INR 50 lakh and a surcharge of 15% in case the total income is more than INR 1 crore. There is also an education cess of 3% applicable over and above the surcharge.

Every individual is eligible for a deduction on the amount of income invested in specific securities. We have listed down all the deductions for AY 2018-19, which will help you prepare your income tax returns easily and make the most of the available tax deductions.

Here is a list of income tax deductions for AY 2018-19 as per various sections of the Income Tax Act, 1961:

Section 80C

This is the most important section for deductions for every taxpayer. The maximum exemption limit in the section is INR 1.5 lakh. There are various avenues like PPF, EPF, [term insurance](#), NPS, etc that could be claimed under section 80C. Below is the complete list:

- Public Provident Fund
- National Savings Certificate
- National Pension Scheme
- Employees' Provident Fund
- Tuition fees
- Post Office tax saving deposits of five year
- Bank deposit
- Life Insurance Premium
- Equity Linked Saving Schemes
- Principal repayment of home loan

- Sukanya Samriddhi Account Deposit Scheme
- Post Office Senior Citizens Savings Scheme

Section 80CCC

This section allows a maximum deduction of INR 1.5 lakh and it includes the contribution made to annuity plan of a life insurance provider for the purpose of obtaining pension from the fund.

Section 80CCD

This section includes the contribution to the Atal Pension Yojana and allows a deduction of a contribution up to 10% of the total salary of salaried employees and 20% of the gross income of non-salaried to the government-notified pension schemes. The contribution can be deducted from the taxable income under Section 80 CCD (1). In case the employer contributes to the scheme as well, the entire contribution amount can be claimed as a tax deduction under Section 80CCD (2).

It is important to remember that the complete deduction under Section 80C, Section 80CCC and Section 80CCD (1) cannot exceed INR 1.5 lakh in aggregate. The additional tax deduction amounting to INR 50,000 under the Section 80CCD (1B) is above this limit.

Section 80D

This section allows deductions on the health insurance premium paid by the taxpayer. The limit for the same is INR 25,000 for self, spouse, and children and an additional INR 25,000 for parents. The limit for senior citizens is INR 30,000. Senior citizens above the age of 80 can seek a deduction of INR 30,000 towards their medical expenditure. An amount of INR 5,000 per family can be claimed as preventive health checkup expenses. However, this is not over and above the individual limits specified.

Section 80DD

An amount of INR 75,000 may be claimed as a deduction for spending on medical treatments of dependents with a 40% disability. This limit is INR 1.25 lakh in case of severe disability.

Section 80DDB

Under this section, individuals who are below the age of 60 years may claim INR 40,000 for the treatment for specified critical ailments for self and dependents. The same limit is INR 60,000 for senior citizens and INR 80,000 for very senior citizens.

Section 80CCG

This section which offered the tax benefits of Rajiv Gandhi Equity Savings Scheme has been withdrawn but if an individual has claimed a deduction in FY 2016-17, you are eligible to continue with the same for the next two financial years.

Section 24B

This section allows individuals to claim a deduction for the loss under the head 'Income from House Property'. It allows a tax benefit on the repayment of the loan of a second house up to INR 2 lakh. The unclaimed amount of loss may be carried forward for 8 years and set off against house property income. Additionally, any interest paid on the housing loan is eligible for a tax benefit. Municipal taxes, interest paid on the loan taken for the house, and 30% of the net annual income is allowed as a deduction.

Section 80E

Interest on loan paid for education is eligible for deduction. Please note that principal repayment on the loan cannot be claimed as a deduction. The loan should have been taken for yourself, your children, and spouse or for an individual for whom you are a legal guardian. There is no limit on the amount of interest that can be claimed as a deduction.

Section 80EE

Individuals who are buying a home for the first time may claim an additional deduction of INR 50,000 on the home loan interest paid. This includes a clause that the loan should be sanctioned in or after FY 2016-17 and the amount of loan should be less than INR 35 lakh. Furthermore, the value of the house should not exceed INR 50 lakh and the individual should not own any other residential house under his name.

Section 80G

This section includes all the contributions made to charitable institutions as well as relief funds. The contribution should be made through cheque, cash or in draft. The amount of deduction eligible is INR 2,000. Moreover, for donations made to political parties, the same deduction could be claimed under 80GGC.

Section 80GG

The deduction amount for this section is INR 60,000 per annum and the section is applicable to only those who neither have the ownership of a residential house nor receive a house rent allowance. The amount of deduction will be the least of the following:

- 25% of the total income
- INR 5,000 per month
- An amount of 10% of the adjusted total income deducted from the rent paid

Section 80TTA

This section allows a deduction of INR 10,000 from the gross total income of individuals or Hindu Undivided Family. The deduction is allowed for the interest earned on the deposits made in a savings account in a bank, cooperative society or a post office. However, the deduction will not be application for the interest earned from fixed deposits in the bank.

Section 80U

This section allows deduction to individuals who are physically and mentally challenged.

It is advisable to plan the investment in advance in order to avoid the last-minute hassles. In case you are unable to invest in the right products, you would have to pay the entire tax depending on your income. The above list of income tax deductions will help you in tax planning and achieving your financial goals.

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