

# FINANCIAL ACCOUNTING & ANALYSIS

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# MEANING OF ACCOUNTING

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- Accounting is a discipline which records, classifies, summarizes and interprets financial information about the activities of a concern so that intelligent decisions can be made about the concern.
- The American Institute of Certified Public Accountants has defined the Financial Accounting as "the art of recording, classifying and summarizing in as significant manner and in terms of money transactions and events which in part, at least of a financial character, and interpreting the results thereof".
- American Accounting Association defines accounting as "the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.

# ATTRIBUTES OF ACCOUNTING :

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- (i) Recording : It is concerned with the recording of financial transactions in an orderly manner, soon after their occurrence In the proper books of accounts.
- (ii) Classifying : It Is concerned with the systematic analysis of the recorded data so as to accumulate the transactions of similar type at one place. This function is performed by maintaining the ledger in which different accounts are opened to which related transactions are posted.

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- (iii) Summarizing : It is concerned with the preparation and presentation of the classified data in a manner useful to the users. This function involves the preparation of financial statements such as Income Statement, Balance Sheet, Statement of Changes in Financial Position, Statement of Cash Flow, Statement of Value Added.
  - (iv) Interpreting : Nowadays, the aforesaid three functions are performed by electronic data processing devices and the accountant has to concentrate mainly on the interpretation aspects of accounting. The accountants should interpret the statements in a manner useful to action. The accountant should explain not only what has happened but also (a) why it happened, and (b) what is likely to happen under specified conditions.

# OBJECTIVES OF ACCOUNTING

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- 1.To keep systematic records :Accounting is done to keep a systematic record of financial transactions. In the absence of accounting there would have been terrific burden on human memory which in most cases would have been impossible to bear.
- 2.To protect business properties :Accounting provides protection to business properties from unjustified and unwarranted use.
- 3.To ascertain the operational profit or loss :Accounting helps in ascertaining the net profit earned or loss suffered on account of carrying the business.This is done by keeping a proper record of revenues and expense of a particular period.



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- 4.To ascertain the financial position of the business :The Profit and Loss Account gives the amount of profit or loss made by the business during a particular period.
  - 5.To facilitate rational decision making :Accounting these days has taken upon itself the task of collection, analysis and reporting of information at the required points of time to the required levels of authority in order to facilitate rational decision-making.
  - 6. Information System :Accounting functions as an information system for collecting and communicating economic information about the business enterprise.This information helps the management in taking appropriate decisions.

# ROLE AND IMPORTANCE OF ACCOUNTIN

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- Accounting plays an important and useful role by developing the information for providing answers to many questions faced by the users of accounting information :
- (1) How good or bad is the financial condition of the business?
- (2) Has the business activity resulted in a profit or loss ?
- (3) How well the different departments of the business have performed in the past?
- (4) Which activities or products have been profitable?
- (5) Out of the existing products which should be discontinued and the production of which commodities should be increased?

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- (6) Whether to buy a component from the market or to manufacture the same?
  - (7) Whether the cost of production is reasonable or excessive?
  - (8) What has been the impact of existing policies on the profitability of the business?
  - (9) What are the likely results of new policy decisions on future earning capacity of the business?
  - (10) In the light of past performance of the business how should it plan for future to ensure desired results.



# GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

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# MEANING

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- Accounting is the Language of business. To make the language convey the same meaning to all people, accountants all over the world developed certain rules, procedures and conventions known as Generally accepted accounting principles (GAAP).
- Generally accepted accounting principles (GAAP) refer to a common set of accounting principles, standards, and procedures issued by the Financial Accounting Standards Board (FASB).
- GAAP is a combination of authoritative standards (set by policy boards) and the commonly accepted ways of recording and reporting accounting information. GAAP aims to improve the clarity, consistency, and comparability of the communication of financial information.
- GAAP helps govern the world of accounting according to general rules and guidelines. It attempts to standardize and regulate the definitions, assumptions, and methods used in accounting across all industries.

# ACCOUNTING CONCEPTS

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- Accounting concepts include the assumptions and conditions on which the science of accounting is based. These are also known as accounting standards.

I. Business Entity

VII. Matching

II. Money Measurement

VIII. Realization

III. Going Concern

IX. Objective Evidence

IV. COST

X. Accrual

V. Dual Aspect

VI. Accounting Period

# ACCOUNTING CONVENTIONS

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- Accounting conventions include the customs and traditions that assist the accountants in preparing accounting statements.
  - An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity.
  - Conventions denote customs or traditions or usages which are in use since long. To be clear, these are nothing but unwritten laws. The accountants have to adopt the usage or customs, which are used as a guide in the preparation of accounting reports and statements. These conventions are also known as doctrine.
  - The basic difference between concepts and conventions is concepts are concerned with maintenance of accounts whereas conventions are applicable while preparing financial statements, i.e., Profit & Loss A/C and Balance Sheet.
- I. Consistency
  - II. Full Disclosure
  - III. Conservatism
  - IV. Materiality

# BUSINESS ENTITY CONCEPT

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- The business and its owner(s) are two separate existence entity. Any private and personal incomes and expenses of the owner(s) should not be treated as the incomes and expenses of the business .
- Example:
- Insurance premiums for the owner's house should be excluded from the expense of the business The owner's property should not be included in the premises account of the business
- Any payments for the owner's personal expenses by the business will be treated as drawings and reduced the owner's capital contribution in the business.



# MONEY MEASUREMENT

- **All transactions of the business are recorded in terms of money . It provides a common unit of measurement.** Examples : Market conditions, technological changes and the efficiency of management would not be disclosed in the accounts.
- This concept assumes that all business transactions must be in terms of money, that is in the currency of a country.
- In our country such transactions are in terms of rupees.
- Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts.
- For example, sale of goods worth Rs.200000, Rent Paid Rs.10000 etc. are expressed in terms of money, and so they are recorded in the books of accounts.
- But the transactions which cannot be expressed in monetary terms are not recorded in the books of accounts.
- For example, sincerity, loyalty are not recorded in books of accounts because these cannot be measured in terms of money although they do affect the profits and losses of the business concern.

# GOING CONCERN

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- **This concept states that a business firm will continue to carry on its activities for an indefinite period of time.** Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future. This is an important assumption of accounting, as it provides a basis for showing the value of assets in the balance sheet.
- Possible losses from the closure of business will not be anticipated in the accounts.
- Prepayments, depreciation provisions may be carried forward in the expectation of proper matching against the revenues of future periods.
- Fixed assets are recorded at historical cost.

# COST CONCEPT

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- **Assets should be shown on the balance sheet at the cost of purchase instead of current value.**
- It states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price.
- It means that fixed assets like building, plant and machinery, furniture, etc are recorded in the books of accounts at a price paid for them.
- Example : The cost of fixed assets is recorded at the date of acquisition cost. The acquisition cost includes all expenditure made to prepare the asset for its intended use. It included the invoice price of the assets, freight charges, insurance or installation costs

# DUAL ASPECT

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- Dual aspect is the foundation or basic principle of accounting.
- According to this concept, every financial transaction involves a two fold aspect, (a) yielding a benefit and giving of that benefit. Thus a giver must implies a receiver and a receiver must implies a giver.
- The receiving account is termed as debtor and the giving account is termed as creditor. Thus every debit must have a corresponding credit.
- The duality concept is commonly expressed in terms of fundamental accounting equation  
:Assets = Liabilities + Capital

# ACCOUNTING PERIOD

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- All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept.
- Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals.
- This is necessary for different purposes like, calculation of profit, ascertaining financial position, tax computation etc.



# MATCHING

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- The matching concept states that the revenue and the expenses incurred must belong to the same accounting period.
- So once the revenue is realised, the next step is to allocate it to the relevant accounting period. This can be done with the help of accrual concept. If the revenue is more than the expenses, it is called profit. If the expenses are more than revenue it is called loss. This is what exactly has been done by applying the matching concept.
- Therefore, the matching concept implies that all revenues earned during an accounting year, whether received/not received during that year and all cost incurred, whether paid/not paid during the year should be taken into account while ascertaining profit or loss for that year.

It guides how the expenses should be matched with revenue for determining exact profit or loss for a particular period.

It is very helpful for the investors/shareholders to know the exact amount of profit or loss of the business.

# REALIZATION

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- This concept states that revenue from any business transaction should be included in the accounting records only when it is realized.
  - The term realization means creation of legal right to receive money. Selling goods is realization, receiving order is not.
  - In other words, it can be said that : Revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both has been created.
  - **The concept of realization states that revenue is realized at the time when goods or services are actually delivered.**
  - Examples:
    - A Jeweler received an order to supply gold ornaments worth Rs.500000. They supplied ornaments worth Rs.200000 up to the year ending 31st December 2005 and rest of the ornaments were supplied in January 2006. The revenue for the year 2005 for a Jeweler is Rs.200000. Mere getting an order is not considered as revenue until the goods have been delivered.
    - Bansal sold goods for Rs.1,00,000 for cash in 2006 and the goods have been delivered during the same year

# OBJECTIVE EVIDENCE

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- The objectivity principle states that accounting will be recorded on the basis of objective evidence. **Objective evidence means that different people looking at the evidence will arrive at the same values for the transaction.** Simply put, this means that accounting entries will be based on fact and not on personal opinion or feelings.
- The source document for a transaction is almost always the best objective evidence available. The source document shows the amount agreed to by the buyer and the seller, who are usually independent and unrelated to each other.

# ACCRUAL

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- The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. **It means that revenues are recognized when they become receivable though cash is received or not received and the expenses are recognized when they become payable though cash is paid or not paid.** Both transactions will be recorded in the accounting period to which they relate.
- Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses. The accrual concept under accounting assumes that revenue is realised at the time of sale of goods or services irrespective of the fact when the cash is received.

# CONSISTENCY

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- The convention of consistency means that **same accounting principles should be used for preparing financial statements year after year**. A meaningful conclusion can be drawn from financial statements of the same enterprise when there is comparison between them over a period of time. But this can be possible only when accounting policies and practices followed by the enterprise are uniform and consistent over a period of time. If different accounting procedures and practices are used for preparing financial statements of different years, then the result will not be comparable.



# FULL DISCLOSURE

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- Convention of full disclosure Convention of full disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information. Adequate means sufficient set of information to be disclosed. Fair indicates an equitable treatment of users. Full refers to complete and detailed presentation of information. Thus, the convention of full disclosure suggests that every financial statement should fully disclose all relevant information. Let us relate it to the business.
- The business provides financial information to all interested parties like investors, lenders, creditors, shareholders etc. The shareholder would like to know profitability of the firm while the creditor would like to know the solvency of the business. In the same way, other parties would be interested in the financial information according to their requirements. This is possible if financial statement discloses all relevant information in full, fair and adequate manner.

# CONSERVATISM

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- This convention is based on the principle that “**Anticipate no profit, but provide for all possible losses**”. It provides guidance for recording transactions in the books of accounts. It is based on the policy of playing safe in regard to showing profit .
- The main objective of this convention is to show minimum profit. Profit should not be overstated. If profit shows more than actual, it may lead to distribution of dividend out of capital. This is not a fair policy and it will lead to the reduction in the capital of the enterprise.
- Thus, this convention clearly states that profit should not be recorded until it is realised. But if the business anticipates any loss in the near future provision should be made in the books of accounts for the same. . **For example, valuing closing stock at cost or market price whichever is lower, creating provision for doubtful debts, discount on debtors, writing off intangible assets like goodwill, patent, etc.** The convention of conservatism is a very useful tool in situation of uncertainty and doubts.

# MATERIALITY

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- The convention of materiality states that, **to make financial statements meaningful, only material fact i.e. important and relevant information should be supplied to the users of accounting information.**
- The materiality of a fact depends on its nature and the amount involved. Example, minor expenditure of Rs20 for the purchase of waste basket may be treated as expense of the period rather than asset.
- Material fact means the information of which will influence the decision of its user.

# ACCOUNTING EQUATION

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- Dual concept states that 'for every debit, there is a credit'. Every transaction should have twosided effect to the extent of same amount. This concept has resulted in accounting equation which states that at any point of time assets of any entity must be equal (in monetary terms) to the total of owner's equity and outsider's liabilities.
- In other words, accounting equation is a statement of equality between the assets and the sources which finance the assets and is expressed as :
- $\text{Assets} = \text{Sources of Finance}$  Assets may be tangible e.g. land, building, plant, machinery, equipment, furniture, investments, cash, bank, stock, debtors etc. or intangible e.g. patent rights, trade marks, goodwill etc.,

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- Sources include internal i.e. capital provided by the owner and external i.e. liabilities. Liabilities are the obligations of the business to others/outside. The above equation gets expanded.  
$$\text{Assets} = \text{Liabilities} + \text{Capital}$$
All transactions of a business can be referred to this equation :
  - $\text{Assets} = \text{Liabilities} + \text{Owner's equity}$
  - To further explain the transaction of revenues, expenses, losses and gains, the equation can be expanded thus :
  - $\text{Assets} + \text{Expenses} = \text{Liabilities} + \text{Revenue} + \text{Owner's equity}$  or
  - $\text{Assets} = \text{Liabilities} + (\text{Revenue} - \text{Expenses}) + \text{Owner's equity}$

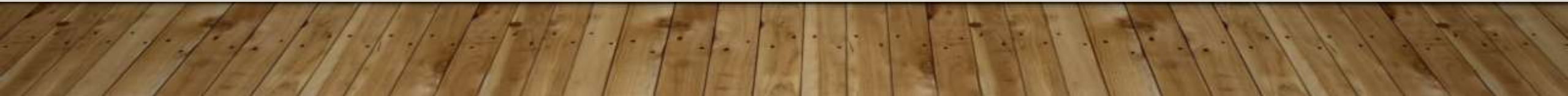


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- Illustration
  - 1. Commenced business with cash Rs. 50,000
  - 2. Purchased goods for cash Rs. 20,000 and on credit Rs. 30,000
  - 3. Sold goods for cash Rs. 40,000 costing Rs. 30,000
  - 4. Rent paid Rs. 500
  - 5. Bought furniture Rs. 5,000 on credit
  - 6. Bought refrigerator for personal use Rs. 5,000

# JOURNAL, LEDGER AND TRIAL BALANCE

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# JOURNAL

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- Business transactions are recorded either in journal or subsidiary books.
- The word Journal is derived from the French word “jour” means a day. Journal therefore means a book in which daily transactions are recorded
- Journal is the book of original entry because transactions are first written in journal from which it is posted to ledger at any convenient time.
- Journal Entry means recording business transactions in a chronological order in journal.
- The transaction is analyzed to determine which account is to be debited and which account to be credited.

# Proforma of Journal

Date	Particulars	L.F.	Dr. {}	Cr. {}
XX-XX-XXXX	Name of the a/c Dr. To Name of the a/c (being _____)		XXXX	XXXX

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- Date: The date of the transaction on which it takes place.
  - Particulars: The name of the accounts to be debited is written first, then the names of the accounts to be credited, and lastly the narration is entered.
  - L.F.(Ledger Folio): In it are entered the page numbers on which the various accounts appear in the ledger.
  - Debit (Amount): The amount to be debited against the 'Dr.' Account is written along with the nature of currency.
  - Credit (Amount): The amount to be credited against the 'Cr.' Account is written along with the nature of currency.



# JOURNALIZING

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- Journalizing is the process of recording journal entries in the Journal.
- It is a systematic act of entering the transaction in a day book in order of their occurrence i.e., date-wise or event-wise.
- At the time of Journalizing of the transactions, when an account is debited it is denoted by 'Dr.' and crediting of an account by 'To'.
- Journalizing Steps:
- Some steps are followed in Journalizing
- (i) Find out what accounts are involved in business transaction.
- (ii) Ascertain what is the nature of accounts involved?
- (iii) Ascertain the golden rule of debit and credit is applicable for each of the accounts involved. (iv) Find out what account is to be debited which is to be credited

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- .(v)Record the date of transaction in the “Date Column”.
  - vi)In the ‘Particulars Column’ along with the word ‘Dr.’ on the same line against the name of the account, the amount to be debited in the ‘Debit Amount column’.
  - (vii)Record the name of the account to be credited in the next line preceded by the word ‘To’ at a few space towards right in the ‘Particulars Column’ and the amount to be credited in the ‘Credit Amount Column’ in front of the name of the account.
  - viii)Record narration (i.e. a brief explanation of the transaction) within brackets in the following line in ‘Particulars Column’.
  - ix) A thin line is drawn all through the particulars column to separate one Journal entry from the other and it shows that the entry of a transaction has been completed.
  - x) After it, ledger posting would be posted.

Journalize the following transactions:-

1. Frozen started business with a capital of Rs. 10,000.
2. He purchased goods from Mohan on credit Rs. 2,000.
3. He paid cash to Mohan Rs. 1,000.
4. He sold goods to Suresh Rs. 2,000.
5. He received cash from Suresh Rs. 3,000.
6. He further purchased goods from Mohan Rs. 2,000.
7. He paid cash to Mohan Rs. 1,000.
8. He further sold goods to Suresh Rs. 2,000.
9. He received cash from Suresh Rs. 1,000

## JOURNAL

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
	Cash Account Dr. To Capital Account (Being commencement of business)		10,000	10,000
	Purchase Account Dr. To Mohan (Being purchase of goods on credit)		2,000	2,000
	Mohan Dr. To Cash (Being payment of cash to Mohan)		1,000	1,000
	Suresh Dr. To Sales (Being good sold to Suresh)		2,000	2,000
	Cash Account Dr. To Suresh (Being cash received from Suresh)		3,000	3,000
	Purchases Account Dr. To Mohan (Being purchase of goods from Mohan)		2,000	2,000
	Mohan Dr. To Cash Account (Being payment of cash to Mohan)		1,000	1,000
	Suresh Dr. To Sales Account (Being goods sold to Suresh)		2,000	2,000
	Cash Account Dr. To Suresh (Being cash received from Suresh)		1,000	1,000
			24,000	24,000



# POINTS TO BE NOTED

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- **1. Capital A/C-** The amount of money / money worth introduced in business is called Capital should be debited to Cash/ stock of goods/ Property Account and credited to the Proprietors Capital Account, as the entity of the business is separate from business.
- **2. Drawings-** When businessman withdraw cash or goods for personal use (called drawings), it should be debited to drawing account and credited to cash/purchase a/c.
- **3. Cash Discount:** It is allowed by creditors to debtors as an incentive to the latter to make an early payment. Cash discount is always recorded in the books of account and a separate account is opened in the ledger. Being the nominal account, it is debited with loss on discount allowed and credited with the gain on discount received.
- **Ex:** If the seller allows 2% discount for payment within a week. On a bill of Rs 1000, the customer would thus pay Rs 980 if payment is made within a week, otherwise he would have to pay full amount of the bill.

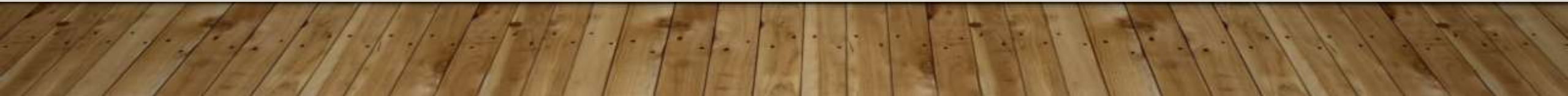


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- **4. Trade Discount:** It is the deduction allowed to the manufacturer to the wholesaler or the retailer on the gross value or list price of goods to enable the buyers to sell the goods further (at list price) and yet make a profit for himself. Trade discounts are not recorded in any account as it is the deduction in the invoice itself from the gross value of goods.

# TRIAL BALANCE & RECTIFICATION OF ERRORS

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# TRIAL BALANCE

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- Is a statement of balances remaining in each and every ledger account classified as to debit and credit entry balances.
- According to the principle of double entry accounting system, the total of the debit side should be equal to the total of credit side
- If both sides of the Trial Balance agree, it is an indication that at least the accounts prepared are arithmetically correct
- By the same principle it can be taken that a disagreement in the Trial Balance is an indication that there are errors in the account prepared
- However, it should be noted that even an agreed Trial Balance is not a sure test of accuracy in the books of accounts

# CLASSIFICATION OF ERRORS

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- These are:
- A. Errors that are not disclosed by the Trial Balance
- B. Errors that are disclosed by the Trial Balance
- **A. Errors that are not disclosed by the Trial Balance**
- 1. Errors of omission
- 2. Errors of commission
- 3. Errors of principle
- 4. Compensating errors
- 5. Errors of original entry
- 6. Errors of complete reversal

# ERRORS OF OMISSION

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- These are transactions that are completely omitted from the books of accounts
- Reasons may be that at the time of entering the books of accounts an invoice might have been misplaced, blown away or duplicate copies were not made
- A sale of Rs.400 to Pinkal has been completely omitted from the accounts.
- The correcting entries should be: Original entry: Pinkal A/c Dr 400
  - To Sales A/c 400
- Wrong entry: No entry



# ERRORS OF COMMISSION

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- This is where amounts are entered on the right side of the account but on the wrong debtor or creditors account
- This is due to the similarity in names
- Example, goods sold to B Bunny were wrongly entered in B Bounty account amount being
- 450 000
- A purchase of goods from C.Lee has been posted to the credit side of C.Lai's account in error, amounting to Rs.500. The correcting entries should be:
  - Original entry: Purchase A/c Dr 500
    - To C Lee A/c 500
  - Wrong entry: Purchase A/c Dr 500
    - To C Lai A/c 500

# ERRORS OF PRINCIPLE

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- These errors will not affect the agreement of the Trial Balance as they arise from debiting and crediting of wrong heads of accounts as would be inconsistent of fundamental principles of double entry accounting.
- These errors offend against a basic idea or principle of separating revenue from capital expenditure or income
- Example, a calculator bought in business for use is entered in the purchases account instead of office equipment account
- Office equipment purchased for Rs.1,000 in cash has been debited to an office expenses account. The correcting entries should be:
  - Original entry: Office Equipment A/c
    - Dr 1000 To Cash A/c 1000
  - Wrong entry: Office Expenses A/c Dr 1000
    - To Cash A/c 1000

# COMPENSATING ERROR

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- This is where an error on the debit side of an account has been compensated for by a similar error on the credit side of another account
- The purchases account was under cast by Rs.2,200, and the sales account was also under cast by Rs.2,200. The correcting entries should be:
  - Purchases 2,200 Dr
  - To Sales 2,200
- Purchases and sales accounts were undercast by Rs.2,200, now corrected.

# ERRORS OF ORIGINAL ENTRY

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- This is made in the books of prime entry and carried forward to the ledger accounts
- A payment of Rs.1,200 to a creditor, Tushar Patel, has been entered as both a debit and credit as Rs.1,000. The correcting entries should be:
- Original entry: Tushar Patel a/c Dr 1200
  - To Bank a/c 1200
- Wrong entry: Tushar Patel a/c Dr 1000
  - To Bank a/c 1000

# COMPLETE REVERSAL OF ENTRIES

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- This is where correct amounts are entered on the wrong side of each account
- The purchase of goods on credit from Chintan for Rs.6000 was entered on the debit side of Chintan's account and the credit side of the purchases account.
- The correcting entries should be: Original entry: Purchase A/c Dr 6000
  - To Chintan A/c 6000
- Wrong entry: Chintan A/c Dr 6000
  - To Purchase A/c 6000



# ERRORS DISCLOSED BY TRIAL BALANCE

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- Errors of calculation, making errors in arithmetic
- Errors of omission of one entry or recording only half an entry, such as a debit without a corresponding credit or, vice versa
- Posting to the wrong side of an account. For example recording both entries on the same side such as two debits instead of a debit and a credit
- Errors in amounts, such as recording one or more amounts incorrectly.

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- i) An item omitted to be posted from a subsidiary book into ledger
  - li) Posting of wrong amount to a ledger account
  - lii) Posting an amount to the wrong side of the ledger account
  - Iv) Wrong additions or balancing of ledger accounts.
  - v) Wrong totaling of subsidiary book
  - Vi) An item in the subsidiary book posted twice in the subsidiary book
  - Vii) Omission of a balance of an account in the trial balance.
  - Viii) Balance of some account wrongly entered in the trial balance
  - Ix) An error in the totaling of the trial balance.

# SUSPENSE ACCOUNT

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- When the trial balance does not agree, the amount of the difference is entered in a suspense account.
- 21. Rs. Rs. Total balances extracted 90 100 Suspense account 10 100 100

# SUBSIDIARY BOOKS

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# MEANING

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- Subsidiary Books are the books that record the transactions which are similar in nature in an orderly manner. They are also known as special journals or Daybooks. In big organizations, it is not easy to record all the transactions in one journal and post them into various accounts. So for the easy and accurate recording of all the transactions, the journal is subdivided into many subsidiary books. For every type of transaction, there is a separate book.
- The subdivisions of journals into various books recording transactions of similar in nature are called subsidiary book.

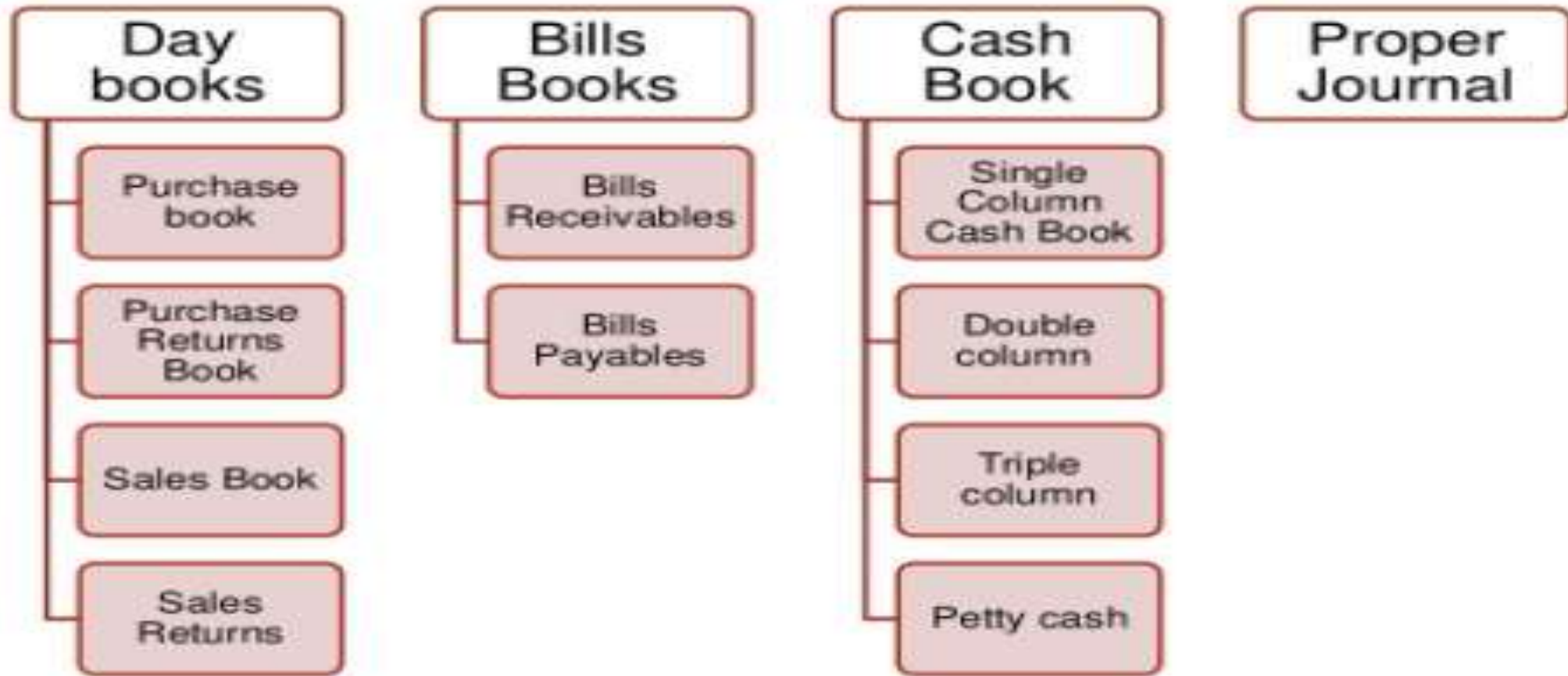


# TYPES OF SUBSIDIARY BOOKS

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- There are basically 8 types of subsidiary books that are used for recording different types of transactions.
- Cash Book
- Purchase Book
- Sales Book
- Purchase Return Book
- Sales Return Book
- Bills Receivable Book
- Bills Payable Books
- Journal Proper

# KINDS OF SUBSIDIARY BOOKS



# ADVANTAGES AND DISADVANTAGES

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- **Advantages**

- posting of each entry becomes easy.
- as one type of transaction are recorded in one books so it becomes convenient to locate any desired transaction.
- important descriptions about the transaction is also made in the related books so a lot of information related to the transaction is easily accessible.

- **Disadvantages**

- They may be expensive in case of a small business as in a small business it is best to keep journal.
- it requires some basic knowledge of accountancy as if any of the entries are recorded incorrect then it will be a problem or they need to be rectified

# CASH BOOK

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- The first and most important subsidiary book is the cash book. It records all the transactions related to cash and bank receipts and payments. There are 3 types of cash books which are maintained by an organization. They are:
- **Single Column Cash Book:** A single column cash book is like a ledger account. It contains a debit side and a credit side. All Cash receipts are recorded in the debit side,

Format of Single Column Cash Book:

Cash Book (Single Column)							
Dr.				Cr.			
Date	Particulars	L.F.	Cash	Date	Particulars	L.F.	Cash

ash book.







# POINTS TO BE CONSIDERED IN THREE COLUMN CASH BOOK

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- 1. Cash Paid into bank
- When cash is paid into bank, it should be debited to Bank A/C by entering the amount in the bank column on the debit side of the cash book as “To Cash” and credited to cash A/C by entering the amount in the cash column on the credit side of the cash book as “ BY Bank” to record the fact of cash having gone out of the business. This Transaction need no posting in the Ledger as both accounts (ie, cash and bank account) involved appear in the Cash Book , so letter “C” is written in the L.F column against this entry on each side of the cash book. Such type of entry appearing both side of Cash book is known as **Contra Entry**.
- 2. Cash withdrawn from bank.
- When cash is withdrawn from bank for office use, the entry would be to debit the cash account by entering entering the amount in the cash column on the receipt side of the cash book as “To Bank” and to credit the bank column as “By Cash”. No posting in ledger is required for this transaction as both accounts( Cash and Bank account) involved in the cash book.

- 
- **3. Receipt of Cheque:** If a cheque is received and kept in cash box (ie, not sent to bank for collection), it should be debited in cash column, but if it is immediately sent to bank for collection, the debit should be given to bank column.

**4. Payment by Cheque:** Such payment should be credited in the bank column of the cash book.

**5. Dishonored Cheque:** If a cheque sent to bank for collection is dishonoured, it should be credited in the bank column of the cash book to cancel the previous debit given to the bank column.

**6. Bank Charges and payment made by bank on behalf of the customer.** These entries should entered in the bank column on the credit side of the cash book as they reduced the balance at bank.

- 
- Posting Three column Cash book:
  - 1. Opening balance of cash and bank columns are not posted to any account as they come in Cash Book from the opening entry in the journal
  - 2. Contra entries are not posted to any account as the dual aspect in respect of them has been compiled in the cash book itself.
  - 3. Remaining items appearing in the cash book and totals of discount columns are posted in the same way as we have described in case of Two Column Cash book.

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- **Purchase Book**

- Purchase Book is a subsidiary book that is used to record all the transactions related to credit purchases. The purchases of the asset are never recorded in the purchase book.
- Format of Purchase Book:

Purchase Book				
Date	Particulars	Inward Invoice No.	L.F.	Amount



---

- **Sales Book**

- The Sales Book records all the transactions related to credit sales. The sales book cannot record the sale of assets. The sales book format is given below.

Sales Book				
Date	Particulars	Outward Invoice No.	L.F.	Amount

---

- **Purchase Return Book**

- The purchase return book, also known as the return outward book, is used to record transactions of all the returns made to the supplier. A debit note is issued against every return and is recorded in the Purchase Return Book.
- Format of Purchase Return Book:

Purchase Return Book					
Date	Particulars	Debit Note No.	L.F.	Details	Amount

---

- **Sales Return Book**

- The sales return book records all the transactions related to inward returns. It is also known as a return inward book. When the customer returns goods, a credit note is issued to the customer for every return, and it is recorded in the Sales Return Book.

- Sales Return Book Format:

Sales Return Book					
Date	Particulars	Credit Note No.	L.F.	Details	Amount

---

- **Bills Receivable Book**

- The Bills Receivable Book records all the transactions of bills drawn in favour of the business. The total of the bills receivable book is posted on the debit side of the Bills Receivable account. The Format of Bills Receivable Book is as follows.

Bills Receivable Book						
Date of Bill	Bill No.	Acceptor	From	Terms	Due Date	Amount

---

- **Bills Payable Book**

- The Bills Payable Book records all the transactions related to bills that are drawn on the business and are payable by the business. The Bills Payable Books Format is as follows.

Bills Payable Book						
Date of Bill	Bill No.	Drawee	Payee	Terms	Date of Maturity	Amount



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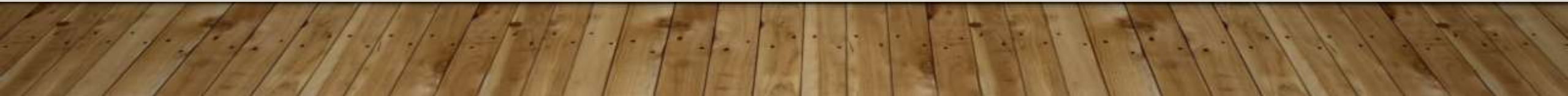
- **Journal Proper**

- There are certain transactions that cannot be recorded in any of the above-mentioned books; these transactions are termed as miscellaneous transactions. So the Journal Proper is used to record all the miscellaneous transactions. It includes transactions such as credit purchase and sale of assets, depreciation etc.

# FINAL ACCOUNTS

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BY: SANJUKTA MOHANTY



# FINAL ACCOUNTS MEANING

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- Final accounts are those accounts that are prepared by a joint stock company at the end of a fiscal year. The purpose of creating final accounts is to provide a clear picture of the financial position of the organization to its management, owners, or any other users of such accounting information.
- Final account preparation involves preparing a set of accounts and statements at the end of an accounting year. The final account consists of the following accounts:
  - 1. Trading and Profit and Loss Account
  - 2. Balance Sheet
  - 3. Profit and Loss Appropriation account
- From Trial Balance. Final Accounts include the preparation of : 1) Trading 2) Profit & Loss account 3) Balance Sheet as these three statements are prepared to give the final results of the business, all these are collectively called as final accounts. Accounting cycle finally ends with these statements

# ACCOUNTING CYCLE

## TRANSACTIONS



# OBJECTIVES OF FINAL ACCOUNT PREPARATION

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- Final accounts are prepared with the following objectives:
  - 1.To determine profit or loss incurred by a company in a given financial period
  - 2.To determine the financial position of the company
  - 3.To act as a source of information to convey the users of accounting information (owners, creditors, investors and other stakeholders) about the solvency of the company.



- 
- Steps in the Process of Finalization of Accounts
  - **A. For Trading Concerns:**
    - 1. Trading Account.
    - 2. Profit and Loss Account.
    - 3. Balance Sheet.
  - **B. For Manufacturing and Trading Concerns:**
    - 1. Manufacturing Account.
    - 2. Trading Account.
    - 3. Profit and Loss Account.
    - 4. Balance Sheet.

# PREPARATION OF FINANCIAL STATEMENTS

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- Profitability Statement – This statement is related to a complete accounting period. It shows the outcome of business activities during that period in a summarized form. The activities of any business will include purchase, manufacture, and sell.
- Balance Sheet – Business needs some resources which have longer life (say more than a year). Such resources are, therefore, not related to any particular accounting period, but are to be used over the useful life thereof. The resources do not come free. One requires finance to acquire them. This funding is provided by owners through their investment, bank & other through loans, suppliers by way of credit terms. The Balance Sheet shows the list of resources and the funding of the resources i.e. assets and liabilities (towards owners and outsiders). It is also referred as sources of funds (i.e. liabilities & capital) and application of funds (i.e. assets).

# TRADING ACCOUNT:

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- It is an account which is prepared by a merchandising concern which purchases goods and sells the same during a particular period. It shows the overall results of purchasing and selling of goods. ' It includes all the direct expenses incurred in the business.
- The purpose of it to find out the gross profit or gross loss which is an important indicator of business efficiency. The difference between sales and cost of good sold is Gross Profit.
- $\text{Gross Profit} = \text{Sales} - \text{Cost of Goods Sold}$
- $\text{Gross Profit} = \text{Sales} - (\text{Opening Stock} + \text{Net Purchases} + \text{Direct Expenses} - \text{Closing Stock})$
- $\text{Gross Profit} = \text{Sales} - \text{Opening Stock} - \text{Net Purchases} - \text{Direct Expenses} + \text{Closing Stock}$
- $\text{Opening Stock} + \text{Net Purchases} + \text{Direct Expenses} + \text{Gross Profit} = \text{Sales} + \text{Closing Stock}$
- The left hand side of this equation represent debit side and the right hand side of the equation is credit side of trading account.

- 
- The following items will appear in the debit side of the Trading Account:
  - (i) Opening Stock: In case of trading concern, the opening stock means the finished goods only. The amount of opening stock should be taken from Trial Balance.
  - (ii) Purchases: The amount of purchases made during the year. Purchases include cash as well as credit purchase. The deductions can be made from purchases, such as, purchase return, goods withdrawn by the proprietor, goods distributed as free sample etc.
  - (iii) Direct expenses: it means all those expenses which are incurred from the time of purchases to making the goods in suitable condition. This expenses includes freight inward, octroi, wages etc.
  - (iv) Gross profit: If the credit side of trading A/c is greater than debit side of trading A/c gross profit will arise

- 
- The following items will appear in the credit side of Trading Account:
  - (i) Sales Revenue: The sales revenue denotes income earned from the main business activity or activities. The income is earned when goods or services are sold to customers. If there is any return, it should be deducted from the sales value. As per the accrual concept, income should be recognized as soon as it is accrued and not necessarily only when the cash is paid for. The Accounting standard 7 (in case of contracting business) and Accounting standard 9 (in other cases) define the guidelines for revenue recognition. The essence of the provisions of both standards is that revenue should be recognized only when significant risks and rewards (vaguely referred to as ownership in goods) are transferred to the customer. For example, if an invoice is made for sale of goods and the term of sale is door delivery; then sale can be recognized only on getting the proof of delivery of goods at the door of customer. If such proof is pending at the end of accounting period, then this transaction cannot be taken as sales, but will be treated as unearned income.



- 
- (ii) Closing Stocks: In case of trading business, there will be closing stocks of finished goods only. According to convention of conservatism, stock is valued at cost or net realizable value whichever is lower.
  - (iii) Gross Loss: When debit side of trading account is greater than credit side of trading account, gross loss will appear.

## Trading Account

(For the year ended...)

Dr.

Cr.

Particulars	Amount	Particulars	Amount
To Opening stock	Xxx	By Sales	xxx
To Purchases	xxx	Less: Return Inwards	<u>(xxx)</u>
Less: Return Outwards	<u>(xxx)</u>	By Closing stock	Xxx
To Wages	Xxx	By Gross Loss	Xxx
To Carriage Inwards	Xxx		
To Freight Inwards/cartage	Xxx		
To Gross Profit c/d	Xxx		
	<u>xxx</u>		<u>xxx</u>

# CAPITAL AND REVENUE EXPENSES

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- Capital expenditure means those expenses whose benefit accrues over a long period of time i.e. is more than a year. eg: expenses made on fixed assets.
- Revenue expenses are those whose benefit expires within a year.

# PROFIT AND LOSS ACCOUNT:

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- Profit and Loss account shows all incomes and indirect expenses related to business. ' Indirect expenses include those expenses such as administrative, selling and distribution expenses that are required for the operation of business.
- The incomes and expenses relating to office or administration, sales and distribution and interest are recorded in P &L A/c.
- The profit or loss found out from P & L A/c is called net profit or net loss respectively.
- net profit / loss is transferred to the balance sheet by adding / deducting it from the capital of the owner.

# ITEMS ON DEBIT SIDE OF PROFIT AND LOSS ACCOUNT

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- Gross loss: It is transferred from the Trading account.
- Salaries: It refers to the amount paid to the employees as their salaries.
- Interest paid: It refers to the amount paid as interest on loans.
- Commission paid: It refers to the amount paid as commission to the agents.
- Repairs: Repairs and small renewals or replacements relating to plant and machinery.
- Trade expenses: It refers to the amount spent on various number of small but important expenses related to business.
- Depreciation: It is an expense due to wea



- 
- Printing and stationary: It refers to the amount spent on printing of bills, invoices, registers, files and letter heads.
  - Advertisements: It refers to the amount spent for attracting customers to buy the products. '
  - Bad debts: It refers to the amount, which is not paid by the debtors to whom the goods were sold on credit.
  - Discount: It refers to the amount, which is reduced from the list price of goods.
  - Samples: Samples are distributed free of charge to push up sales.

# ITEMS ON CREDIT SIDE OF PROFIT AND LOSS ACCOUNT

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- Gross profit: It is transferred from the Trading account.
- Interest received: It refers to the amount received as interest on investments.
- Commission received: It refers to the commission earned by the business for giving business to others.
- Apprentice Premium: This the amount charged from a person to whom training is given by the business. It's a gain and hence credited to P&L account.

**ABC Company**  
**Profit and Loss Account**  
**For the Year Ended 31st Dec.**

	\$		\$
Gross Loss (Transferred from Trading A/c)	xxxx	Gross Profit (Transferred from Trading A/c)	xxxx
Office and Administration Expenses		Commission Received	xxxx
Salaries	xxxx	Rent Received	xxxx
Rent, Rates, and Taxes	xxxx	Interest Received	xxxx
Postage and Telegram	xxxx	Discount Received	xxxx
Telephone Charges	xxxx	Discount from Creditors	xxxx
Printing and Stationery	xxxx	Discount on Purchases	xxxx
Office Electricity	xxxx	Dividend Received	xxxx
Insurance	xxxx	Interest on Drawings	xxxx
Legal Charges	xxxx	Reserve for Discount on Creditors	xxxx
Marketing and Selling Expenses		Interest on Renewal of Bills	xxxx
Carriage outwards	xxxx	Bad Debts Recovered	xxxx
Freight Outwards	xxxx	Provision for Bad Debts (Cr.)	xxxx
Sales Salaries	xxxx	Royalty Received	xxxx
Advertisement	xxxx	Apprentice Premium	xxxx
Godown Rent	xxxx	Miscellaneous Income	xxxx
Commissions	xxxx	Sundry Income	xxxx
Discount Allowed	xxxx		
Bad Debts	xxxx		
Financial and Other Expenses			
Bank Charges	xxxx		
Interest	xxxx		
Depreciation	xxxx		
Repairs and Maintenance	xxxx		
Audit Fees	xxxx		
Loss by Theft, Accident, and Fire	xxxx		
Miscellaneous and Sundry Expenses	xxxx		
Net Profit Transferred to Capital	xxxx	Net Loss (Transferred to Capital)	xxxx

FROM THE FOLLOWING BALANCES EXTRACTED AT THE CLOSE OF THE YEAR ENDED 31<sup>ST</sup> MARCH 2003. PREPARE PROFIT AND LOSS ACCOUNT OF MR ASHOK AND SON AS AT THAT DATE:

			179
	Rs.		Rs.
Gross Profit-	1,01,000	Discount (Dr.)	500
Carriage Outward	2,500	Apprentice Premium (Cr.)	1,500
Salaries	5,500	Printing & Stationery	250
Rent	4,100	Rates & Taxes	350
Fire Insurance Premium	900	Travelling Expenses	200
Bad Debts	2,100	Sundry Trade Expenses	300
Income Tax Paid	3,500	Rent received on sub-letting	1,000
Life Insurance Premium	3,000		
<b>Solution</b>			



# MANUFACTURING ACCOUNT

---

- Those concern which convert the raw materials into finished goods are required to find out the cost of goods manufactured besides gross and net profit of the concern. These are manufacturing cum trading concerns.
- In order to find out the cost of goods manufactured, these concerns firstly prepare Manufacturing Account and then prepare the trading and Profit and Loss Account.
- The main objectives of Manufacturing Account is to show:
  - 1) Cost of finished goods produced
  - 2) constituent items thereof such as cost of material consumed, productive wages, direct and indirect expenses.



# DEBIT SIDE OF MANUFACTURING ACCOUNT

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- - It starts with cost of material consumed, (I.e. Opening stock of raw materials + Net Purchases – closing stock of raw materials), Procurement cost , ex: custom duty, landing charges, excise duty, carriage and freight inwards, insurance on incoming raw materials should be included with the cost of raw materials.
- - Closing stock is is taken and valued at lower of cost or net realizable value and is then deducted from the opening stock and purchases
- - Next to raw materials productive wages and direct expenses
- - Indirect Factory expenses ex: rents, rates, salaries of supervising staff, power, light, heat & fuel, repairs and renewals, depreciation relating to factory property etc.

given below.

**MANUFACTURING, TRADING AND PROFIT AND LOSS A/C**  
*for the year ended 31st March, 2004*

	Rs.		Rs.
To Raw Materials Consumed : (Opening Stock of Raw Materials + Purchases during the year – Closing Stock of Raw Materials)	× × ×	By Cost of Goods Manufactured transferred to Trading A/c	× × ×
" Direct Wages	× × ×		
" Direct Expenses (as carriage on purchases)	× × ×		
Prime Cost			
Factory Expenses :			
" Factory Lighting      × × ×			
Factory Rent      × × ×			
" Wages      × × ×			
Depreciation on Plant & Machinery      × × ×			

Factory Supervisor's Salary	xxx			
Stores Consumed etc.	xxx			
		xxx		
		xxx		
To Work-in-Progress				
Beginning	xx			
Less : Closing Work-in-Progress	xx			
Sale of Scrap	xx	xxx		
		xxx		xxx
To Opening Stock of Finished Goods		xxx		
" Cost of Goods Manufactured transferred from Manufacturing Account		xxx		
" Gross Profit c/d		xxx		
		xxx		xxx
To Administration Expenses		xxx		
" Selling Expenses		xxx		
" Distribution Expenses		xxx		
" Financial Expenses		xxx		
" Maintenance Expenses		xxx		
" Net Profit transferred to Capital Account		xxx		
		xxx		xxx
			By Sales	xxx
			" Closing Stock of Finished Goods	xxx
				xxx
			By Gross Profit b/d	xxx
			" All Items of Income and Gain	xxx
				xxx

**Illustration 5.** The following are the balances in the Ledger of Mr. S. for the year ended 31st March, 2004 :



# BALANCE SHEET

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- Balance Sheet is a component of financial statements which shows balances of capital, liabilities & assets.
- All nominal accounts are closed by transferring these to Trading & Profit & Loss Account. Only personal & real accounts are left.
- Balance Sheet is the final phase in accounting cycle. It is a 'mirror' which reflects the true position of the assets & liabilities of the business on a particular date.
- “A statement of financial position of economic unit disclosing as at a given moment of time its assets, liabilities & ownership equities. Eric L.kohler

# A. LIABILITIES

---

- (a) Capital: This indicates the initial amount the owner or owners of the business contributed. This contribution could be at the time of starting business or even at a later stage to satisfy requirements of funds for expansion, diversification etc. As per business entity concept, owners and business are distinct entities, and thus, any contribution by owners by way of capital is liability.
- (b) Reserves and Surplus: The business is a going concern and will keep making profit or loss year by year. The accumulation of these profit or loss figures (called as surpluses) will keep on increasing or decreasing owners' equity. In case of non-corporate forms of business, the profits or losses are added to the capital A/c and not shown separately in the balance sheet of the business.



- 
- (c) Long Term or Non-Current Liabilities: These are obligations which are to be settled over a longer period of time say 5-10 years. These funds are raised by way of loans from banks and financial institutions. Such borrowed funds are to be repaid in installments during the tenure of the loan as agreed. Such funds are usually raised to meet financial requirements to procure fixed assets. These funds should not
  - (d) Short Term or Current Liabilities: A liability shall be classified as Current when it satisfies any of the following :
    - It is expected to be settled in the organisation's normal Operating Cycle,
    - It is held primarily for the purpose of being traded,
    - It is due to be settled within 12 months after the Reporting Date, or
    - The organization does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

- 
- Current liabilities comprise of :
  - (i) Sundry Creditors - Amounts payable to suppliers against purchase of goods. This is usually settled within 30-180 days.
  - (ii) Advances from customers – At times customer may pay advance i.e. before they get delivery of goods. Till the business supplies goods to them, it has an obligation to pay back the advance in case of failure to supply. Hence, such advances are treated as liability till the time they get converted to sales.
  - (iii) Outstanding Expenses: These represent services procured but not paid for. These are usually settled within 30–60 days e.g. phone bill of Sept is normally paid in Oct.

- 
- (iv) Bills Payable: There are times when suppliers do not give clean credit. They supply goods against a promissory note to be signed as a promise to pay after or on a particular date. These are called as bills payable or notes payable.
  - (v) Bank Overdrafts: Banks may give fund facilities like overdraft whereby, business is permitted to issue cheques up to a certain limit. The bank will honour these cheques and will recover this money from business. This is a short term obligation.

## B.ASSETS

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- In accounting language, all debit balances in personal and real accounts are called as assets. Assets are broadly classified into fixed assets and current assets.
- (a) Fixed Assets: These represent the facilities or resources owned by the business for a longer period of time. The basic purpose of these resources is not to buy and sell them, but to use for future earnings. The benefit from use of these assets is spread over a very long period. The fixed assets could be in tangible form such as buildings, machinery, vehicles, computers etc, whereas some could be in intangible form viz. patents, trademarks, goodwill etc. The fixed assets are subject to wear and tear which is called as depreciation. In the balance sheet, fixed assets are always shown as “original cost less depreciation”.

- 
- (b) Investments: These are funds invested outside the business on a temporary basis. At times, when the business has surplus funds, and they are not immediately required for business purpose, it is prudent to invest it outside business e.g. in mutual funds or fixed deposit. The purpose is to earn a reasonable return on this money instead of keeping them idle. These are assets shown separately in balance sheet. Investments can be classified into Current Investments and Non-current Investments. Non-current Investments are investments which are restricted beyond the current period as to sale or disposal. Whereas, current investments are investments that are by their nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made.



- 
- (c) Current Assets: An asset shall be classified as Current when it satisfies any of the following :
    - It is expected to be realised in, or is intended for sale or consumption in the organisation's normal Operating Cycle,
    - It is held primarily for the purpose of being traded,
    - It is due to be realised within 12 months after the Reporting Date, or
    - It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.
  - Current assets comprise of: (i) Stocks: This includes stock of raw material, semi-finished goods or WIP, and finished goods.

- 
- Stocks are shown at lesser of the cost or market price. Provision for obsolescence, if any, is also reduced. Generally, stocks are physically counted and compared with book stocks to ensure that there are no discrepancies. In case of discrepancies, the same are adjusted to P & L A/c and stock figures are shown as net of this adjustment.
  - ii) Debtors: They represent customer balances which are not paid. The bad debts or a provision for bad debt is reduced from debtors and net figure is shown in balance sheet.
  - (iii) Bills receivables: Credit to customers may be given based on a bill to be signed by them payable to the business at an agreed date in future. At the end of accounting period, the bills accepted but not yet paid are shown as bills receivables.

- 
- (iv) Cash in Hand: This represents cash actually held by the business on the balance sheet date. This cash may be held at various offices, locations or sites from where the business activity is carried out. Cash at all locations is physically counted and verified with the book balance. Discrepancies if any are adjusted.
  - (v) Cash at Bank: Dealing through banks is quite common. Funds held as balances with bank are also treated as current asset, as it is to be applied for paying to suppliers. The balance at bank as per books of accounts is always reconciled with the balance as per bank statement, the reasons for differences are identified and required entries are passed.
  - (vi) Prepaid Expenses: They represent payments made against which services are expected to be received in a very short period.
  - (vii) Advances to suppliers: When amounts are paid to suppliers in advance and goods or services are not received till the balance sheet date, they are to be shown as current assets. This is because advances paid are like right to claim the business gets.

- 
- Please note that both current assets and current liabilities are used in day-to-day business activities. The current assets minus current liabilities are called as working capital or net current assets. The following report is usual horizontal form of balance sheet. Please note that the assets are normally shown in descending order of their liquidity. Also, capital, long term liabilities and short term liabilities are shown in that order.



arrangement is given in Balance Sheet (I) as below :

**BALANCE SHEET (I)**

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<i>Current Liabilities :</i>		<i>Liquid Assets :</i>	
Bills Payable		Cash in Hand	
Sundry Creditors		Cash at Bank	
Bank Overdraft		<i>Floating Assets :</i>	
<i>Long Term Liabilities :</i>		Sundry Debtors	
Loan from Bank		Investments	
Any Other Loan		Bills Receivable	
<i>Fixed Liabilities :</i>		Stock in Trade	
Capital		Prepaid Expenses	
		<i>Fixed Assets :</i>	
		Machinery	
		Furniture & Fixtures	
		Motor Car	
		Building	
		<i>Intangible Assets :</i>	
		Goodwill	
		Patents	
		Copyright	
		Licenses	
		<i>Fictitious Assets :</i>	
		Advertisement (to the extent not written off)	
		Misc. Expenses (to the extent not written off)	
		Profit & Loss A/c	
<b>Total</b>		<b>Total</b>	

**Note :** For contingent liabilities, if any.



# ACCOUNTING FOR SHARES

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BY: SANJUKTA MOHANTY



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- “A Company is an artificial person created by law, having separate entity with a perpetual succession and a common seal.” Definition given by Prof. Haney
  - Types of Companies
  - **(i) Private Company** – Section 2 (68) of the Companies Act, 2013 defines “A private Company means a company which has a minimum paid up capital of Rs. 100,000 and which by its Articles of Association –
    - (a) restricts the right to transfer its shares;
    - (b) limits the number of its members to 200.
    - (c) Prohibits any invitation to public to subscribe for any of its securities.
  - **Note:** Memorandum of Association is a document that contains all the fundamental information which are required for the incorporation of the company. Articles of Association is a document containing all the rules and regulations that governs the company.

- 
- (ii) Public Company – According to section 2 (71) of the Companies Act, 2013 a public company means a company which is not a private company and has a minimum paid up capital of L 500,000 or higher. The minimum number of members of public company is 7 and there is no limit to maximum number of members.
  - (iii) One Person Company – Section 2 (62) of the Companies Act, 2013 states one person company is a company which has only one person as a member. Rule 3 of the Companies (In Corporation) Rules, 2014 provides that (i) only on Indian citizen resident in India can form one person company (ii) Its paid up capital is not more than 50 lakhs; (iii) Its Average annual turnover should not exceed Rs. 2 crores; (iv) It cannot carry out Non banking financial Investment activities.

# WHAT ARE SHARES AND TYPES OF SHARES?

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- A company's capital is divided into small equal units of a finite number. Each unit is known as a share. In simple terms, a share is a percentage of ownership in a company or a financial asset. Investors who hold shares of any company are known as shareholders.

For example ; if the market capitalization of a company is Rs. 10 lakh, and a single share is priced at Rs. 10 then the number of shares to be issued will be 1 lakh. Let's learn more.

- **TYPES OF SHARES**

- **1. PREFERENCE SHARES**

- As the name suggests, this type of share gives certain preferential rights as compared to other types of share. The main benefits that preference shareholders have are: They get first preference when it comes to the payout of dividend, i. e. a share of the profit earned by the company.
- When the company winds up, preference shareholders have the first right in terms of getting repaid.



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- **2. EQUITY SHARES**

- Equity shares are also known as ordinary shares. The majority of shares issued by the company are equity shares. This type of share is traded actively in the secondary or stock market. These shareholders have voting rights in the company meetings. They are also entitled to get dividends declared by the board of directors. However, the dividend on these shares is not fixed and it may vary year to year depending on the company's profit. Equity shareholders receive dividends after preference shareholders.

- **3. DIFFERENTIAL VOTING RIGHT (DVR) SHARES**

- The DVR shareholders have less voting rights compared to equity shareholders. To dilute the voting privileges, companies provide extra dividend to DVR shareholders. As DVR shares have less voting rights, their prices are also low. The price gap between equity shares and DVR shares is almost 30-40%.



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- **WHY DOES A COMPANY ISSUE SHARES?**

- Companies invest in raising funds from investors. They also allow stakeholders a stake in the company's profits.

Investing in shares gives better returns on investment than traditional investment options and can help you compound your wealth in the long-run.



# DISTINCTION BETWEEN EQUITY SHARE AND PREFERENCE SHARE

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<i>Basic</i>	<i>Equity Share</i>	<i>Preference Share</i>
1. Refund of Capital	On Winding up, the equity share capital is paid after the preference share capital is paid or equity shareholder received residual amount.	On winding up, the preference Share capital is paid before the Equity share capital is paid or preference shareholder have preference to get refund of capital over Equity share-holders.
2. Right of Dividend	Dividend is paid on Equity shares after payment of dividend on preference shares.	Dividend is paid on preference share before payment of dividend on Equity shares.

3. Right of Dividend	No fixed rate of dividend. It is decided by board of directors every year and vary periodically.	Fixed rate of dividend prescribed on the face of preference shares e.g. 9% Preference same in this case rate of dividend is 9%.
4. Right to Vote	Equity shareholder have the right to vote in meeting of shareholders and they elect director for managing the company.	In normal course of business, preference shareholders do not enjoy the right to vote in the meetings of shareholders. But they have it only in special circumstances.
5. Redemption	Equity share are not redeemable, however, a company may buy back its equity shares as condition	Preference share are always redeemable, now a company cannot issue irredeemable preference shares.



# TYPES OR CLASSES OF PREFERENCE SHARES

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- (a) With Reference to Dividend :
  - (i) Cumulative Preference shares : Cumulative preference shares are these preference shares, the holders of which are entitled to receive arrears of dividend before any dividend is paid on equity shares.
  - (ii) Non-cumulative Preference shares : Non-cumulative preference shares are those preference share, the holders of which do not have the right to receive arrear of divided. If no dividend is declared in any year due to any reason. Such shareholders get nothing, nor they can claim unpaid dividend in any subsequent years

- 
- (b) With Reference to Participation (i) Participating preference shares : such shares, in addition to the fixed preference dividend, carry a right to participate in the surplus profit, if any, after providing dividend at a stipulated rate to equity shareholders.
  - (ii) Non-Participating preference shares : Such shares get only a fixed rate of dividend every year and do not have a right to participate in the surplus profit.
  - (c) With Reference to Convertibility (i) Convertible preference shares : are those preference shares which have the right/option to be converted into equity shares
  - (ii) Non-convertible preference shares : are those preference shares which do not have the right/option to be converted into Equity shares.



- 
- (d) With Reference to Redemption
  - (i) Redeemable preference shares : are those preference shares the amount of which can be redeemed by the company at the time specified for their repayment or earlier.
  - (ii) Irredeemable preference shares : are those preference shares the amount of which cannot be refunded by the company unless the company is wound up. Now a company cannot issue irredeemable preference shares.

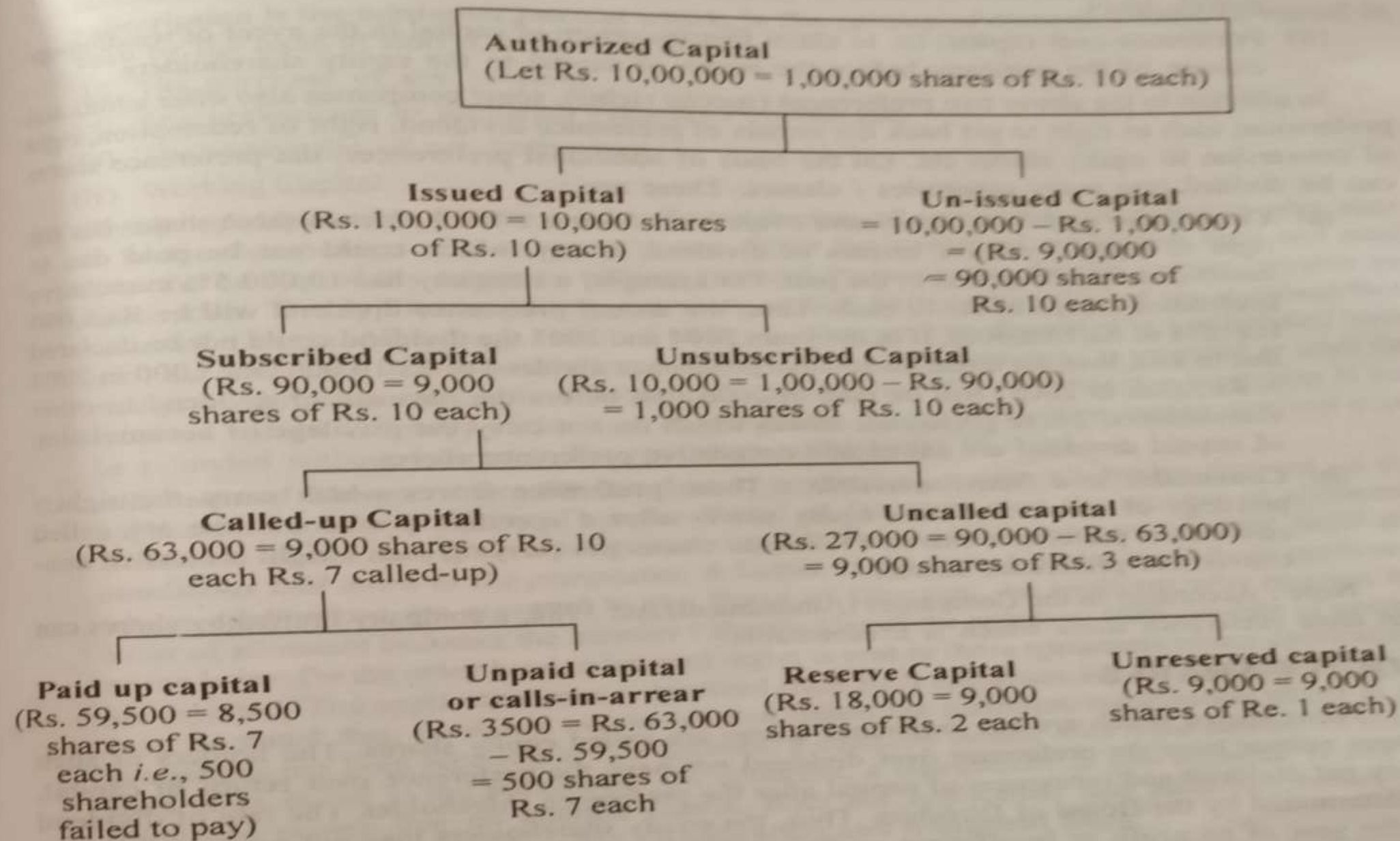
# SOME IMPORTANT TERMS USED IN ACCOUNTING FOR SHARE CAPITAL

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- Note 1 :
- **Minimum Subscription** (Section 39) – It is the minimum amount stated in the prospectus that must be subscribed by the public before an allotment of any security is made.
- **Prospectus** : It is an invitation to public for subscription of shares or debentures.
- **Capital** : means amount invested in the business for the purpose of earning revenue. In case of company money is contributed by public and people who contributed money are called shareholders.
- **Share Capital** : Capital raised by issue of shares is called share capital.
- **Authorized Capital**: Also called as Nominal or registered capital. It is the maximum amount of capital a company can issue. It is stated in Memorandum of Association at the time of registration of a company.

- 
- **Issued Capital** : This is part of authorized capital which is offered to public for subscription. It cannot exceed authorized capital.
  - **Subscribed Capital**: It is the part of the issued capital which is actually subscribed/applied for by the public. That part of the issued capital which is not subscribed by the public is called unsubscribed capital.
  - **Called Up Capital** : It is that part of the subscribed capital which is called up/demanded by the company to meet its current financial requirements. It is the amount of nominal value of shares that has been called up by the company for payment by the subscriber towards the share.
  - **Paid Up Capital** : It is part of called up capital that the members of company or shareholders have paid.
  - **Reserve Capital** : It is part of increased capital and/or portion of uncalled share capital of an unlimited company which can be called only in case of winding up of the company.
  - **Capital Reserve** : It is capital profit not available for distribution as dividend. It is represented in balance sheet of company as Reserves and Surplus under the heading Shareholder's Funds.

## COMPONENTS OF AUTHORIZED CAPITAL





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**Illustration :** S T L Global Ltd. was formed with a nominal Share Capital of ₹ 40,00,000 divided into 4,00,000 shares of ₹ 10 each. The Company offers 1,30,000 shares to the public payable ₹ 3 per share on Application, ₹ 3 per share on Allotment and the balance on First and Final Call. Applications were received for 1,20,000 shares. All money payable on allotment was duly received, except on 200 shares held by Y. First and Final Call was not made by the Company.

How would you show the relevant items in the Balance Sheet of STL Global Ltd.?



**Balance Sheet (Extract) of S T L Global Ltd. (Relevant Part only)**  
**As at \_\_\_\_\_**

<i>Particulars</i>	<i>Notes No.</i>	<i>(₹)</i>
<b><i>Equity and Liabilities</i></b>		
<b>Shareholder's Funds :</b>		
(a) Share Capital	(1)	7,14,000
<b><i>Assets</i></b>		
<b>Current Assets :</b>		
Cash and Cash Equivalents (cash at Bank)		7,14,000

<i>Particulars</i>	<i>Details</i>	<i>(₹)</i>
<b>(1) Share Capital</b>		
<b>Authorised Capital :</b>		
4,00,000 shares of ₹ 10 each		40,00,000
<b>Issued Capital :</b>		
1,30,3000 shares of ₹ 10 each		13,00,000
<b>Subscribed but not Fully Paid Capital:</b>		
1,20,000 shares of ₹ 10 each ₹ 6 per share called-up	7,20,000	
Less : Calls in Arrears (200 shares × ₹ 3)	6,000	
		7,14,000

- 
- Issue of Shares can be issued in two ways
  - 1. for cash
  - 2. for consideration other than cash
  - **Terms of Issue of Shares**
  - **Shares can be issued in two ways.**
  - 1. Issue of shares at Par
  - 2. Issue of shares at Premium

# ACCOUNTING PROCEDURE

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- The accounting procedure relating to the issue of shares usually consist of the following:
- 1. Journalizing the transaction
- 2. Preparation of ledger account
- 3. Preparation of cash book
- 4. Presentation in Balance Sheet

# STAGES IN SHARE ACCOUNTING

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- There are 5 stages of share accounting.
- A) Application
- B) Allotment
- C) Calls
- D) Forfeiture
- E) Re-issue

# ISSUE OF SHARES AGAINST LUMP SUM PAYMENT :

- **When whole amount due on shares is payable in one instalment.**The journal entries will be as follow:

- Illustration 3 :Vaibhav Ltd. issued 1,00,000 shares of L 10 each at per.The whole amount

## Solution

### Journal

<i>Date</i>	<i>Particulars</i>	<i>LF.</i>	<i>Debit (₹)</i>	<i>Credit (₹)</i>
	Bank A/c Dr. To Share Application and allotment A/c (Being the application money received on 1,00,000 shares at ₹ 10 per share)		10,00,000	10,00,000
	Share Application and Allotment A/c Dr. To Share Capital A/c (Being the share allotted and transfer of application money on 1,00,000 shares to share capital account)		10,00,000	10,00,000



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- **Shares Payable in Instalments:**

- 1. First instalment paid along with application is called as applications money.
- 2. Second instalment paid on allotment is called as allotment money.
- 3. Subsequent instalment paid are called as call money calls can be more than one and called First call, second call or as the case may be

# ISSUE OF SHARES FOR CASH AT PAR :

- This means shares are issued at face value | Journal entries:

For Application money	Bank Account To Share Application A/c	Dr.	(No. of Application X Application amount per share)
On acceptance of Applications	Share Application A/c To Share Capital A/c	Dr.	(No. of Share allotted X application amount called on cash)
For allotment money due	Share Allotment A/c To Share Allotment A/c	Dr.	(No. of Shares allotted X amount called on allotment for each share)
On receipt of allotment money	Bank Account To Share Allotment A/c	Dr.	(No. of allotment share X Amount received on allotment for each share) or actual amount received)
For call money due	Share Call A/c To share Capital A/c	Dr.	(No. of shares allotted X amount called on each call share)
On receipt of Calls money	Bank A/c To share Call A/c		(No. of application allotted X Amount received on each share)

- 
- Illustration 4 : X Ltd. invited application for 10,000 shares of the value of L 10 each. The amount is payable as Rs 2 on application and Rs 5 on allotment and balance on First and Final Call. The whole of the above issue was applied and cash duly received. Give Journal entries for the above transaction:

# SOLUTION

Journal				
Date	Particulars	LF.	Debit (₹)	Credit (₹)
	Bank A/c Dr. To Share Application A/c (Being the application money received on 10,000 shares at ₹ 2 per share)		20,000	20,000
	Share Application A/c Dr. To Share Capital A/c (Being the transfer of application money on 10,000 shares to share capital account).		20,000	20,000
	Share Allotment A/c Dr. To Share Capital A/c (Being the amount due on 10,000 shares at ₹ 5 per share)		50,000	50,000
	Bank A/c Dr. To Share Allotment A/c (Being the receipt of ₹ 5 on 10,000 shares)		50,000	50,000



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Share first & final call A/c	Dr.	30,000	
To Share Capital A/c			30,000
(Being the amount due on 10,000 shares at ₹ 3 per share)			
Bank A/c	Dr.	30,000	
To share first & final call A/c			30,000
(Being the receipt of ₹ 3 on 10,000 shares)			

**Note :** *For each entry narration is compulsory*



# ISSUES OF SHARES AT PREMIUM

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- It is issue of share at more than face value. This premium can be utilized for : (Section 52)
- 1. Issue of fully paid bonus shares to the shareholders.
- 2. Write off preliminary expenses of the company.
- 3. Writing off securities issue expenses commission paid discount on issue of securities.
- 4. For providing the premium payable on redemption of Redeemable preference shares or debentures of the company.
- 5. For Buy back of its own shares as per Section 68.

- 
- Journal Entries for accounting of securities premium, the securities premium may be collected by the company with application money / Allotment money / First call/Final Call depend upon the terms of issue of shares. If questions is silent regarding the securities premium amount due, it is assumed that securities premium money is due with the allotment money. Following are the various situation of securities premium received with application, allotment and call.

1. For Application money	Bank Account To Share Application A/c	Dr.	(No. of Application X Application amount per share)
On acceptance of Applications	Share Application A/c To Share Capital A/c To Securities Premium A/c	Dr.	(No. of Share allotted X application amount called on cash) (Amount of Securities Premium Received if any)
2. For allotment money due	Share Allotment A/c To Share Allotment A/c To Securities Premium A/c	Dr.	(No. of Shares allotted X amount called on allotment for each share) (Securities Premium due)
On receipt of allotment money	Bank Account To Share Allotment A/c	Dr.	(No. of allotment share x Amount received on allotment for each share) or actual amount received)
3. For call money due	Share Call A/c To share Capital A/c To Securities Premium A/c	Dr.	(No. of shares allotted x amount called on each call share) (Securities Premium due)
On receipt of Cells money	Bank A/c To share Call A/c		(No. of application allotted x Amount received on each share)

- 
- Illustration 5 :V Ltd. Issued 20,000 Equity shares of Rs 10 each at a premium of rs 3 payable as follows:
  - On Application Rs 4
  - On Allotment Rs 5 (including Securities Premium Reserve)
  - On First Call Rs 2
  - On Final Call Rs 2
  - All shares were duly subscribed and all money duly received. Pass necessary Journal Entries.



**Solution :****In the Book of X Ltd.**

<i>Date</i>	<i>Particulars</i>	<i>LF.</i>	<i>Debit (₹)</i>	<i>Credit (₹)</i>
	Bank A/c Dr. To Equity Share Application A/c (Being the application money received on 20,000 Equity Shares at ₹ 4 per Equity Share)		80,000	80,000
	Equity Share Application Account Dr. To Equity Share Capital Account (Being the transfer of application money on 20,000 Equity Shares to Equity Share capital account)		80,000	80,000
	Equity Share Allotment Account Dr. To Equity share Capital Account To Securities Premium Reserve A/c (Being the amount due on 10,000 Equity Shares at ₹ 5 including Premium ₹ 3 Shares)		1,00,000	40,000 60,000
	Bank A/c Dr. To Equity Share Allotment A/c (Being the receipt of ₹ 5 on 10,000 Equity Shares)		1,00,000	1,00,000



Equity Shares First Call A/c To Equity Share Capital Account (Being the amount due on 20,000 Equity Shares at ₹ 2 per Equity Share)	Dr.		40,000	40,000
Bank A/c To Equity Share First call A/c (Being the receipt of ₹ 2 on 20,000 Equity Shares)	Dr.		40,000	40,000

Equity Share Final call A/c To Equity Share Final call A/c (Being the receipt of ₹ 2 on 20,000 Equity Shares)	Dr.		40,000	40,000
Bank A/c To Equity Share First call A/c (Being the receipt of ₹ 2 on 20,000 Equity Shares)	Dr.		40,000	40,000

- 
- Issue of shares at discount [Section 53] :A company cannot issue shares at discount other than sweat equity shares
  - Private Placement of Shares [Section 42]:This is an issue of shares to institutional investors or some selected group of persons subject to prior approval of existing shareholders. There is no need of issuing formal prospectus and it is cost and time saving method of raising capital.
  - Under subscription :When the number of Share application received is less than the number of shares offered to public it is under subscription.
  - Over subscription :When the number of Share application received is more than the number of shares offered to public it is over subscription 1. Either reject the excess applications 2. Make pro-rata allotment 3. Partially refund amount and on other applications pro-rata allotment is made

- 
- **Calls in arrear** :Any Amount which has been called or demanded by company from shareholders but not paid by the shareholder till the last date mentioned in call letter is called as call in arrear, Company can charge interest on this at rate mentioned in Article of Association or 10% p.a
  - **Calls in advance** :Any amount paid in excess of what they has asked to pay is called as call in advance. Interest is paid on this at rate mentioned in Article of Association or 12% p.a.
  - **Forfeiture of shares** : If any shareholder fail to pay the amount on any call, his money is forfeited or withheld by company this is called forfeiture of shares. Forfeiture of share refers to the cancellation or termination of membership of a share holder by taking away the shares and rights of membership.

# ACCOUNTING FOR DEBENTURES

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- Debenture : It is a document issued by a company under its common seal acknowledging the debt and it also contains the terms of repayment of debt and payment of interest at a specified rate.
- Section 2 (30) of Companies Act, 2013 defines debenture as “Debenture includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the company’s assets or not.” Debentures are generally freely transferable by the debenture holder.
- Debenture holders have no rights to vote in the company’s general meetings of shareholders. The interest paid to them is a charge against profit in the company’s financial statements.



# TYPES OF DEBENTURES

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- Convertibility point of view :There are two types of debentures :
- **Convertible debentures**, which can be converted into equity shares of the issuing company after a predetermined period of time. These may be Partly Convertible Debentures (PCD) :A part of these instruments are converted into Equity shares in the future at notice of the issuer. The issuer decides the ratio for conversion. This is normally decided at the time of subscription.
- **Fully convertible Debentures (FCD)** :These are fully convertible into Equity shares at the issuer's notice. The ratio of conversion is decided by the issuer. Upon conversion the investors enjoy the same status as ordinary shareholders of the company.
- **Non-convertible Debentures**, which are simply regular debentures, cannot be converted into equity shares. These are debentures without the convertibility feature, these usually carry higher interest rates than their convertible counterparts.



- 
- On basis of Security, debentures are classified into:
  - **Secured Debentures** : These instruments are secured by a charge on the fixed assets of the issuer company. So if issuer fails to pay of either the principal or interest amount, its assets can be sold to repay the liability towards debenture holders.
  - **Unsecured Debentures** : These instrument are unsecured in the sense that if the issuer defaults on payment of the interest or principal amount, the investor is treated like other unsecured creditors of the company.
  - From Redemption point of view
  - **Redeemable Debentures** : Redeemable debentures are those which are redeemed or paid off after the termination of fixed term. The amount paid off includes the principal amount and the current year's interest. The company always has the option of either to redeem a specific number of debentures each year or redeem all the debentures at specified date.

- 
- **Irredeemable or Perpetual Debentures** : Irredeemable debentures are those debentures which do not have any fixed date of redemption. They are redeemed either in the event of winding up or at a very remote period of time. Irredeemable or perpetual

**Distinguish between a Share and Debenture**

<i>Basis</i>	<i>Share</i>	<i>Debenture</i>
Ownership	Shareholders are the owners of company	Debenture holders are the lenders of company
Form of return	Dividend	Interest
Security	Not secured	Secured by a charge on assets
Voting right	Equity shareholders have the voting right	No voting right in normal course of business
Risk	More risk as compared to Debentures	Risk Free due to secured Debentures

# ISSUE OF DEBENTURES

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- Debentures can be issued in following ways :
- 1. for cash
- 2. for consideration other than cash
- 3. As collateral security
- Terms of Issue
- Debentures can be issued in following ways:
- 1. Issue of Debentures at Par
- 2. Issue of Debenture at Premium
- 3. Issue of Debentures at Discount.

# DEBENTURE PAYABLE IN INSTALLMENTS

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- 1. First instalment paid along with application is called as application money.
- 2. Second instalment paid on allotment is called as allotment money.
- 3. Subsequent instalments paid are called as call money calls can be more than one and called First call, second call or as the case may be



# ISSUE OF DEBENTURES FOR CASH

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## Issue of Debentures for Cash

*(a) When Debentures amount received in lump sum with the application*

On receipt of application money	Bank A/c To Debenture Application and Allotment A/c	Dr.	With the application money received
On acceptance of application money	Debenture Application and Allotment A/c To X% Debentures A/c To Bank A/c	Dr.	With Amount of application money on allotted debentures, and Excess amount refunded.



- 
- **(b) When Debentures amount received in installments.**
  - In this case accounting entries will be same as at the time of issue of shares in instalments with small change in the name of term like-the share capital word replaced with the X% Debentures A/c, and Share word replaced with Debentures e.g. Equity share capital into 8% Debentures, Equity share application into Debentures Application and follows on.
  - **AT Par : means debentures are issued at face value.**
  - Illustration I : Raj Ltd. Issued 2,000 12% Debentures of Rs 100 each at par payable Rs 25 Application, Rs 50 on Allotment and the balance on first and final call. In all 3,000 application were received.
  - Allotment was made to 2,000 applicant other were rejected. Give Journal entries.

**In the Books of X Ltd.**

<i>Date</i>	<i>Particulars</i>	<i>LF.</i>	<i>Debit (₹)</i>	<i>Credit (₹)</i>
	Bank A/c Dr. To Debentures Application A/c (Being the application money received on 3,000 Debentures at ₹25 per Debentures)		75,000	75,000
	Debentures Application Account Dr. To 12% Debentures Account To Bank A/c (Being the transfer of application money on 2,000 Debentures to 12% Debentures A/c)		75,000	50,000 25,000
	Debentures Allotment Account Dr. To 12% Debentures Account (Being the amount due on 2,000 Debentures at ₹ 50 per Debentures)		1,00,000	1,00,000
	Bank A/c Dr. To Debentures Allotment A/c (Being the receipt of ₹50 on 2,000 Debentures)		1,00,000	1,00,000
	Debentures First & Final Call A/c Dr. To 12% Debentures Account (Being the amount due on 2,000 Debentures at ₹25 per Debentures)		50,000	50,000
	Bank A/c Dr. To Debentures First & Final call A/c (Being the receipt of ₹25 on 2,000 Debentures)		50,000	50,000

- 
- Issue of Debentures at premium : It is issue of Debenture at more than its face value.
  - Note : Premium is presumed to be demanded on Allotment unless specified and Credited to Securities Premium Reserve Account.
  - Illustration 2



### Journal

<i>Date</i>	<i>Particulars</i>	<i>LF.</i>	<i>Debit (₹)</i>	<i>Credit (₹)</i>
	Bank A/c Dr. To Debenture Application A/c (Being the application money received on 4800 debentures @ ₹40 per debenture)		1,92,000	1,92,000
	Debentures Application A/c Dr. To Debenture A/c (Being the transfer of application money to 8% debentures account)		1,92,000	1,92,000
	Debenture Allotment A/c Dr. To 8% Debenture A/c To Security Premium Reserve A/c (Being the allotment money due on 4,800 debentures @ ₹60 and premium of ₹2 share)		2,97,600	2,88,000 9600
	Bank A/c Dr. To Debenture Allotment A/c (Being the application money received)		2,97,600	2,97,600

- 
- **Oversubscription of debentures** : In such case excess application are rejected or partial or Pro-rata allotment is done or combination of both is carried on.
  - **Illustration 3** : Ganga Ltd. issued 2,000 12% debentures of Rs100 each at a premium of 10% payable Rs25 on application; Rs40 (including premium) payable on allotment and balance on First and Final Call. In all 3,500 application were received 500 application were rejected and allotment was made to applicants to 3,000 debentures on Pro-rata basis. The excess money was adjusted on allotment. Give journal entries.



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### Journal

<i>Date</i>	<i>Particulars</i>	<i>LF.</i>	<i>Debit (₹)</i>	<i>Credit (₹)</i>
	Bank A/c Dr. To 12% Debentures Application A/c (Being the application money received on 3,500 debentures @ ₹25 per debenture)		87,500	87,500
	12% Debenture Application A/c Dr. To 12% Debentures A/c To Bank Account		87,500	50,000 12,500

To Debentures Allotment A/c (Being the transfer of application money to Debenture A/c and refund made on rejected Application)			25,000
12% Debenture Allotment A/c Dr. To 12% Debenture Account To Security Premium A/c (Being the allotment money due on 2,000 debentures @ ₹30 and premium of ₹10)	80,000	60,000 20,000	
Bank A/c Dr. To 12% Debenture Allotment A/c (Being the Allotment money received ₹80,000 - ₹25,000)	55,000	55,000	
12% Debenture First & Final Call A/c Dr. To 12% Debenture Account (Being the call money due on, 2000 debentures @ ₹45)	90,000	90,000	
Bank A/c Dr. To 12% Debenture First & Call A/c (Being the call money received)	90,000	90,000	

# FINANCIAL STATEMENT ANALYSIS

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BY: SANJUKTA MOHANTY



# MEANING

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- Financial statement analysis is the process of analyzing a company's financial statements for decision-making purposes.
- It is the systematic numerical representation of the relationship of one financial fact with the other to measure the profitability, operational efficiency, solvency and the growth potential of the business.



# TYPES OF FINANCIAL STATEMENTS

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- Companies use the balance sheet, income statement, and cash flow statement to manage the operations of their business and also to provide transparency to their stakeholders. All three statements are interconnected and create different views of a company's activities and performance.

# IMPORTANCE OR OBJECTIVES OF FINANCIAL STATEMENT ANALYSIS

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- (i) Judging the operational efficiency of the business.
- (ii) Measuring the profitability.
- (iii) Measuring short-term and long-term financial position.
- (iv) Indicating the trend of achievements.
- (v) Assessing the growth potential of the business.
- (vi) Inter-firm comparison

# WHAT ARE THE DIFFERENT TYPES OF FINANCIAL STATEMENT ANALYSIS?

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- Most often, analysts will use three main techniques for analyzing a company's financial statements.
- ❑ First, **horizontal analysis** involves comparing historical data. Usually, the purpose of horizontal analysis is to detect growth trends across different time periods. Horizontal analysis compares data horizontally, by analyzing values of line items across two or more years.
- ❑ Second, **vertical analysis** compares items on a financial statement in relation to each other. For instance, an expense item could be expressed as a percentage of company sales. Vertical analysis looks at the vertical effects line items have on other parts of the business and also the business's proportions.
- ❑ Finally, **ratio analysis**, a tool to interpret quantitative relationship between two variables of the Financial Statements.

Ratio analysis uses important ratio metrics to calculate statistical relationships.

Types	Meaning
<b>Horizontal Analysis</b>	<ul style="list-style-type: none"><li>• It refers to the analysis of financial statement figures that are dynamic in nature.</li><li>• It compares one item with another in a different time period.</li><li>• It analyses the business's finances from one year to the next.</li></ul>
<b>Vertical Analysis</b>	<ul style="list-style-type: none"><li>• The relationship between various items on a financial statement is analyzed.</li><li>• For instance, one item is measured against another during an accounting period.</li><li>• The relationship is expressed in percentage.</li></ul>
<b>Liquidity Analysis</b>	<ul style="list-style-type: none"><li>• It uses ratios to determine whether or not a company will be able to pay back any debts or other expenses.</li><li>• It is helpful for businesses as they can predict financial troubles in future.</li><li>• This analysis is helpful for lenders, creditors, etc. who want some insight into the business' financial standing before giving them any loans or credit.</li></ul>



# COMPARATIVE STATEMENT

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- The Financial statements of two year are compared and difference in absolute term and percentage terms are calculated . It is a form of Horizontal Analysis.
- The comparative analysis is done through a comparative Income Statement and Comparative Balance Sheet.

## Format of Comparative Income Statement



Comparative Income Statement As at ...				
Particulars	31st March 2020	31st March 2021	Absolute Change	Percentage Change
<b>I. Revenue from Operations</b>	...	...	...	...
<b>II. Other Incomes</b>	...	...	...	...
<b>III. Total Revenue (I+II)</b>	<u>...</u>	<u>...</u>	<u>...</u>	<u>...</u>
<b>IV. Expenses</b>				
A. Cost of Materials Consumed	...	...	...	...
B. Purchases	...	...	...	...
C. Changes in inventories of finished goods, Work-in- progress, & stock in trade	...	...	...	...
D. Employee benefit expenses	...	...	...	...
E. Finance cost	...	...	...	...
F. Depreciation	...	...	...	...
G. Other expenses	...	...	...	...
<b>V. Total Expenses</b>	<u>...</u>	<u>...</u>	<u>...</u>	<u>...</u>
<b>VI. Profit Before Tax (III-IV)</b>	<u>...</u>	<u>...</u>	<u>...</u>	<u>...</u>
<b>VII. Less: Income Tax</b>				

Comparative Balance Sheet For the years ended ...				
Particulars	Previous Year (INR)	Current Year (INR)	Absolute Change	Percentage Change
<b>I. Equity &amp; Liabilities</b>				
<b>A. Shareholder's Funds</b>				
1. Share Capital				
a) Equity Capital	...	...	...	...
b) Preference Capital	...	...	...	...
2. Reserves & Surplus	...	...	...	...
<b>B. Non-Current Liabilities</b>				
1. Long Term Borrowings	...	...	...	...
2. Provisions	...	...	...	...
<b>C. Current Liabilities</b>				
1. Short Term Borrowings	...	...	...	...
2. Trade Payables	...	...	...	...
3. Other Current Liabilities	...	...	...	...
4. Short Term Provisions	...	...	...	...
Total	...	...	...	...
<b>II. Assets</b>				
<b>A. Non Current Assets</b>				
1. Fixed Assets				
a) Tangible Assets	...	...	...	...
b) Non Tangible Assets	...	...	...	...
2. Non Current Investments	...	...	...	...
3. Long Term Loans & Advances	...	...	...	...
<b>B. Current Assets</b>				
1. Current Assets	...	...	...	...
2. Inventories	...	...	...	...
3. Trade Receivables	...	...	...	...
4. Cash & Cash Equivalents	...	...	...	...
5. Short Term Loans & Advances	...	...	...	...
6. Other Current Assets	...	...	...	...
Total	...	...	...	...



# COMPARATIVE BALANCE SHEET EXAMPLE - I

	1,00,00,000	1,03,00,000	3,00,000		3
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**Illustration 2.** Following are the Balance sheets of Rachana Ltd. as on 30th June 2004 and 2005 :

<i>Liabilities</i>	<i>2004 Rs.</i>	<i>2005 Rs.</i>	<i>Assets</i>	<i>2004 Rs.</i>	<i>2005 Rs.</i>
Share Capital	1,00,000	1,50,000	Fixed Assets	2,00,000	3,00,000
Reserves	1,00,000	1,00,000	Current Assets	50,000	80,000
Loan	20,000	80,000			
Current Liabilities	30,000	50,000			
	2,50,000	3,80,000		2,50,000	3,80,000

Prepare a Comparative Balance Sheet



**Solution**

**Comparative Balance Sheet of Rachana Ltd.**

*as on 30th June 2004 and 2005*

<i>Particulars</i>	<i>2004 Rs.</i>	<i>2005 Rs.</i>	<i>Absolute Change Rs.</i>	<i>Percentage Change %</i>
A. Fixed Assets	2,00,000	3,00,000	1,00,000	50
B. Working Capital :				
Current Assets	50,000	80,000	30,000	60
Less : Current Liabilities	30,000	50,000	20,000	66.67
C. Capital Employed (A+B)	20,000	30,000	10,000	50
D. Loan	2,20,000	3,30,000	1,10,000	50
E. Shareholder's Funds (C-D)	20,000	80,000	60,000	300
Represented By :	2,00,000	2,50,000	50,000	25
F. Share Capital	1,00,000	1,50,000	50,000	50
G. Reserves	1,00,000	1,00,000	-	-
Shareholder's Funds (F +G)	2,00,000	2,50,000	50,000	25

**Illustration 3.** The following are the Balance Sheets of a concern for the years 2003 and 2004. Prepare a Comparative Balance Sheet and study the financial position of the concern.

**Balance Sheet**  
*As on 31st December*

	2003 Rs.	2004 Rs.		2003 Rs.	2004 Rs.
Equity Share Capital	6,00,000	8,00,000	Land & Buildings	3,70,000	2,70,000
Reserves & Surplus	3,30,000	2,22,000	Plant & Machinery	4,00,000	6,00,000
Debentures	2,00,000	3,00,000	Furniture & Fixtures	20,000	25,000
Long-term loans on Mortgage	1,50,000	2,00,000	Other Fixed Assets	25,000	30,000
Bills Payable	50,000	45,000	Cash in hand and at Bank	20,000	80,000
Sundry Creditors	1,00,000	1,20,000	Bills Receivables	1,50,000	90,000
Other Current Liabilities	5,000	10,000	Sundry Debtors	2,00,000	2,50,000
			Stock	2,50,000	3,50,000
			Prepaid Expenses		2,000
	14,35,000	16,97,000		14,35,000	16,97,000

**Solution :**

Solution :

<b>Comparative Balance Sheet</b> <i>for the year ending December 31, 2003 and 2004</i>				
	Year ending 31 December		Increase/ Decrease (Amounts)	Increase/ Decrease (Percentages)
	2003	2004		
<b>ASSETS</b>	<b>Rs.</b>		<b>Rs.</b>	<b>Rs.</b>
<i>Current Assets :</i>				
Cash in hand and at Bank	20,000	80,000	+60,000	+300
Bills Receivables	1,50,000	90,000	-60,000	-40
Sundry Debtors	2,00,000	2,50,000	+50,000	+25
Stock	2,50,000	3,50,000	+1,00,000	+40
Prepaid Expenses	—	2,000	+2,000	
Total Current Assets	6,20,000	7,72,000	+1,52,000	+24.52
<i>Fixed Assets :</i>				
Land & Buildings	3,70,000	2,70,000	-1,00,000	-27.03
Plant & Machinery	4,00,000	6,00,000	+2,00,000	+50.00
Furniture & Fixtures	20,000	25,000	+5,000	25.00
Other Fixed Assets	25,000	30,000	+5,000	20.00
Total Fixed Assets	8,15,000	9,25,000	+1,10,000	+13.49
Total Assets	14,35,000	16,97,000	+2,62,000	+18.26
<b>LIABILITIES &amp; CAPITAL</b>				
<i>Current Liabilities :</i>				
Bills Payable	50,000	45,000	-5,000	-10
Sundry creditors	1,00,000	1,20,000	+20,000	+20
Other current liabilities	5,000	10,000	+5,000	+100
Total Current Liabilities	1,55,000	1,75,000	+20,000	+12.9



Debentures			+1,00,000	+50
Long-term loans on Mortgage	2,00,000	3,00,000	+50,000	+33
Total Liabilities	1,50,000	2,00,000		
Equity Share Capital	5,05,000	6,75,000	+1,70,000	+33.66
Reserve & Surpluses	6,00,000	8,00,000	+2,00,000	+33
	3,30,000	2,22,000	-1,08,000	-32.73
Total	14,35,000	16,97,000	+2,62,000	+18.26

### Interpretation

- (1) The comparative balance sheet of the company reveals that during 2004 there has been an increase in fixed assets of 1,10,000 i.e. 13.49% while long-term liabilities to outsiders have relatively increased by Rs. 1,50,000 and equity share capital has increased by Rs. 2 lakhs. This fact depicts that the policy of the company is to purchase fixed assets from the long-term sources of finance thereby not affecting the working capital.
- (2) The current assets have increased by Rs. 1,52,000 i.e. 24.52% and cash has increased by Rs. 60,000. On the other hand, there has been an increase in inventories amounting to Rs. 1 lakh. The current liabilities have increased only by Rs. 20,000 i.e. 12.9%. This further confirms that the company has raised long-term finances even for the current assets resulting into an improvement in the liquidity position of the company.
- (3) Reserves and surpluses have decreased from Rs. 3,30,000 to Rs. 2,22,000 i.e., 32.73% which shows that the company has utilised reserves and surpluses for the payment of dividends to shareholders either in cash or by the issue of bonus shares.
- (4) The overall financial position of the company is satisfactory.

(ii) COMPARATIVE INCOME STATEMENT



# COMPARATIVE INCOME STATEMENT EXAMPLE

**Illustration 5.** The income statements of a concern are given for the year ending on 31st Dec., 2003 and 2004. Re-arrange the figures in a comparative form and study the profitability position of the concern.

	2003 Rs.(000)	2004 Rs.(000)
Net sales	785	900
Cost of goods sold	450	500
<b>Operating Expenses:</b>		
General and administrative expenses	70	72
Selling expenses	80	90
<b>Non-operating Expenses :</b>		
Interest paid	25	30
Income -tax	70	80

# Solution

## Comparative Income Statement of Java Ltd.

Particulars	2004 (Rs.)	2005 Change (Rs.)	Absolute Change (Rs.)	Percentage (%)
Sales	24,00,000	37,50,000	13,50,000	56.25
Less : Cost of goods sold	20,00,000	25,00,000	5,00,000	25.00
Gross Profit	4,00,000	12,50,000	8,50,000	212.50
Less : Indirect expenses	40,000	1,25,000	85,000	212.50
Profit before tax	3,60,000	11,25,000	7,65,000	212.50
Less : Income tax	1,80,000	5,62,500	3,82,500	212.50
Net Profit after tax	1,80,000	5,62,500	3,82,500	212.50

31st Dec 2003

# COMMON SIZE STATEMENT

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- It is a vertical analysis of Financial Statements in which amounts of individual items of Balance Sheet or Statement of Profit or Loss are written.
- The figures of financial statements are converted into percentage with respect to a common base.
- These percentages can be compared with the corresponding percentages in other periods and meaningful conclusions can be drawn.
- Such statements may be prepared for intra-firm and inter-firm comparison. Such statements may be prepared for Balance Sheet as well as Income Statement
- The Common size income statement shows the sales figure to be 100 and all other figures expressed as a percentage of sales.
- The Common size balance sheet shows the total assets and liabilities to be assumed as 100 the figures are expressed as percentage of the total.



Common Size Income Statement For the years ended ...				
Particulars (I)	Absolute Amounts		Percentage of Revenue from Operations (Net Sales)	
	Previous Year (INR) (2)	Current Year (INR) (3)	Previous Year (%) (4)	Current Year (%) (5)
I. Revenue from Operations (Net Sales)	...	...	...	...
II. Other Incomes	...	...	...	...
III. Total Revenue (I+II)	...	...	...	...
IV. Expenses				
A. Cost of Materials Consumed	...	...	...	...
B. Purchases of stock in trade	...	...	...	...
C. Changes in inventories , Work-in-progress, & stock in trade	...	...	...	...
D. Employee benefit expenses	...	...	...	...
E. Finance cost	...	...	...	...
F. Depreciation	...	...	...	...
G. Other expenses	...	...	...	...
V. Total Expenses	...	...	...	...
VI. Profit Before Tax (III-IV)	...	...	...	...
VII. Less: Income Tax	...	...	...	...
VIII. Profit After Tax	...	...	...	...



**Comparative Balance Sheet**  
For the years ended ...

Particulars	Previous Year (INR)	Current Year (INR)	Absolute Change	Percentage Change
<b>I. Equity &amp; Liabilities</b>				
<b>A. Shareholder's Funds</b>				
1. Share Capital				
a) Equity Capital	---	---	---	---
b) Preference Capital	---	---	---	---
2. Reserves & Surplus	---	---	---	---
<b>B. Non-Current Liabilities</b>				
1. Long Term Borrowings	---	---	---	---
2. Provisions	---	---	---	---
<b>C. Current Liabilities</b>				
1. Short Term Borrowings	---	---	---	---
2. Trade Payables	---	---	---	---
3. Other Current Liabilities	---	---	---	---
4. Short Term Provisions	---	---	---	---
<b>Total</b>	---	---	---	---
<b>II. Assets</b>				
<b>A. Non Current Assets</b>				
1. Fixed Assets				
a) Tangible Assets	---	---	---	---
b) Non Tangible Assets	---	---	---	---
2. Non Current Investments	---	---	---	---
3. Long Term Loans & Advances	---	---	---	---
<b>B. Current Assets</b>				
1. Current Assets	---	---	---	---
2. Inventories	---	---	---	---
3. Trade Receivables	---	---	---	---
4. Cash & Cash Equivalents	---	---	---	---
5. Short Term Loans & Advances	---	---	---	---
6. Other Current Assets	---	---	---	---
<b>Total</b>	---	---	---	---

# EXAMPLE :I

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Prepare Common size Balance Sheet of Vishal Paper Ltd. from the following information:

Particulars	31.03.2017	31.03.2016
Share Capital	21,00,000	21,00,000
Reserve and Surplus	9,10,000	6,00,000
Non-Current Liabilities	24,45,000	20,40,000
Current Liabilities	15,45,000	12,60,000
Non-Current Assets	43,40,000	36,00,000
Current Assets	26,60,000	24,00,000

# Common Size Balance Sheet of Vishal Paper Ltd.

As on 31<sup>st</sup> March 2016 and 2017

Particulars	Note No.	Absolute Amounts		Percentage of Balance Sheet Total (%)	
		31.3.2016	31.3.2017	31.3.2016	31.3.2017
<b>I. Equity And Liabilities:</b>					
1. Shareholder's Funds					
(a) Share Capital		21,00,000	21,00,000	35	30
(b) Reserve and Surplus		6,00,000	9,10,000	10	13
2. Non-Current Liabilities		20,40,000	24,45,000	34	34.93
3. Current Liabilities		12,60,000	15,45,000	21	22.07
<b>Total</b>		<b>60,00,000</b>	<b>70,00,000</b>	<b>100</b>	<b>100.00</b>
<b>II. Assets:</b>					
1. Non-Current Assets		36,00,000	43,40,000	60	62.00
2. Current Assets		24,00,000	26,60,000	40	38.00
<b>Total</b>		<b>60,00,000</b>	<b>70,00,000</b>	<b>100</b>	<b>100.00</b>

## Working Note:-

$$\text{Percentage of Share Capital (2016)} = \frac{21,00,000}{60,00,000} \times 100 = 35\%$$

$$\text{Percentage of Share Capital (2017)} = \frac{21,00,000}{70,00,000} \times 100 = 30\%$$

$$\text{Percentage of Reserve and Surplus (2016)} = \frac{6,00,000}{60,00,000} \times 100 = 10\%$$

$$\text{Percentage of Reserve and Surplus (2017)} = \frac{9,10,000}{70,00,000} \times 100 = 13\%$$



Question .3. Prepare a common size balance sheet and comment on the financial position of A Ltd. and B Ltd. The Balance Sheet of A Ltd. and B Ltd. as at 31.3.2018 are given below:

### Balance Sheet

Particulars	Note No.	Amount	
		A Ltd.	B Ltd.
<b>I. Equity And Liabilities:</b>			
1. Shareholder's Funds			
(a) Share Capital		4,00,000	5,40,000
(b) Reserve and Surplus		2,00,000	2,60,000
2. Non-Current Liabilities		3,00,000	2,50,000
3. Current Liabilities		1,00,000	1,50,000
<b>Total</b>		<b>10,00,000</b>	<b>12,00,000</b>
<b>II. Assets:</b>			
1. Non-Current Assets		4,00,000	7,00,000
2. Current Assets		6,00,000	5,00,000
<b>Total</b>		<b>10,00,000</b>	<b>12,00,000</b>



**Common Size Balance Sheet of \_\_\_\_\_**  
As at 31<sup>st</sup> march, 2016 and 2017

Particulars	Note No.	Amounts		Percentage of Balance Sheet	
		A Ltd.	B Ltd.	A Ltd.	B Ltd.
<b>I. Equity And Liabilities:</b>					
1. Shareholder's Funds					
(a) Share Capital		4,00,000	5,40,000	40.00	45.00
(b) Reserve and Surplus		2,00,000	2,60,000	20.00	21.67
2. Non-Current Liabilities		3,00,000	2,50,000	30.00	20.83
3. Current Liabilities		1,00,000	1,50,000	10.00	12.50
<b>Total</b>		<b>10,00,000</b>	<b>12,00,000</b>	<b>100.00</b>	<b>100.00</b>
<b>II. Assets:</b>					
1. Non-Current Assets		4,00,000	7,00,000	40.00	58.33
2. Current Assets		6,00,000	5,00,000	60.00	41.67
<b>Total</b>		<b>10,00,000</b>	<b>12,00,000</b>	<b>100.00</b>	<b>100.00</b>

### **Comments:-**

Below are the observations in the financial position of A Ltd. and B Ltd. on the basis of above Common size balance sheet:

- (i) The Share Capital of B Ltd is better as compared to A Ltd.
- (ii) The position current liabilities of A Ltd. (10%) are better as compared to B Ltd. (12.50%)
- (ii) The long term position of B Ltd. is better as compared to A Ltd.
- (iv) The non-current assets of B Ltd. is 18.33% more as compared to A Ltd.

Question .5. From the following Statement of Profit and Loss prepare a Common Size Statement of Profit and Loss of Jayant Ltd. for the year ended 31.3.2018:

**Statement of Profit & Loss of Jayant Ltd.**

For the year ended 31.3,2018

Particulars	Note No.	Amount
<b>Income:</b>		
Revenue from Operations		25,38,000
Other Incomes		38,000
Total Revenue		<b>25,76,000</b>
<b>Expenses:</b>		
Cost of Materials Consumed		14,00,000
Other Expenses		5,00,000
Total Expenses		<b>19,00,000</b>
Tax		3,38,000

**Common Size Statement of Profit & Loss**  
for the year ended 31.03.2018

Particulars	Note No.	Absolute Amounts	% of Revenue from Operations
Revenue from Operations		25,38,000	100.00
Add: Other Income		38,000	1.5
<b>Total Revenue</b>		<b>25,76,000</b>	<b>101.5</b>
Less: Expenses:			
Cost of Materials Consumed		14,00,000	55.16
Other Expenses		5,00,000	19.70
<b>Total Expenses</b>		<b>19,00,000</b>	<b>74.86</b>
Profit before Tax		6,76,000	26.64
Less: Tax		3,38,000	13.32
Profit after Tax		<b>3,38,000</b>	<b>13.32</b>



## Differences between Horizontal Analysis and Vertical Analysis:

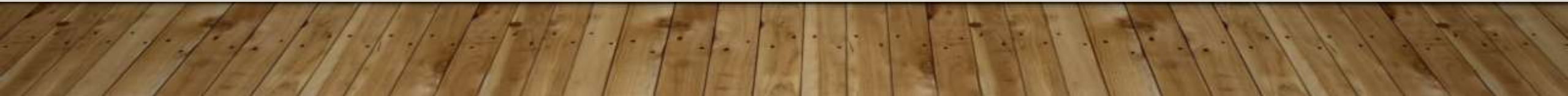
Following are the points of differences between Horizontal Analysis and Vertical Analysis:

Basis	Horizontal Analysis	Vertical Analysis
<b>1.Period</b>	It requires comparative financial statements of two or more accounting periods.	It requires financial statement of one period.
<b>2.Components or items</b>	It deals with same item of different period.	It deals with different items of same period.
<b>3.Information</b>	Information is provided in absolute and percentage terms.	It provides information in percentage terms.
<b>4.Usefulness</b>	It is useful for Time Series Analysis.	It is generally used for Cross Sectional Analysis.

# CASH FLOW STATEMENT

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BY: SANJUKTA MOHANTY



# MEANING

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- **Cash Flows** are inflows and outflows, i.e., the movement of cash and cash equivalents.
- Cash flow' implies movement of cash in and cash out due to some non-cash items. Receipt of cash from non-cash item is termed as cash inflow while cash payment in respect of such items as cash outflow.
- **For example, purchase of machinery by paying cash is cash outflow, while sale proceeds received from sale of machinery is cash inflow.**

- 
- The **Cash Flow Statement** is prepared according to Revised Accounting Standard-3 on cash flow statement. The standard requires that cash flow be classified and shown in the cash flow statement under three heads, namely:
    - 1. Cash Flow from Operating Activities
    - 2. Cash Flow from Investing Activities ; and
    - 3. Cash Flow from Financing Activities.
  - Cash flow is a statement which picturise the position of the changes in cash between one period to another period. means cash flow statement describes the causes of change in cash in one period to another period.



# OBJECTIVES OF CASH FLOW STATEMENT

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- The objectives of cash flow statement are:
  - ❑ To ascertain the sources from activities (i.e., operating/investing/financing activities) from which cash and cash equivalents were generated by an enterprise.
  - ❑ To ascertain the uses by activities (i.e., operating/investing/financing activities) for which cash and cash equivalents were used by an enterprise.
  - ❑ To ascertain the net change in cash or cash equivalents indicating the difference between sources and uses from or by the three activities between the dates of two Balance Sheets.

# ADVANTAGE OF CASH FLOW STATEMENT

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- **1. Ascertaining Liquidity and Profitability Positions:**
  - Cash Flow Statement helps the management to ascertain the liquidity and profitability position of a firm. Liquidity means one's ability to pay the obligation as soon as it becomes due. Since Cash Flow Statement presents the cash position of a firm at the time of making payment it directly helps to ascertain the liquidity position, the same is also applicable in case of profitability.
- **2. Ascertaining Optimum Cash Balance:**
  - Cash Flow Statement also helps to ascertain the optimum cash balance of a firm. If optimum cash balance can be determined, it is possible for a firm to ascertain the idle and/or excess and/or shortage of cash position. After ascertaining the cash position, the management can invest the surplus cash, if any, or borrow funds from outside sources accordingly to meet the cash deficit.

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- **3. Cash Management:**

- Proper management of cash is possible if Cash Flow Statement is properly prepared. The management can prepare an estimate about the various inflows of cash and outflows of cash so that it becomes very helpful for them to make plans for the future.

- **4. Movement of Cash:**

- A Cash Flow Statement presents the management the flows in and flows out of cash for various purposes on the basis of which future estimated can be prepared.

- **5. Performance Appraisal:**

- By comparing the actual Cash Flow Statement with the projected Cash Flow Statements, the management can evaluate or appraise the performances regarding cash. If any unfavorable variance is found, the reason for such variation is located and rectified accordingly.

# DISADVANTAGE OF CASH FLOW STATEMENT

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- 1. Cash flow statement shows only cash inflow and cash outflow. But, the cash balance disclosed by the statement cannot reveal the true liquid position of the business
- 2. Net Cash Flow disclosed by Cash Flow Statement does not necessarily mean net income of the business because net income is determined by taking into account both cash and non-cash items.
- 3. It does not give complete picture of the financial position of the business concern.
- 4. The preparation of cash flow statement is only postmortem analysis. There is no projection of cash in future in this method.
- 5. It is not a substitute of Income Statement.
- 6. The accuracy of cash flow statement is based on the balance sheet. If balance sheet is wrong, the cash flow statement is also wrong



# CLASSIFICATION OF CASH FLOW STATEMENT

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- A cash flow statement typically breaks out a company's cash sources and uses for the period in to three categories:
- 1. Cash flow from operating activities
- 2. Cash flow from investing activities
- 3. Cash flow from financial activities

# INVESTING ACTIVITIES

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- Investing activities of an enterprise are acquisition and disposal of the long term assets and other investments not included in cash equivalents. Accordingly, the cash inflow and outflow relating to the fixed assets, shares and debt instruments of other enterprises, interests in joint ventures, advances and loans to third parties and also their repayments are shown under investing activities in the cash flow statement.
- *Cash flow from investing activities is ascertained by analyzing the changes in fixed assets and long term investments in the beginning and at the end of the year.*
- The knowledge of cash flow from investment is essential because by these cash flows that limit time is known by which the creation for future the income and cash flows the expenses are incurred.
- Examples:--
  1. Cash received on sale of fixed assets.
  2. The amount received for loans and advances given to their party.
  3. Collection of loans.

# INVESTING ACTIVITIES

```
graph TD; A[INVESTING ACTIVITIES] --> B[Cash Inflow]; A --> C[Cash Outflow]; B --> D[• Sale of Fixed Assets]; B --> E[• Sale of Investments]; B --> F[• Interest received]; B --> G[• Dividends received]; C --> H[Purchase of Fixed Assets]; C --> I[Purchase of Investments];
```

## Cash Inflow

- Sale of Fixed Assets
- Sale of Investments
- Interest received
- Dividends received

## Cash Outflow

Purchase of Fixed Assets  
Purchase of Investments

# CASH FLOW FROM FINANCING ACTIVITIES

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- Financing Activities of an enterprise are those activities that result in change in the size and composition of owner's capital and borrowing of the enterprise. It includes proceeds from issue of shares or other similar instruments, issue of debentures, loans, bonds, other short-term loans or long term borrowings and repayments of amounts borrowed. Accordingly, receipts and payments on account of the above are disclosed in the cash flow statement as the cash flow from financing activities.
- Dividends paid (in all enterprises) and interest paid (in case of non-financing enterprise) is also included in Financing Activities.
- ***It is important to note that an increase in share capital due to bonus issue will not be shown in the cash flow statement, since it is a capitalization of reserves.***



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## FINANCING ACTIVITIES

### Cash Inflow

1. Issue of shares in Cash
2. Issue of Debentures in Cash
3. Proceeds from Long-term Borrowings

### Cash Outflow

Payment of Loans  
Redemption of preference shares  
Buy-back of Equity shares  
Payment of Dividend  
Payment of Interest

# CASH FLOW FROM OPERATING ACTIVITIES

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- **Operating Activities:** The principal revenue-generating activities of an organization and other activities that are not investing or financing; any cash flows from current assets and current liabilities. In other words, it reflects how much cash is generated from a company's products or services.
- This is the amount of cash that is generated by doing what you do. This is how much cash is generated by making, selling or providing services or product to your customers. These are the activities or accounts that you will find on your income statement. Add all the cash you received from your customers, and subtract all your expenses for the month.

## OPERATING ACTIVITIES

```
graph TD; OA[OPERATING ACTIVITIES] --> CI[CASH INFLOW]; OA --> CO[CASH OUTFLOW]; CI --> CI_List["• Cash Sales<br>• Cash received from Debtors<br>• Cash received from commission and Fees<br>• Royalty."]; CI --> CI_Fin["In the case of financial companies<br>• Cash received for Interest and Dividends<br>• Sale of Securities"]; CO --> CO_List["Cash purchase<br>Payment to creditors<br>Cash operating expenses<br>Payment of Wages<br>Income Tax"]; CO --> CO_Fin["In the case of financial companies<br>Cash paid for interest<br>Purchase of Securities"];
```

### CASH INFLOW

- Cash Sales
- Cash received from Debtors
- Cash received from commission and Fees
- Royalty.

#### **In the case of financial companies**

- Cash received for Interest and Dividends
- Sale of Securities

### CASH OUTFLOW

Cash purchase  
Payment to creditors  
Cash operating expenses  
Payment of Wages  
Income Tax

#### **In the case of financial companies**

Cash paid for interest  
Purchase of Securities

## Cash Flow from Operating Activities : Direct Method

Cash Flow from Operating Activities	Amount (Rs.)	Amount (Rs.)
Cash Receipts from :		
Sales	XXX	
Commission & Fees	XXX	
Interest Received	XXX	
		XXX
Cash Payment for :		
Purchases	XXX	
Payments to and for employees	XXX	
Operating Expenses	XXX	
Interest Payments	XXX	
Direct Taxes Paid		XXX
		XXX
<i>Net Cash Flow from Operating Activities</i>		



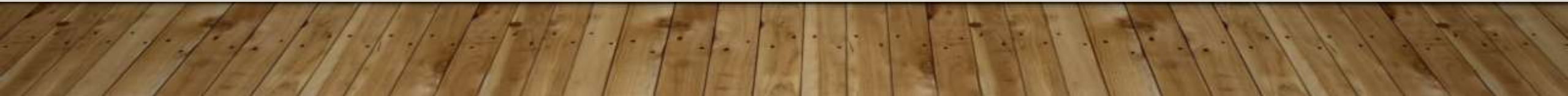
## Cash Flow from Operating Activities : Indirect Method

Cash Flow from Operating Activities	Amount (Rs.)	Amount (Rs.)
<i>Net Profit before Tax</i>		XXX
Adjustment for :		
Depreciation	XXX	
Loss on Sale of Fixed Assets	XXX	
Loss on revaluation	XXX	XXX
<i>Operating Profit before Working Capital Changes</i>		
Adjustment* for :		XXX
Trade and other Receivables		
Inventories or Stocks	XXX	
Trade Payments or (Creditors and B/P)	XXX	XXX
<i>Cash Generated from Operations</i>		XXX
Interest Paid	XXX	XXX
Taxes Paid	XXX	
<i>Net Cash Flow from Operating Activities</i>		XXX

# RATIO ANALYSIS

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BY: SANJUKTA MOHANTY



# MEANING

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- **Meaning of Ratio:** Ratio is an arithmetical expression of relationship between two related or interdependent items. Ratios, when calculated on the basis of accounting information, are called '**Accounting Ratios**'.
- Accounting ratio is, thus, an arithmetical relationship between two accounting variables.
- Ratio Analysis is a technique of Financial Statements Analysis and is the most widely used tool to interpret quantitative relationship between two variables of the Financial Statements.
- "Ratio analysis is a study of relationship among various financial factors in a business."

# STEPS INVOLVED IN RATIO ANALYSIS:

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- 1. Selection of Relevant Data,
- 2. Calculation of Appropriate Ratios,
- 3. Comparative Study of Ratios and
- 4. Interpretation of Ratios.



# OBJECTIVES/SIGNIFICANCE OR UTILITY OF RATIO ANALYSIS:

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- 1. Useful in Simplifying Accounting Figures,
- 2. Useful in Analysis of Financial Statements,
- 3. Useful in Assessing the Operating Efficiency of Business,
- 4. Helpful in Financial Forecasting and Planning,
- 5. Useful in Comparative Study,
- 6. Useful in Communication and Co-ordination and
- 7. Useful in Inter-firm and Intra-firm Comparison.

# LIMITATIONS OF RATIO ANALYSIS:

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- 1. Limited use of a Single Ratio: One single ratio used without reference to other ratios may produce misleading results. According to **Kennedy** and **Medullar**, “**A single ratio in itself is meaningless, it does not furnish a complete picture.**”
- 2. Historical Analysis,
- 3. Lack of Qualitative Analysis,
- 4. Effect of Incorrect Original Data,
- 5. Different accounting practices render ratios in comparable,

- 
- 6. Misleading Results in the absence of absolute data,
  - 7. Lack of uniformity in definitions of various terms used in computation of ratios,
  - 8. Effect of personal ability and bias of the analyst,
  - 9. Effect of Price Level Changes are not taken into account,
  - 10. Lack of Adequate Standard Ratio and
  - 11. Limited Comparability.

# CLASSIFICATION OR TYPES OF RATIOS

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- **(a) Structural Classification or Classification according to Financial Statements:**
  - 1. Balance Sheet Ratios, 2. Profit and Loss Account Ratios or Income Statement Ratios or Operating Ratios, 3. Composite or Mixed Ratios.
- **(b) Functional Classification:**
  - 1. Liquidity Ratios,
  - 2. Activity or Turnover Ratios,
  - 3. Profitability Ratios and
  - 4. Capital Structure Ratios or Long-term Solvency Analysis Ratios.



# 1. LIQUIDITY RATIOS,

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- The liquidity of a business is defined as its ability to meet maturing debt obligations. That is, does the firm here have the resources, either in place or available, to pay the creditors when the debt comes due and must be paid?
- Liquidity ratios measure a company's ability to meet its debt obligations using its current assets. When a company is experiencing financial difficulties and is unable to pay its debts, it can convert its assets into cash and use the money to settle any pending debts with more ease.
- Some common liquidity ratios include the **quick ratio**, the cash ratio, and the current ratio. Liquidity ratios are used by banks, creditors, and suppliers to determine if a client has the ability to honor their financial obligations as they come due.

- 
- 1. Current Ratio - This ratio measures the liquidity position of the concern for a

- short period:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} \quad (\text{Eq. 1})$$

Where,

Current Assets = Inventories + Sundry Debtors + Cash and Bank Balances + Receivables/ Accruals + Loans and Advances + Disposable Investments + Any other current assets.

Current Liabilities = Creditors for goods and services + Short-term Loans + Bank Overdraft + Cash Credit + Outstanding Expenses + Provision for Taxation + Proposed Dividend + Unclaimed Dividend + Any other current liabilities.

- 
- 2. Quick Ratio/ Acid Test Ratio - It is designed to show how the amount of cash is made available to meet immediate payments:

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

Quick Assets	=	Current Assets – Inventories – Prepaid expenses
Current Liabilities	=	As mentioned under Current Ratio.

# ABSOLUTE LIQUID RATIO

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This ratio considers only the absolute liquidity available with the firm.

$$\text{Cash Ratio} = \frac{\text{Cash and Bank balances} + \text{Marketable Securities}}{\text{Current Liabilities}}$$

Or,

$$\frac{\text{Cash and Bank balances} + \text{Current Investments}}{\text{Current Liabilities}}$$



- Example : I The following is the balance sheet of the company as on 31<sup>st</sup> March:

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share Capital	2,00,000	Land and Buildings	1,40,000
Profit & Loss Account	30,000	Plant and Machinery	3,50,000
General Reserve	40,000	Stock	2,00,000
12% Debentures	4,20,000	Sundry Debtors	1,00,000
Sundry Creditors	1,00,000	Bills Receivable	10,000
Bills Payable	50,000	Cash at Bank	40,000
	8,40,000		8,40,000

Calculate :

- (1) Current Ratio
- (2) Quick Ratio
- (3) Inventory to working Capital
- (4) Debt to Equity Ratio
- (5) Proprietary Ratio
- (6) Capital Gearing Ratio
- (7) Current Assets to Fixed Assets

$$\begin{aligned}(1) \text{ Current Ratio} &= \frac{\text{Current assets}}{\text{Current Liabilities}} \\ &= \frac{\text{Rs. 3,50,000}}{\text{Rs. 1,50,000}} = 2.33 : 1\end{aligned}$$

$$\begin{aligned}(2) \text{ Quick Ratio} &= \frac{\text{Liquid Assets}}{\text{Liquid Liabilities}} \\ &= \frac{\text{Rs. 1,50,000}}{\text{Rs. 1,50,000}} = 1 : 1\end{aligned}$$

$$\begin{aligned}(3) \text{ Inventory to Working Capital} &= \frac{\text{Inventory}}{\text{Working Capital}} \\ &= \frac{\text{Rs. 2,00,000}}{\text{Rs. 2,00,000}} = 1 : 1\end{aligned}$$

$$\begin{aligned}(\text{Working Capital} &= \text{Current Assets} - \text{Current Liabilities} \\ &= \text{Rs. 3,50,000} - \text{Rs. 1,50,000} = \text{Rs. 2,00,000})\end{aligned}$$

$$(4) \text{ Debt to Equity Ratio} = \frac{\text{Long Term Debts}}{\text{Shareholders' Fund}}$$

$$= \frac{\text{Rs. 4,20,000}}{\text{Rs. 2,70,000}} = 1.56 : 1$$

$$(5) \text{ Proprietary Ratio} = \frac{\text{Shareholders' Fund}}{\text{Total Assets}}$$

$$= \frac{\text{Rs. 2,70,000}}{\text{Rs. 8,40,000}} = 0.32 : 1$$

$$(6) \text{ Capital Gearing Ratio} = \frac{\text{Fixed Interest Bearing Securities}}{\text{Equity Share Capital}}$$

$$= \frac{\text{Rs. 4,20,000}}{\text{Rs. 2,00,000}} = 2.1 : 1$$

$$(7) \text{ Current Assets to Fixed Assets Ratio} = \frac{\text{Current Assets}}{\text{Fixed Assets}}$$

$$= \frac{\text{Rs. 3,50,000}}{\text{Rs. 4,90,000}} = 0.71 : 1$$

## EXAMPLE:2

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- X Ltd., has a current ratio of 3.5 : 1 and quick ratio of 2 : 1. If excess of current assets over quick assets represented by inventories is Rs. 24,000, calculate current assets and current liabilities.



# SOLUTION:

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- Current Ratio = 3.5 : 1      Quick Ratio = 2 : 1  
Let Current liabilities = x  
Current assets = 3.5x and  
Quick assets = 2x  
Inventories = Current assets – Quick assets  
 $24,000 = 3.5x - 2x$   
 $24,000 = 1.5x$   
Current Liabilities = Rs. 16,000  
Current Assets =  $3.5x = 3.5 \times \text{Rs. } 16,000 = \text{Rs. } 56,000$ .
- **Verification:**
- Current Ratio = Current assets : Current liabilities  
= Rs. 56,000 : Rs. 16,000  
= 3.5: 1  
Quick Ratio = Quick assets : Current liabilities  
= Rs. 32,000 : Rs. 16,000 = 2 : 1

# PROFITABILITY RATIOS

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- Profitability ratios measure a business' ability to earn profits, relative to their associated expenses. Recording a higher profitability ratio than in the previous financial reporting period shows that the business is improving financially. A profitability ratio can also be compared to a similar firm's ratio to determine how profitable the business is relative to its competitors.
- Some examples of important profitability ratios include the return on equity ratio, return on assets, profit margin, gross margin, and return on capital employed.

- **I. Gross Profit Ratio/ Gross Profit Margin:**

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

### **Interpretation**

Gross profit margin depends on the relationship between price/ sales, volume and costs. A high Gross Profit Margin is a favourable sign of good management.

- 
- 2. Net Profit Ratio: It measures the relation between net profit and sales of the business.

$$(i) \quad \text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Sales}} \times 100 \quad \text{or} \quad \frac{\text{Earnings after taxes (EAT)}}{\text{Sales}} \times 100$$

$$(ii) \quad \text{Pre-tax Profit Ratio} = \frac{\text{Earnings before taxes (EBT)}}{\text{Sales}} \times 100$$



---

- 3. Operating Profit Ratio:

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

or,

$$\frac{\text{Earnings before interest and taxes (EBIT)}}{\text{Sales}} \times 100$$

---

- Where,
- Operating Profit = Sales – Cost of goods sold(COGS) - Expenses

## Interpretation

Operating profit ratio measures **the percentage of each sale in rupees that remains after the payment of all costs and expenses except for interest and taxes**. This ratio is followed closely by analysts because it focuses on operating results. Operating profit is often referred to as earnings before interest and taxes or EBIT.

- 
- Financial Ratios:
    - (i) Cost of Goods Sold (COGS) Ratio  $= \frac{\text{COGS}}{\text{Sales}} \times 100$
    - (ii) Operating Expenses Ratio  $= \frac{\text{Administrative exp.} + \text{Selling \& Distribution OH}}{\text{Sales}} \times 100$
    - (iii) Operating Ratio  $= \frac{\text{COGS} + \text{Operating expenses}}{\text{Sales}} \times 100$
    - (iv) Financial Expenses Ratio  $= \frac{\text{Financial expenses}^*}{\text{Sales}} \times 100$

- Return on Investment (ROI) : It is the percentage of return on funds invested in the business

$$\text{Return on Investment} = \frac{\text{Return / Profit / Earnings}}{\text{Investment}} \times 100$$

Or,

$$= \frac{\text{Return / Profit / Earnings}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Investment}}$$

$$\frac{\text{Return / Profit / Earnings}}{\text{Sales}} = \text{Profitability Ratio}$$

$$\text{Investment Turnover Ratio} = \frac{\text{Sales}}{\text{Investments}}$$



---

So, **ROI = Profitability Ratio × Investment Turnover Ratio**. ROI can be improved either by improving Profitability Ratio or Investment Turnover Ratio or by both.

- **Return on Assets:** The profitability ratio measures in term of relationship between net profits and assets employed to earn that profit. This ratio measures the profitability of the firm

$$ROA = \frac{\text{Net Profit after taxes}}{\text{Average Total Assets}} \text{ or } \frac{\text{Net Profit after taxes}}{\text{Average Tangible Assets}} \text{ or } \frac{\text{Net Profit after taxes}}{\text{Average Fixed Assets}}$$

$$= \frac{\text{Net Profit after taxes} + \text{Interest}}{\text{Average Total Assets} / \text{Average Tangible Assets} / \text{Average Fixed Assets}}$$

Or,

$$\frac{\text{EBIT}(1-t)}{\text{Average Total Assets}} \text{ \{also known as **Return on Total Assets** (ROTA)\}}$$

Or,

$$\frac{\text{EBIT}(1-t)}{\text{Average Net Assets}} \text{ \{also known as **Return on Net Assets** (RONA)\}}$$

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- **Return on Capital Employed:**

$$\text{ROCE (Pre-tax)} = \frac{\text{Earnings before interest and taxes(EBIT)}}{\text{Capital Employed}} \times 100$$

$$\text{ROCE (Post-tax)} = \frac{\text{EBIT}(1-t)}{\text{Capital Employed}} \times 100$$

Sometime it is calculated as

$$= \frac{\text{Net Profit after taxes(PAT / EAT)+Interest}}{\text{Capital Employed}} \times 100$$

- Where, Capital Employed = Total Assets- Current Liabilities = Fixed Asset + Working Capital

- 
- **Return on Equity:** It measures the profitability of equity funds invested in the firm. It also measures the percentage of return generated by equity shareholders.

$$\text{ROE} = \frac{\text{Net Profit after taxes - Preferred dividend (if any)}}{\frac{\text{Net worth}}{\text{equity shareholders' fund}}} \times 100$$



**(a) Earnings per Share (EPS):** The profitability of a firm from the point of view of ordinary shareholders can be measured in terms of earnings n per share basis. This is known as Earnings per share. It is calculated as follows:

$$\text{Earnings per Share (EPS)} = \frac{\text{Netprofit available to equity shareholders}}{\text{Number of equity shares outstanding}}$$

**(b) Dividend per Share (DPS):** Earnings per share as stated above reflects the profitability of a firm per share; it does not reflect how much profit is paid as dividend and how much is retained by the business. Dividend per share ratio indicates the amount of profit distributed to equity shareholders per share. It is calculated as:

$$\text{Dividend per Share (DPS)} = \frac{\text{Total Dividend paid to equity shareholders}}{\text{Number of equity shares outstanding}}$$

**(c) Dividend Payout Ratio (DP):** This ratio measures the dividend paid in relation to net earnings. It is determined to see to how much extent earnings per share have been retained by the management for the business. It is computed as:

$$\text{Dividend payout Ratio} = \frac{\text{Dividend per equity share (DPS)}}{\text{Earning per Share (EPS)}}$$

The following Trading and Profit and Loss Account of Fantasy Ltd. for the year 31-3-2000 is given below. Calculate: Gross Profit Ratio, Expenses Ratio, Operating Ratio, Net Profit Ratio, Operating Ratio, Stock Turnover Ratio.

Particular	Rs.	Particular	Rs.
To Opening Stock	76,250	By Sales	5,00,000
“ Purchases	3,15,250	“ Closing stock	98,500
“ Carriage and Freight	2,000		
“ Wages	5,000		
“ Gross Profit b/d	2,00,000		
	5,98,500		5,98,500
To Administration expenses	1,01,000	By Gross Profit b/d	2,00,000
“ Selling and Dist. expenses	12,000	“ Non-operating incomes:	
“ Non-operating expenses	2,000	“ Interest on Securities	1,500
“ Financial Expenses	7,000	“ Dividend on shares	3,750
Net Profit c/d	84,000	“ Profit on sale of shares	750
	2,06,000		2,06,000



### PROFIT AND LOSS ACCOUNT

	Rs.		Rs.
Opening Stock of Materials	99,500	Sales	8,50,000
Purchase of Materials	3,20,000	Stock of Materials (Closing)	89,000
Direct Wages	2,25,250		
Manufacturing Expenses	14,250	Stock of Finished Goods (Closing)	60,000
Selling & Distribution Expenses	30,000	Non-operating Income Interest	3,000
Administrative Expenses	1,50,000	Profit on Sale of Shares	6,000
Finance Charges	15,000		
Non-operating Expenses:			
Loss on Sale of Assets	4,000		
Net Profit	1,50,000		
	10,08,000		10,08,000

Work out the following ratios :

- (1) Gross Profit Ratio
- (2) Net Profit Ratio
- (3) Operating Ratio
- (4) Cost Ratios (to cost of Production)
  - (i) Materials Consumed Ratio
  - (ii) Labour Cost Ratio
  - (iii) Production Overhead Cost Ratio.

**SOLUTION:**

<i>Gross Sales (a)</i>		Rs. 8,50,000
<i>Less : Cost of Goods Sold :</i>	Rs.	
Opening Stock of Materials	99,500	
Add : Materials Purchased	3,20,000	
	4,19,500	
<i>Less : Stock of Materials (Closing)</i>	89,000	
<i>Materials Consumed : (b)</i>	3,30,500	
Direct Wages	2,25,250	
Manufacturing Expenses	14,250	
<i>Cost of Production (c)</i>	5,70,000	
<i>Less : Closing Stock of Finished Products</i>	60,000	
<i>Cost of Goods Sold (d)</i>		5,10,000
<i>Gross Profit (e)</i>		3,40,000
<i>Less : Administrative Expenses</i>	1,50,000	
Selling and Distribution	30,000	
<i>Net Operating Profit before Interest and Taxation : (f)</i>		1,80,000
<i>Add : Non-operating Incomes (g)</i>		1,60,000
Interest	3,000	
Profit on Sale of Shares	6,000	
		9,000
<i>Less : Loss on Sale of Assets</i>	4,000	
Finance Charges	15,000	
<i>Income before Taxation (h)</i>		1,69,000
		19,000
		1,50,000



$$(1) \text{ Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

$$= \frac{\text{Rs. 3,40,000}}{\text{Rs. 8,50,000}} \times 100 = 40\%$$

$$(2) \text{ Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$$

$$= \frac{1,60,000}{\text{Rs. 8,50,000}} \times 100 = 18.82\%$$

$$(3) \text{ Operating Ratio} = \frac{\text{Cost of Goods Sold} + \text{Operating Expenses}}{\text{Net Sales}} \times 100$$

$$= \frac{\text{Rs. 5,10,000} + \text{Rs. 1,80,000}}{\text{Rs. 8,50,000}} \times 100 = 81.18\%$$

$$(4) (i) \text{ Material Consumed Ratio} = \frac{\text{Material Consumed}}{\text{Cost of Product}} \times 100$$

$$= \frac{\text{Rs. 3,30,500}}{\text{Rs. 5,70,000}} \times 100 = 57.98\%$$

$$(iii) \text{ Production Overhead Ratio} = \frac{\text{Production Overhead}}{\text{Cost of Production}} \times 100$$

$$= \frac{\text{Rs. 14,250}}{\text{Rs. 5,70,000}} \times 100 = 2.5\%$$

# SOLVENCY RATIOS/ LEVERAGE RATIO

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- Solvency ratios measure a company's long-term financial viability. These ratios compare the debt levels of a company to its assets, equity, or annual earnings.
- Important solvency ratios include the debt to capital ratio, debt ratio, interest coverage ratio, and equity multiplier. Solvency ratios are mainly used by governments, banks, employees, and institutional investors.
- These ratios indicate the mix of funds provided by owners and lenders and assure the lenders of the long term funds with regard to:
  - (i) Periodic payment of interest during the period of the loan and
  - (ii) Repayment of principal amount on maturity.

# LEVERAGE RATIOS ARE OF TWO TYPES:

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## I. CAPITAL STRUCTURE RATIO

- a) Equity Ratio
- b) Debt Ratio
- c) Debt Equity Ratio
- d) Debt to Total Assets Ratio
- e) Capital Gearing Ratio
- f) Proprietary Ratio

## 2.2. COVERAGE RATIOS

- (a) Debt-Service Coverage Ratio (DSCR)
- (b) Interest Coverage Ratio
- (c) Preference Dividend Coverage Ratio
- (d) Fixed Charges Coverage Ratio

## CAPITAL STRUCTURE RATIOS

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These ratios provide an insight into the financing techniques used by a business and focus, as a consequence, on the **long-term solvency position**.

I. (a) Equity Ratio:

$$\text{Equity Ratio} = \frac{\text{Shareholders' Equity}}{\text{Capital Employed}}$$

This ratio indicates proportion of owners' fund to total fund invested in the business. Traditionally, it is believed that higher the proportion of owners' fund lower is the degree of risk.



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- **2. Debt Ratio:**

$$\text{Debt Ratio} = \frac{\text{Total outside liabilities}}{\text{Total Debt} + \text{Net worth}}$$

Or,

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

Total debt or total outside liabilities includes short and long term borrowings from financial institutions, debentures/bonds, deferred payment arrangements for buying capital equipment, bank borrowings, public deposits and any other interest bearing loan.

- **Interpretation**
- This ratio is used to analyse the long-term solvency of a firm.

---

- **3. Debt to Equity Ratio:**

$$\begin{aligned}\text{Debt to Equity Ratio} &= \frac{\text{Total Outside Liabilities}}{\text{Shareholders' Equity}} = \frac{\text{Total Debt}^*}{\text{Shareholders' Equity}} \\ &\text{Or,} \\ &= \frac{\text{Long-term Debt}^{**}}{\text{Shareholders' equity}}\end{aligned}$$

- A high debt to equity ratio here means less protection for creditors, a low ratio, on the other hand, indicates a wider safety cushion (i.e., creditors feel the owner's funds can help absorb possible losses of income and capital). This ratio indicates the proportion of debt fund in relation to equity.

- 
- (a) **Capital Gearing Ratio:** In addition to debt-equity ratio, sometimes capital gearing ratio is also calculated to show the proportion of fixed interest (dividend) bearing capital to funds belonging to equity shareholders i.e. equity funds or n

$$\text{Capital Gearing ratio} = \frac{(\text{Preference Share Capital} + \text{Debentures} + \text{Other Borrowed funds})}{(\text{Equity Share Capital} + \text{Reserves \& Surplus} - \text{Losses})}$$

- 
- Debt Service Coverage Ratio (DSCR): Lenders are interested in debt service coverage to judge the firm's ability to pay off current interest and instalments.

$$\text{Debt Service Coverage Ratio} = \frac{\text{Earnings available for debt services}}{\text{Interest} + \text{Instalments}}$$

Earning for debt service\* = Net profit (Earning after taxes) + Non-cash operating expenses like depreciation and other amortizations + Interest + other adjustments like loss on sale of Fixed Asset etc.

\*Fund from operations (or cash from operations) before interest and taxes also can be considered as per the requirement.

- Normally DSCR of 1.5 to 2 is satisfactory.



# COVERAGE RATIOS

---

- Coverage ratios measure a business' ability to service its debts and other obligations. Analysts can use the coverage ratios across several reporting periods to draw a trend that predicts the company's financial position in the future. A higher coverage ratio means that a business can service its debts and associated obligations with greater ease.
- Key coverage ratios include the debt coverage ratio, interest coverage, fixed charge coverage, and EBIDTA coverage

- 
- **Interest Coverage Ratio:** This ratio also known as “**times interest earned ratio**” indicates the firm’s ability to meet interest (and other fixed-charges) obligations. This ratio is computed as:

$$\text{Interest Coverage Ratio} = \frac{\text{Earnings before interest and taxes (EBIT)}}{\text{Interest}}$$

- This ratio indicates the extent to which earnings may fall without causing any embarrassment to the firm regarding the payment of interest charges. A high interest coverage ratio means that an enterprise can easily meet its interest obligations even if earnings before interest and taxes suffer a considerable decline. A lower ratio indicates excessive use of debt or inefficient operations.

# EFFICIENCY RATIOS

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- Efficiency ratios measure how well the business is using its assets and liabilities to generate sales and earn profits. They calculate the use of inventory, machinery utilization, turnover of liabilities, as well as the usage of equity. These ratios are important because, when there is an improvement in the efficiency ratios, the business stands to generate more revenues and profits.
- These ratios are employed to **evaluate the efficiency with which the firm manages and utilises its assets**. For this reason, they are often called 'Asset management ratios'. These ratios usually indicate the frequency of sales with respect to its assets. These assets may be capital assets or working capital or average inventory.

# ACTIVITY RATIOS/ EFFICIENCY RATIOS/ PERFORMANCE RATIOS/ TURNOVER RATIOS:

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- (a) Total Assets Turnover Ratio
- (b) Fixed Assets Turnover Ratio
- (c) Capital Turnover Ratio
- (d) Current Assets Turnover Ratio
- (e) Working Capital Turnover Ratio
- (i) Inventory/ Stock Turnover Ratio
- (ii) Receivables (Debtors) Turnover Ratio
- (iii) Payables (Creditors) Turnover Ratio.
- These ratios are usually calculated with reference to sales/cost of goods sold and are expressed in terms of rate or times.



- 
- Asset Turnover Ratios: Based on different concepts of assets employed, it can be expressed as follows:
  - (a) Total Asset Turnover Ratio: This ratio measures the efficiency with which the firm

$$\text{Total Asset Turnover Ratio} = \frac{\text{Sales / Cost of Goods Sold}}{\text{Total Assets}}$$

- (b) Fixed Assets Turnover Ratio: It measures the efficiency with which the firm uses its

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Sales / Cost of Goods Sold}}{\text{Fixed Assets}}$$

- 
- Interpretation
  - A high fixed assets turnover ratio indicates efficient utilisation of fixed assets in generating sales. A firm whose plant and machinery are old may show a higher fixed assets turnover ratio than the firm which has purchased them recently
  - (c) Capital Turnover Ratio/ Net Asset Turnover Ratio:

$$\text{Capital Turnover Ratio} = \frac{\text{Sales / Cost of Goods Sold}}{\text{Net Assets}}$$

- 
- This ratio indicates the firm's ability of generating sales/ Cost of Goods Sold per rupee of long term investment. The higher the ratio, the more efficient is the utilisation of owner's and long-term creditors' funds. Net Assets includes Net Fixed Assets and Net Current Assets (Current Assets – Current Liabilities). Since Net Assets equals to capital employed it is also known as Capital Turnover Ratio.

$$\text{Current Assets Turnover Ratio} = \frac{\text{Sales / Cost of Goods Sold}}{\text{Current Assets}}$$

current assets

**(e) Working Capital Turnover Ratio:**

$$\text{Working Capital Turnover Ratio} = \frac{\text{Sales / Cost of Goods Sold}}{\text{Working Capital}}$$

---

Interpretation:

- Working Capital Turnover is further segregated into Inventory Turnover, Debtors Turnover, and Creditors Turnover.
- Note: Average of Total Assets/ Fixed Assets/ Current Assets/ Net Assets/ Working Capital also can be taken.

(i) **Inventory/ Stock Turnover Ratio:** This ratio also known as **stock turnover ratio** establishes the relationship between the cost of goods sold during the year and average inventory held during the year. It measures the efficiency with which a firm utilizes or manages its inventory. It is calculated as follows: