ଓଡ଼ିଶା ରାଜ୍ୟ ମୁକ୍ତ ବିଶ୍ୱବିଦ୍ୟାଳୟ, ସମ୍ବଲପୁର, ଓଡ଼ିଶା

Odisha State Open University, Sambalpur, Odisha

Established by an Act of Government of Odisha.

Master Of Commerce

(MCOM)

MCO-3

Accounting for Managerial Decisions

Block-1

FUNDAMENTALS OF ACCOUNTING

Unit-1 Accounting An Overview

Unit-2 Basic Cost Concepts

Unit-3 Financial Statements

Unit-4 Understanding Financial Statements

UNIT 1 ACCOUNTING: AN OVERVIEW

Structure

1.0 Objectives
1.1 Introduction
1.2 Need for Accounting
1.3 Definition of Accounting
1.4 Objectives of Accounting
1.5 Accounting as Part of the Information System
1.6 Branches of Accounting
1.6.1 Financial Accounting
1.6.2 Cost Accounting
1.6.3 Management Accounting
1.7 Role of Management Accountant
1.8 Financial Accounting Process
1.9 Accounting Equation
1.10 Accounting Concepts
1.10.1 Concepts to be Observed at the Recording Stage
1.10.2 Concepts to be Observed at the Reporting Stage
1.11 Accounting Standards
1.12 Accounting Assumptions and Policies as per Accounting Standards of India
1.13 Let Us Sum Up
1.14 Key Words
1.15 Answers to Check Your Progress
1.16 Terminal Questions
1.17 Some Useful Books

1.0 OBJECTIVES

After studying this unit you should be able to appreciate:

- the need for accounting;
- definition of accounting and its objectives;
- describe the advantages and limitations of branches of accounting;
- identify the parties interested in accounting information;
- activities of a management accountant;
- identify the stages involved in accounting process;
- explain the accounting concepts to be observed at the recording and reporting stages; and
- understand and appreciate the Generally Accepted Accounting Principles.

1.1 INTRODUCTION

In business numerous transactions take place every day. It is humanly impossible to remember all of them. With the help of accounting records the businessman is able to ascertain the profit or loss and the financial position of the business at a given period

and communicate such information to all interested parties. In this unit you will learn about an overview of accounting and the basic concepts which are to be observed at the recording and reporting stage. You will also learn different stages involved in accounting process and importance of accounting standards to maintain uniformity in the practice of accounting.

1.2 NEED FOR ACCOUNTING

In early days the business organisations and transactions were small and easily manageable by the owners of the business themselves. The businessmen used to remember the transactions by memorizing them. In those days accounting developed as a result of the needs of the business to keep relationship with the outsiders, listing of their assets and liabilities. The advent of industrial revoluation and technological changes have widened the market opportunities. Most of the business concerns in these days are run by company type of organisation. The business concern has constantly enter into transactions with outsiders. A transaction involves transfer of money or money's worth (goods or services) from one person to another. In addition to the transactions with outsiders, there are also events requiring monetary record. It is not possible for a human being to keep in memory all the transactions. Therefore, it is necessary to record all these transactions properly to get required financial information. With the help of accounting records the businessman would be able to ascertain the profit or loss and the financial position of his business at the end of a given period and would be able to communicate the results of business operations to various interested parties. It is, therefore, necessary to record all the transactions systematically from time to time irrespective of the form of business organisation. The accounting information is useful both for the management and the outside agencies. The management needs it for the purpose of planning , controlling and decision making. The outsiders like banks, creditors etc. also require it for assessing the financial solvency of the business and the tax authorities use it for determining the amount of tax liability. Infact accounting is necessary not only for business organisations but also for non-business organisations like schools, colleges, hospitals, clubs etc.

1.3 DEFINITION OF ACCOUNTING

Accounting as said earlier, involves the collection, recording, classification and presentation of financial data for the benefit of management and outside agencies such as shareholder, creditors, investors, government and other interested parties. Accounting has been defined in different ways by different authorities on the subject. The following are some of the important definitions of accounting:

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

Eric L. Kohlen (A Dictionary for Accountants) defines accounting as "the procedure of analysing, classifying and recording transactions in accordance with a pre-conceived plan for the benefit of : (a) providing a means by which an enterprise can be conducted in orderly fashion, and (b) establishing a basis for reporting the financial condition of enterprise and the results of its operations."

The former definition denotes that accounting is concerned with the recording of transactions which are measurable in monetary terms in such a way that analysis and interpretation of business activities is possible. According to the latter definition

accounting is concerned with the recording of business transactions for better management of the concern and also reporting the true financial position of the concern.

The American Accounting Association (AAA) defines accounting as "the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of information."

Smith and Ashburne define accounting as "the science of recording and classifying business transactions and events, primarily of a financial character, and the art of making significant summaries, analysis and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgments." Thus this definition emphasises financial reporting and decision making aspects of accounting.

From the above definitions it is clear that accounting is a science of recording transactions of economic nature in a systematic manner and also an art of analysing and interpreting the same.

Based on the above definitions, we can summarise the functions of accounting as:

i) Identifying financial transactions,

ii) Recording of transactions which are financial in character,

iii) Classification of transactions,

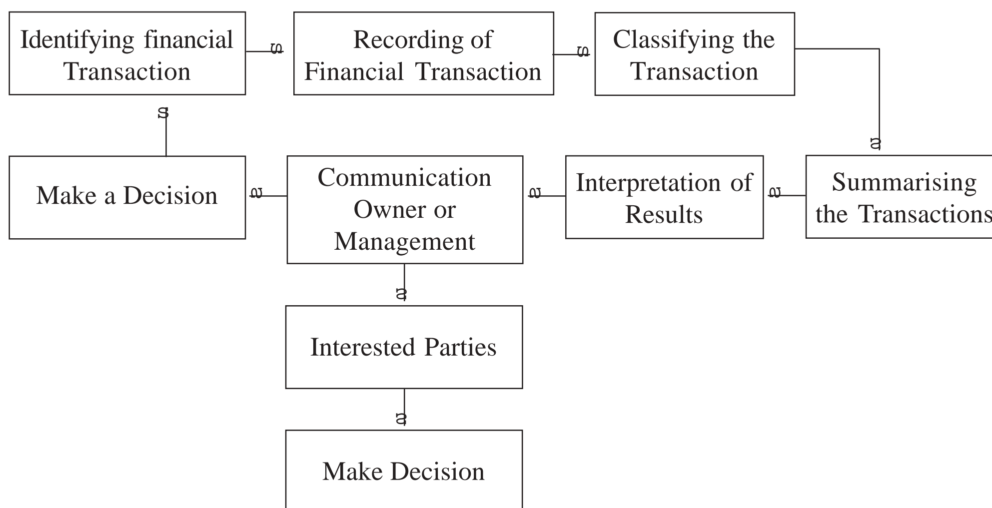
iv) Summarising the transactions which also includes preparation of trail balance, income statements and balance sheet,

v) Interpretation of financial results, and

vi) Communicating the interpreted financial results in a proper form and manner to the proper person.

Look at the following figure and note the functions of accounting which starts from identifying financial transactions to be recorded in the books and ends with communicating to the interested parties who use them for decision making.

Functions of Accounting



1.4 OBJECTIVES OF ACCOUNTING

The basic objectives of accounting is to provide necessary information to the persons interested who will make relevant decisions and form judgement. The persons interested in the business are classified into two types : i) Internal users, and ii) External users. Internal users are those who manage the business. External users are those other than the internal users such as investors, creditors, Government, etc. Information required by the external users are provided through Profit and Loss account and Balance sheet whereas the internal users get required information from the records of the business. Thus the main objectives of accounting are as follows:

1) **To keep systematic records of the business :** Accounting keeps a systematic record of all financial transactions like purchase and sale of goods, cash receipts and cash payments etc. It is also used for recording all assets and liabilities of the business. In the absence of accounting it is impossible to a human being to keep in memory all business transactions.
2) **To ascertain profit or loss of the business :** By keeping a proper record of revenues and expenses of business for a particular period, accounting helps in ascertaining the profit or loss of the business through the preparation of profit and loss account. Profit and Loss account helps the interested parties in assessing the profit or loss made by the business during a particular period. It also helps the management to take remedial action in case the business has not proved remunerative or profitable. A proper record of all incomes and expenses helps in preparing a profit and loss account and in ascertaining net operating results of a business during a particular period.
3) **To ascertain the financial position of business :** The business man is also interested to know the financial position of his business apart from operating results of the business during a particular period. In other words, he wants to know how much he owns and how much owes to others. He would also like to know what happened to his capital, whether it has increased or decreased or remained constant. A systematic record of assets and liabilities facilitates the preparation of a position statement called Balance Sheet which provides necessary information to the above questions. Balance Sheet serves as barometer for ascertaining the financial solvency of the business.
4) **To provide accounting information to interested parties :** Apart from owners there are various parties who are interested in the accounting information. These are bankers, creditors, tax authorities, prospective investors etc. They need such information to assess the profitability and the financial soundness of the business. The accounting information is communicated to them in the form of an annual report.

Parties Interested in Accounting Information

Many people are interested in examining the financial information provided in the financial statements besides a owner or management of the concern. These financial statements help them to know the following :

i) To study the present financial position of business,
ii) To compare its present performance with that of past years, and
iii) To compare its performance with similar enterprises.

The following are the various parties interested in the financial statements:

i) **Owners/Shareholders :** Shareholders are the real owners of the company because they contribute the required capital and take the risk of business. Obviously they are interested to know the result of operations and financial position of the company. The shareholders are also interested to use the accounting information to evaluate the performance of the managers because in company type of organisation management of business is vested in the hands of paid managers.

ii) **Prospective Investors :** The persons who are interested in buying shares of a company or who want to advance money to the company, would like to know how safe and rewarding the investments already made or proposed investments would be.

iii) **Lenders :** Initially the required funds of the business are provided by the owners. When business is going on, it requires more funds. These funds are usually provided by banks and other money lenders. Before lending money they would like to know about the solvency of the enterprise so as to satisfy themselves that their money will be safe and repayments will be made on time.

iv) **Creditors** : The creditors are those who supply goods and services on credit. These creditors like other money lenders are also interested to know the credit worthiness of the business. The accounting information greatly helps them in assessing the ability of the enterprise to what extent credit can be granted.

v) **Managers :** Accounting information is very much useful to managers. It helps them to plan, control and evaluate all business activities. They also need such information for making various decisions relating to the business.

vi) **Government :** The Government may be interested in accounting information of a business on account of taxation, labour and corporate laws. The financial statements are of great importance for assessing the tax liability of the enterprise.

vii) **Employees :** The employees of the enterprise are also interested in knowing the state of affairs of the organisation in which they are working, so as to know how safe their interests are in the organisation. The knowledge of accounting information helps them in conducting negotiations with the management.

viii) **Researchers :** The accounting information is of immense value to the researchers undertaking research in accounting theory and practices.

ix) **Citizen :** An ordinary citizen as a voter and tax payer may be interested to know the accounting information to measure the performance of Government Company or a public utility concern like banks, gas, transport, electricity companies etc.

1.5 ACCOUNTING AS PART OF THE INFORMATION SYSTEM

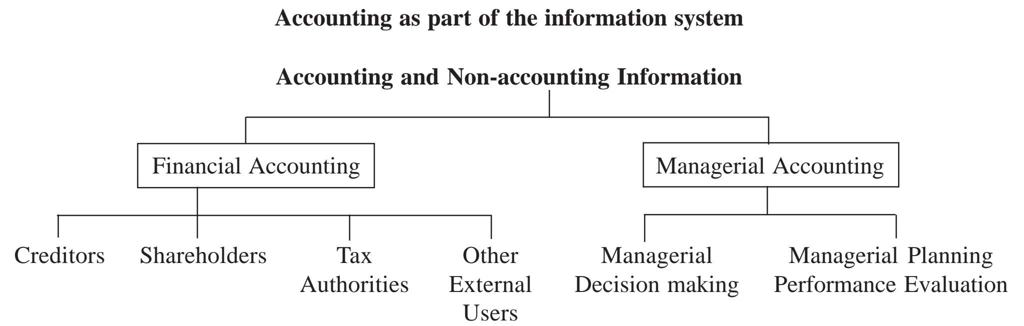
Accounting is part of an organisation's information system, which includes both financial and non-financial data. Accounting is the process of identifying, measuring and communicating economic information to permit judgment and decisions by users of the information. The main objective of accounting is to provide information to the users. Accounting is also required to serve some broad social obligations since the accounting information is used by a large body of people such as customers, employees, investors, creditors and government.

Accounting is commonly divided into (1) Financial Accounting, and (2) Managerial Accounting. Financial accounting refers to the preparation of general purpose reports for use by persons outside an organisation. Such users include shareholders, creditors, financial analysts, labour unions, government regulations etc. External users are interested primarily in reviewing and evaluating the operations and financial status of the business as a whole.

Managerial accounting, on the other hand, refers to providing of information to managers inside the organisation. For example a production manager may want a report on the number of units of product manufactured by various workers in order to evaluate their performance. A sales manager might want a report showing the relative profitability of two products in order to pinpoint selling efforts. The financial reports are available from the libraries or companies themselves where as managerial

accounting reports are not widely distributed outside because they often contain confidential information. The following figure shows that accounting is part of an organisation system which includes both Financial and non financial data :

Accounting as part of the information system



Uses of Accounting Information

Accounting provides information for the following three general uses :-

1) **Managerial decision making :** Management is continuously confronted with the need to make decisions. Some of these decisions may have immediate effect while the others have in the long run. Decisions regarding the price of the product, make or buy the product or to dropt it, to expand its area of operations etc., are some of the examples of decisions that face management and accounting provides necessary information to arrive at right conclusions.

2) **Managerial planning, control and internal performance evaluation** : Managerial accounting plays an important role in the planning and control. By assisting management in the decision making process, information is provided for establishing the standard. Accounting also provides actual results to compare with projections.

   Planning can be defined as the process of deciding how to use available resources. The key word in this definition is deciding, because planning is essentially a matter of choosing the set of alternatives which seem most likely to enable the organisation to meet its objectives. Several different kinds of planning processes can be identified, but most important is periodic planning for the activities of the organisation as a whole.

   Control is the complement of planning. It consists of management's efforts to prevent undesirable departures from planned results and to take corrective action in response to it.

   The planning and control process consist of the following steps :

   i) Setting standards as to what actual performance should be.
   ii) Measuring the actual performance.
   iii) Evaluating actual performance by comparing actual performance with the standards. This evaluation aids management in assessing actions already taken and in deciding which course of action should be taken in future.

   The main relationship between planning and control is the planning produces a plan. This becomes a set of instructions to be executed. The results of the action taken on the basis of the plan are then compared with the planned results. The difference of the plan are interpreted to determine what kind of response is appropriate. A corrective response requires a change in the way of plan is carried out, while adaptive response requires replanning. Each of these leads back to an earlier phase of the process and the loop is completed.

   For example where a marketing manger is given a target of sales revenues of Rs. 10 crores, the amount of Rs. 10 crores will serve as a standard for evaluating

the performance of the marketing manager. If annual sales revenues vary significantly from Rs. 10 crores, steps will be taken to ascertain the causes for the difference. When the factors leading to the variance are not under the control of the marketing manager, then the marketing manager would not be held responsible for it. On the other hand the cause for variance is under the control of marketing manager then he will be held responsible in evaluating the performance of marketing manager.

3) **External Financial reporting and performance evaluation :** Accounting has always been used to supply information to those who are interested in the affairs of the company. Various laws have been passed under which financial statements should be prepared in such way that required information is supplied to shareholders, creditors, government etc. For example, the investors may be interested in the financial strength of the business, creditors may require information about the liquidity position, government may be interested to collect details about sales, profit, investment, liquidity, dividend policy, prices etc. in deciding social and economic policies. Information is required in accordance with generally accepted accounting principles so that it is useful in taking important decisions.

1.6 BRANCHES OF ACCOUNTING

To meet the requirements of different people interested in accounting information, accounting can be broadly classified into three categories :

1) Financial Accounting,
2) Cost Accounting, and
3) Management Accounting

1.6.1 Financial Accounting

The American Institute of Certified Public Accountants has defined Financial Accounting as "the art of recording, classifying and summarizing in a significant manner in terms of money transactions and events which are in part at least of a financial character, and interpreting the results thereof". Accounting is the language effectively employed to communicate the financial information of a business unit of various parities interested in its progress.

The object of financial accounting is to find out the profitability and to provide information about the financial position of the concern. Two important statements of financial accounting are Income and Expenditure Statement and Balance Sheet. All revenue transactions relating to a particular period are recorded in this statement to decide the profitability of the concern. The balance sheet is prepared at a particular date to determine the financial position of the concern.

Functions of Financial Accounting

Financial accounting provides information regarding the status of the business and results of its operations to management as well as to external parties. The following are some of the important functions of financial accounting :

a) **Recording of Information**

In business, it is not possible to keep in memory all the transactions. These transactions need to be systematically recorded and pass through the journals, ledgers and worksheets before they could take the form of final accounts. Only those transactions are recorded which are measurable in terms of money. The transactions which cannot be expressed in monetary terms does not form part of financial accounting even though such transactions have a significant bearing on the working of a business.

b) **Managerial Decision Making**

Financial accounting is greatly helpful for managers in taking decisions. Without accounting, the managerial functions and decision making programmes may mislead. The performance of daily activities are to be compared with the predetermined standards. The variations of actual operations and their analysis are possible only with the help of financial accounting.

c) **Interpreting Financial Information**

Interpretation of financial information is very important for decision making. The recorded financial data is interpreted in such a manner that the end users such as creditors, investors, bankers etc., can make a meaningful judgment about the financial position and profitability of the business operations.

d) **Communicating Results**

Financial accounting is not only concerned with the recording of facts and figures but it is also connected with the communication of results. In fact accounting is the source of business operation. Therefore, the information accumulated and measured should be periodically communicated to the users. The information is communicated through statements and reports. The financial statements and reports should be reliable and accurate. A variety of reports are needed for internal management depending upon its requirement. In communicating reports to outsiders, standard criteria of full disclosure, materiality, consistency and fairness should be adhered to.

Limitations of Financial Accounting

Financial accounting was able to cope up with the needs of business in the initial stages when business was not so complex. This is because financial accounting is mainly concerned with the preparation of final accounts, i.e., profit and loss account and balance sheet. But the growth and complexities of modern business have made financial accounting highly inadequate. The management needs information for planning, controlling and coordinating business activities.

The limitations of financial accounting are as follows :

1) **Historic nature** : Financial accounting is the record of all those transactions which have taken place in the business during a particular period. As management's decisions relates to future course of action, they are made on the basis of estimates and projections. Financial accounting provides information about the past data and not about the future. It does not suggest the measures about what should be done to improve efficiency of the business. Past data are needed for making future decisions but that does not alone sufficient.

2) **It records only actual costs :** Financial accounting has always been concerned with figures treating them as single, simple and silent items because it records only actual cost figures. The price of goods and assets changes frequently. The current prices may be different from recorded costs. Financial accounts do not record these price fluctuations. Therefore, the recorded information may not give correct information.

3) **It provides quantitative information :** Financial accounting considers only those factors which are quantitatively expressed. Anything which cannot be measured quantitatively will not constitute a part of financial accounting. Today business decisions are influenced by a number of social considerations. Governments polices have a direct bearing on the working of business. Therefore, in addition to social consideration the management has also to take into account, the impact of government policies on the business. But these factors cannot be measured quantitatively so their impact will not reflect in financial statement.

4) **It provides information about the whole concern :** Financial accounting provides information about the concern as a whole. It discloses only net results of the collective activities of a business. Detailed information regarding product-wise, process-wise, department wise, etc. is not recorded in financial accounts. Thus, product wise or job wise cost of production cannot be determined. It is essential to record the transactions activity wise for cost determination and cost control purpose.

5) **Difficulty in price fixation :** The cost of the product can be obtained only when all expenses have been incurred. It is not possible to determine the prices in advance. Price fixation requires detailed information about variable and fixed costs, direct and indirect costs. Financial accounting cannot supply such information and therefore, it is difficult to quote the prices during the periods of inflation or depression in trade.

6) **Appraisal of policies is not possible :** Financial accounting do not provide data for evaluation of business policies and plans. There is no technique for comparing actual performance with the budgeted targets. Financial accounting do not provide any measure to judge the efficiency of a business. The only criteria for determining efficiency is the profit at the end of financial period. Therefore, the only yardstick for measuring the managerial performance is profit and loss account which is not a reliable test for ascertaining efficiency of the management.

7) **It is not helpful in Decision Making :** Financial accounting do not help the management in taking strategic decisions because they do not provide adequate information to compare the probable effect of alternative courses of action such as replacement of labour by machinery, introduction of new product line, expansion of capacity etc. The impact of these decisions and cost involved is to be ascertained in advance. Due to historic nature of accounting data available from financial accounts, it is not of much helpful to the management.

8) **Lack of uniformity in accounting principles :** Accounting policies differ on the use of accounting principles. There is lack of unanimity on the use of accounting principles and procedures. The financial statements prepared by two different persons of the same concern gives different results due to varying personal judgment in applying a particular convention. The methods of valuing inventory, methods of depreciation, allocation of expenses between revenue and capital etc. are the most controversial issues on which unanimity is not possible. The use of different accounting methods reduces the usefulness and reliability of financial accounting.

9) **It is not possible to control costs :** Another limitation of financial accounting is that the cost figures are known only at the end of financial period. When the cost has already been incurred then nothing can be done to control the cost. A constant review of actual costs from time to time is required for cost control and this is not possible in financial accounting.

10) **Possibility of manipulation of accounts :** The over and under valuation of inventory may affect the profit figures. The profit may be shown more or less to get more remuneration, to pay more dividend or to raise the share prices, or to save taxes or not to pay bonus to workers, etc. The possibility of manipulating financial accounts reduces their reliability.

11) **Technological revolution :** With the advancement in science and technology very minute and detailed break-up of all types of data relating to various parts of a business unit have become a must for the management of its day to day functioning. It is clear that financial accounting with its simple structure is not in a position to cater the needs of the management because it supplies only elementary information.

The limitations of financial accounting have given scope for the development of Costing and Management accounting.

1.6.2 Cost Accounting

Cost accounting is one of the important elements of accounting information about the problems of internal managerial control. Financial accounts are unable to meet information needs about the cost structure of a product. The need for cost determination and controls necessitated new set of principles of accounting and thus emerged 'Cost accounting' as a specialised branch of accounting. Cost accounting is the process of accounting for costs. It includes the accounting procedures relating to recording of all income and expenditure and preparation of periodical statements and report with the object of ascertaining and controlling costs. Such cost accounting is a good technique for ascertaining profitability and for decision making. The Institute of Cost and Management, London defines cost accounting as "the application of costing and costing principles, methods and techniques to the science, art and practice of cost control and ascertainment of profitability. It includes presentation of information derived therefrom for the purpose of managerial decision making."

Functions of Cost Accounting

The main functions of cost accounting can be briefed as follows :

a) Cost accounting enables the management to ascertain the cost of product, job, contract, service or unit of production.

b) It helps in price fixation or quotation.

c) It provides information for the preparation of estimates and tenders.

d) It helps in minimizing the cost of manufacture.

e) It helps in determining profitability of each product, process, department etc.

f) It is a useful tool for managerial control and helps in cost reduction and cost control.

g) It increases efficiency and reduces wastages and costs.

h) It provides cost data for comparison in different periods.

Limitations of Cost Accounting

Cost accounting lacks a uniform procedure. It is developed through theories and accounting practices based on reasoning and common sense. There is no common system of cost accounting applicable to all industries. A limitation of cost accounting is its emphasis on cost data and largely based on estimates. Hence, it is considered very narrow in its perspective as it fails to consider the revenue aspect in detail. Moreover, cost accounting can be used only in big organisations.

1.6.3 Management Accounting

Cost accounting helps the internal management by directing their attention on inefficient operations and assisting in a day-to-day control of business activities. The costing data needs to be arranged, re-analysed and processed further for effective role in managerial process. In addition to costing and accounting data, managerial functions need the use of socio-economic and statistical data (e.g., population break-ups, income structure, etc.). Cost and financial accounting do not provide such information and this limitation pave the way for the emergence of management accounting. Management accounting is a systematic approach to planning and control functions of management. It generates information for establishing plans and

controls. It provides for a system of setting standards, plans, or targets and reporting variances between planned and actual performances for corrective actions. Thus, Management accounting consists of cost accounting, budgetory control, inventory control, statistical methods, internal auditing and reporting. It also covers financial accounting.

Management accounting is the process of identification, measurement, accumulation, analysis, preparation, interpretation and accumulation of financial information used by management to plan, evaluate, and control within an organisation and to assure appropriate use of and accountability for its resources. Management accounting also comprises the preparation of financial reports for management groups such as shareholders, creditors, regulator agencies and tax authorities.Thus it is the application of professional information to assist the management in the formation of policies and in planning and control of the operations of the business enterprise.

Thus Management accounting helps an organisation to accomplish its goals in the following ways :

1) It provides a way to communicate expectations to managers throughout the organisation.
2) It provides feedback which enables a manager to monitor the day to day operations of the company for which he is responsible. If actuals differ significantly from targeted results, the manager is alerted, can look for causes for deviation and can take corrective actions.
3) It provides a set of prescribed tools and techniques for use in decision making.

Limitations of Management Accounting

Though Management Accounting is a useful tool for planning, directing and controlling functions still it suffers from the following limitations :

1) **Based on Cost and Financial Information:** Management accounting derives information from financial and cost accounting and other records. The accounting statements and records suffer from certain limitations as they are prepared on the basis of certain accounting concepts and conventions. The correctness and effectiveness of managerial decisions will depend upon the quality of data on which these decisions are based. If financial data is not reliable then management accounting will not provide correct analysis. The limitations of financial statements and records may be transmitted to the management accounting system. This may limit its effectiveness and make the information a substandard one.
2) **Persistence of Intuitive Decision Making:** Management accounting provides facts and figures of various situations and assists management in taking decisions scientifically. It includes decision tools such as marginal costing, differential costing and OR techniques like linear programming, decision theory, etc. Despite the facilities provided, the management mostly resorts to simple methods of decision making by intuition. Intuitive decisions limit the usefulness of management accounting.
3) **It has a very Wide Scope:** For taking decision, management requires information from both accounting as well as non-accounting sources and also quantitative as well as qualitative information. This creates many problems and brings a degree of inexactness and subjectivity in the conclusions obtained through it .
4) **Lack of Knowledge:** The use of Management accounting requires the knowledge of a number of related subjects. Lack of knowledge in the related subjects limits the use of management accounting

5) **It is very Costly System:** The installation of Management accounting system needs a very elaborate organisational system. A large number of rules and regulations are also required to make this system workable and effective. This results in heavy investment which only big concerns can afford.

6) **Scope for Personal Bias:** The interpretation of financial information depends upon the capability of interpreter as one has to make a personal judgment. There is every possibility of personal bias in analysis and interpretation. Personal bias will affect the quality of decision making.

7) **It invites Resistance within the Organisation:** The installation of management accounting needs a radical change in the accounting organisation. New rules and regulations are also to be framed. It demands rearrangement of personnel and their activities. This will affect a number of personnel and therefore, there is a possibility of resistance by some of the people of the organisation concerned.

Check Your Progress A

1. What is Accounting ?

   ....

   ....

   ....

2. List out various Accounting activities in an organisation.

   ....

   ....

   ....

3. What are the limitations of Accounting ?

   ....

   ....

   ....

4. Name the parties interested in accounting information.

   ....

   ....

   ....

5. What is the main purpose of Financial Accounting and Management Accounting ?

   ....

   ....

   ....

6. State whether each of the following statements is True or False :

   i) Accounting is concerned only with the recording of transactions.
   ii) Accounting is the language of the business.
   iii) Accounting records both financial and non financial transactions.
   iv) Management accounting provide necessary information to outsiders only.
   v) Cost accounting helps in ascertaining and controlling costs.
   vi) The main objective of financial accounting is to ascertain the operating results and financial position of a concern.
   vii) Management accounting provides decision to the management.

1.7 ROLE OF MANAGEMENT ACCOUNTANT

The term Management Accountant has been applied to any one who performs accounting work within a firm and it encompasses persons performing activities which range from :

i) Posting customers' receivable accounts,

ii) Doing financial analysis for decision making, and

iii) Making high-level decisions in a large scale organisation.

There is no particular academic or professional accomplishments have been associated with the term. He plays a significant role in the decision making process of an organisation. The positional status of management accountant in an organisation varies from concern to concern depending upon the pattern of management system in the concern. He plays a significant role in the decision making process of the organisation heading the accounting department. In large organizations he is known as Financial Controller, Financial Advisor, Chief Accounts officer etc. He is responsible for installation, development and efficient functioning of the management accounting system. He plays an important role in collecting, compiling, reporting and interpreting internal accounting information. He prepares the financial and cost control reports to satisfy the requirements of different levels of management. He computes variances by comparing the actuals with the standards and interprets the results of operations to different levels of the organisation and to the owners of the business.

Thus, the management accountant occupies an important position in the organization. He performs a staff function and also has line authority over the accountants. If he participates in planning and execution of policies, he is equal to other functional managers. In most of the organisations, management accountant performs staff functions. He supplies information and gives his views about the data and leaves the final decision making to functional heads. If management accountant provides the facts accurately and are presented in a manner which allows proper analysis and interpretation then he cannot be held responsible for any wrong judgment by the management. On the other hand, if the information provided by the management accountant is biased, inaccurate and is not presented properly then he is responsible to the management for wrong decision making.

Functions of Management Accountant

The functions of the Management Accountant depends upon the position he occupies in the organisation and requirements of the organisation. The functions of the controller, by whatever name he is called, have been laid down by the controllers' Institute of America which are as follows :

1) **Planning and Control :** Management accountant establishes, coordinates and maintains an integrated plan for the control of operations. Such a plan would provide, to the extent required in the business cost standards, profit planning, programmes for capital investing and for financing, sales forecast and the expense budgets, together with necessary procedures to effectuate the plan.

2) **Reporting and Interpreting :** Management accountant measures the performance against given plans and standards. The results of the operations are interpreted to all levels of management and to the owners of the business. This also includes installation of accounting and costing system and recording of actual performance to find out deviation, if any.

3) **Evaluation of Policies and Programmes :** He is responsible to evaluate various policies and programmes. The effectiveness of policies, programmes and

organisation structure to attain the objectives of the organisation to a large extent depends upon the caliber of the management accountant.

4) **Tax administration :** It is also the function of management accountant to report to the government as required under different laws in force and to establish and administer tax policies and procedures. He has also to supervise and coordinate preparation of reports to government agencies.

5) **Protection of assets :** The management accountant has to assure fiscal protection for the assets of the business through adequate internal control and proper insurance coverage.

6) **Appraisal of External Effects :** He has to assess continuously the effect of various economic and social forces and government policies and interpret their effect upon the business towards the attainment of common goals.

The functions as stated above can also prove to be useful under the Indian context. Some of the above functions, in India are performed by Company Secretary, top level management, statistical department etc.

1.8 FINANCIAL ACCOUNTING PROCESS

Accounting may be defined as the process of recording, classifying, summarizing, analysing, and interpreting the financial transactions and communicating the results thereof to the persons interested in such information.

Thus the accounting process consists of the following five stages :

1) Recording the Transactions,
2) Classifying the Transactions,
3) Summarizing the Transactions, and
4) Interpreting the Tesults.

Let us discuss briefly these stages:

1) **Recording the Transactions :** The accounting process begins with the basic function of recording all the transactions in the book of original entry. This book is called 'Journal'. The journal is a daily record of business transactions. All business transactions of financial character are recorded in the journal in a chronological order (date wise) with the help of various vouchers such as cash memos, cash receipts, invoices, etc. The process of recording a transaction in the journal is called journalising. The journal may be further sub-divided into various subsidiary books such as cash journal for recording cash transactions, Purchase Journal for recording purchase of goods, Sales Journal for recoding sale of goods, etc. The number of subsidiary books to be maintained will depend upon the nature and size of the business.

2) **Classifying the Transactions :** The journal is just a chronological record of all business transactions and it does not provide all information regarding a particular item at one place. To overcome this difficulty we maintain another book called 'Ledger'. It consists of systematic analysis of the recorded data with a view to group the transactions of similar nature and posting them to the concerned accounts. It contains different pages of individual account heads under which all financial transactions of similar nature are collected. For example, all transactions related to cash are posted to cash account and transactions related to different persons are entered separately in the account of each person. The objective of classifying the transaction in this manner is to ascertain the combined effect of all transactions of a given period in respect of each account. For this purpose all accounts are balanced periodically.

3) **Summarising the Transactions :** The third step is presenting the classified data in a manner which is understandable and useful to the internal as well as external end users of accounting information. This can be done through the preparation of a year end summary known as 'Final Accounts'. Before proceeding to final accounts one has to prepare a statement called 'Trial Balance' in order to check the arithmetical accuracy of the books of accounts. If the Trial Balance tallies, more or less it means that the transactions have been accurately recorded and posted into the ledgers. Then with the help of the Trial Balance and some other additional information, final accounts are prepared. The objective of preparing final accounts are :

   i) To know the net operating results of the business, and

   ii) To ascertain the financial position of the business at a particular date.

   The operating results of the business can be ascertained by preparing an income statement called Trading and Profit and Loss Account and financial position of the business can be known by preparing a position statement called 'Balance Sheet'. The Trading and Profit and Loss account gives information about the profit or loss made during the year and the Balance Sheet shows the position of assets and liabilities of the business at a particular time.

4) **Interpreting the Results :** The final stage of accounting is analysing and interpreting the results shown by the final accounts. The recorded financial data is analysed and interpreted in a manner that the end users can make a meaningful judgement about the financial position and profitability of the business operations. This involves computation of various accounting ratios to assess the liquidity, solvency and profitability of the business. The balance on various accounts appearing in the Balance Sheet will then be transferred to the new books of account for the next year. Thereafter the process of recording transactions for the next year starts again.

The accounting information after being meaningfully analysed and interpreted has to be communicated in the proper form and manner to the proper person. This is done through preparation and distribution of accounting reports which includes besides the final accounts, in the form of ratios, graphs, diagrams, funds flow statements, etc.

1.9 ACCOUNTING EQUATION

The recording of transactions in the books of accounts is based on accounting equation. Each transaction has double effect on the financial profit of a concern. Accounting equation is a formula expressing equivalence of the two expressions of assets and liabilities. Thus, the total claims will equal to the total assets of the firm. The total claims may be to outsiders and the proprietor. In the beginning the owner of the firm provides funds to the business in the form of 'capital' which is also known as 'owners equity'. Initially the capital contributed by the owner to the business will be in the form of cash and this cash is treated as an asset of the firm. At the same time a liability will be created in the form of owners' equity according to business entity concept (i.e., business and the owner are two separate entities). Thus, the asset is (cash) balanced against liability (capital).

The accounting equation can thus be expressed as follows :

Cash (Asset) = Capital (Liabilities)

Total Assets = Total Liabilities (Capital + Liabilities)

OR

Fixed Assets + Current Assets = Internal Liabilities + External Liabilities

Capital = Assets – Liabilities

OR

Liabilities = Assets – Capital

Thus the above relationship is known as accounting equation and it is also called as Balance Sheet equation. Each transaction will affect the above equation but the relationship will remain the same on account of dual aspect of the transaction. An increase in asset side leads to increase in the liabilities side and vice versa. Thus dual effect will take place either on the same side or on both the sides of accounting equation. Let us take a few transactions and see how accounting equation is always maintained.

1. Mr. X started business with Rs. 1,00,000 cash : The business received a cash of Rs. 1,00,000 which is an asset to business. The capital contributed by Mr. X is a liability to the business because from the business point of view owner and business are separate legal entity.

   The equation now stands as follows:

   Equation : Assets = Capital + Liabilities

   Rs. 1,00,000 (Cash) = Rs. 1,00,000 + Nil

2. The business purchased furniture worth Rs. 15000 and paid cash : The effect of this transaction is that on one hand it increases one asset (furniture) and on other hand it decreases another asset (cash). The equation now will appear as follows;

	Assets						
	Cash	+	Furniture	=	Capital	+	Liabilities
Old equation	1,00,000	+	–	=	1,00,000	+	–
New Transaction	–15,000	+	15,000	=	–	+	–
New Equation	85,000	+	15,000	=	1,00,000	+	–

3. The business purchased goods on credit from Mr. Z for Rs. 10,000: The effect of this transaction is that it increases an asset (stock of good) and creates a liability (creditor). The equation now will be as follows :

	Assets								
	Cash	+	Furniture	+	Stock	=	Capital	+	Liabilities
Old equation	85,000	+	15,000	+	–	=	1,00,000	+	–
New Transaction (Creditor)	–	+	–	+	10,000	=	–	+	10,000
New Equation	85,000	+	15000	+	10,000	=	1,00,000	+	10,000

4. The business sold goods for Rs. 7,000 on credit : In this transaction, assets will be decreased by Rs. 7,000 in the form of stock and assets will be increased by Rs. 7,000 in the form of sundry debtors.

	Assets								Liabilities		
	Cash	+	Furniture	+	Stock	+	Sundry Debtors	=	Capital	+	Creditors
Old equation	85,000	+	15,000	+	10,000	+	–	=	1,00,000	+	10,000
New Transaction	–	+	–	+	(–7000)	+	7,000	=	–	+	–
New Equation	85,000	+	15000	+	3000	+	7000	=	1,00,000	+	10,000

5. Mr. X withdrew Rs. 10,000 for his private expenses : Withdrawing of cash from the business for private expenses, reduces business assets in the form of cash as well as his capital by Rs. 10,000.

	Assets					Liabilities	
	Cash	+ Furniture	+ Stock	+ Sundry Debtors	=	Capital	+ Creditors
Old equation	85,000	+ 15000	+ 3000	+ 7000	=	1,00,000	+ 10,000
New Transaction	–10,000	+ –	+ –	+ –	=	–10,000	+ –
New Equation	75,000	+ 15000	+ 3000	+ 7000	=	90,000	+ 10,000

Thus, the sum of assets will be equal to the sum of Capital and Liabilities irrespective of the number of transactions. The equation can also be presented in the form of statement of assets and liabilities called Balance Sheet which is always prepared at a particular date. The last equation stated above if presented in the form of Balance Sheet, it will be as follows :

Balance Sheet of Mr. X as at …………

Capital and Liabilities	*Rs.*	*Assets*	*Rs.*
Capital	90,000	Cash	75,000
Creditors	10,000	Stock	3,000
		Sundry debtors	7,000
		Furniture	15,000
	1,00,000		1,00,000

It should be noted that the total of both the sides of Balance Sheet should be equal irrespective of the number of transactions and the items affected thereby. It is due to the dual effect of business transactions on the assets and liabilities of the business.

1.10 ACCOUNTING CONCEPTS

Accounting is the language of business. Business firms communicate their affairs and financial position to the outsiders through accounting in the form of financial statements. To make the language to convey the same meaning to all interested parties it is necessary that it should be based on certain uniform scientifically laid down standards. The accountants in general, have agreed on certain principles to be followed strictly by them to maintain uniformity and also for comparison purpose. These principles are termed as 'Generally Accepted Accounting Principles'. Accounting principles may be defined as "those rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. They are a body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practice and as a guide for selection of conventions or procedures where alternatives exist." To explain these principles, the writers have used a variety of terms such as concepts, postulates, conventions, underlying principles, basic assumptions, etc. The same rule may be described by one author as a concept, by another as a postulate and still by another as convention. Hence, it is better to call all rules and conventions which guide accounting activity and practice as 'Basic Accounting Concepts. These are the fundamental ideas or basic assumptions underlying the theory and practice of financial accounting and are broad

working rules for all accounting activities developed and accepted by the accounting profession. It brings about uniformity in the practice of accounting.

These concepts can be classified into two broad groups which are as follows :

1) Concepts to be observed at the recording stage i.e., while recording the transactions, and
2) Concepts to be observed at the reporting stage i.e., at the time of preparing final accounts.

It must however be remembered that some of them are overlapping and even contradictory.

1.10.1 Concepts to be Observed at the Recording Stage

The concept which guide us in identifying, measuring and recording the transactions are :

1) Business Entity Concept
2) Money Measurement Concept
3) Objective Evidence Concept
4) Historical Record Concept
5) Cost Concept
6) Dual Aspect Concept

Let us explain them one by one and learn the accounting implications of each concept.

1) **Business Entity Concept**

According to this concept business is treated as a separate entity from its owners. All transactions of the business are recorded in the books of the firm. Business transactions and business property are different from personal transactions and personal property. If business affairs are mixed with private affairs, the true picture of the business is not available. The owner of the firm is treated as a creditor to the extent of his capital. From the accounting point of view the owner is different and the business is different. Therefore, under this concept the capital contributed by the owner of the firm is the liability to the firm and the owner is regarded as the creditor of the firm. However, personal expenditure of the owner is met from business funds it shall be recorded in the business books as drawings by the owner and not as business expenditure.

The business entity concept is applicable to all form of business organisation. This distinction can be easily maintained in the case of a limited company because the company has a separate legal entity of its own. But such distinction becomes difficult in case of a sole proprietorship or partnership, because in the eyes of law sole proprietor or partners are not considered separate entities. They are personally liable for all business transactions. But for accounting purpose they are treated as separate entities. This enables them to ascertain the profit or loss of the business more conveniently and accurately.

2) **Money Measurement Concept**

Usually business deals in a variety of items having different physical units such as kilograms, quintals, tons, metres, liters, etc. If the sales and purchase of different items are recorded in the physical terms, it will pose problems. But if these are recorded in common denomination their total become homogeneous and meaningful. Therefore, we need a common unit of measurement. Money does this function. It is adopted a common measuring unit for the purpose of accounting. All recording,

therefore, is done in terms of the standard currency of the country where business is set up. For example, in India, it is done in terms of Rupees. In USA it is done in terms of US dollars and so on.

Another implication of money measurement concept is that only those transactions and events are recorded in the books of accounts which can be expressed in terms of money such as purchases, sales, salaries etc. Other happenings (non-monetary) like labour management relations, sales policy, labour unrest, effectiveness of competition, a team of dedicated and trusted employees etc., which are vital importance to the business concern do not find place in accounting. This is because their effect is not measurable and quantifiable in terms of money.

Another limitation of this concept is that it is based on the assumption that the money value is constant which is not true. The value of money changes over a period of time. The value of rupee today is much less than what it was in 1971. This is due to a fall in money value. Thus this concept ignores the qualitative aspect of things and the impact of inflationary changes is not adjustable in this principle. That is why accounting data does not reflect the true and fair view of the affairs of business.

Now-a-days it is considered desirable to provide additional data showing the effect of changes in the price level on the reported income and the assets and liabilities of the business.

3) **Objective Evidence Concept**

The term objectivity refers to being free from bias or free from subjectivity. Accounting measurements are to be unbiased and verifiable independently. For this purpose all accounting transactions should be evidenced and supported by documents such as invoices, receipts, cash memos etc. These supporting documents (Vouchers) form the basis for making entries in the books of account and for their verification by auditors. As per the items like depreciation and the provision for doubtful debts where no documentary evidence is available, the policy statements made by the management are treated as the necessary evidence.

4) **Historical Record Concept**

Recording the transactions in the books of account will be done only after identifying the transactions and measuring them in terms of money. According to the historic record concept we record only those transactions which have actually taken place in the business during a particular period of time and not those transactions which may take place in future. It is because accounting record presupposes that the transactions are to be identified and objectively evidenced. This is possible only in the case of past (actually happened) transactions. The future transactions can hardly be identified and measured accurately. You also know that all transactions are to be recorded in chronological (date wise) order. This leads to the preparation of a historical record of all transactions. It also implies that we simply record the facts and nothing else.

One limitation of this concept is that the impact of future uncertainties has no place in accounting. Management needs information for future planning not only of the past but also for future. You know that we will also make a provision for some expected losses such as doubtful debts at the time of ascertaining profit or loss of the business which is contrary to the historic record concept. But it is not a routine item. This is done in accordance with another concept called conservation concept which you will study later.

5) **Cost Concept**

The price paid (or agreed to be paid in case of a credit transaction) at the time of purchase is called cost. Under this concept fixed assets are recorded in the books of

account at the price at which they are acquired. This cost is the basis for all subsequent accounting for the asset. For example, when an asset is acquired for Rs. 1,00,000, it is recorded in the books of account at Rs. 1,00,000 even though the market value may be different later. But the asset is shown in the books at cost price.

You know that with passage of time the value of an asset decreases. Hence, it may systematically be reduced from year to year by charging depreciation and the assets be shown in the balance sheet at the depreciated value. The depreciation is usually charged at a fixed percentage on cost. It bears no relationship with the changes in its market value. This makes it difficult to assess the true financial position of the concern and it is, therefore, considered an important limitation of the cost concept.

Another limitation of the cost concept is that if the business pays nothing for an item it acquired, then this will not appear in the accounting records as an asset. Thus, all such events are ignored which affect the business but have no cost. Examples are : a favourable location, a good reputation with its customers, market standing etc. The value of an asset may change but the cost remains the same in the books of account. As such the book value of an asset as recorded do not reflect their real value.
It should, however, be noted that the cost concept is applicable to the fixed assets and not to the current assets.

In spite of the above limitations the cost concept is preferred because firstly, it is difficult and time consuming to ascertain the market values and secondly, there will be too much of subjectivity in assessing current values. However, this limitation can be overcome with the help of inflation accounting.

6) Dual Aspect Concept

This is a basic concept of accounting. According to this concept every business transaction has a two-fold effect. In commercial context it is a famous dictum that "every receiver is also a giver and every giver is also a receiver". For example, if you purchase a machine for Rs. 8,000, you receive machine on the one hand and give Rs. 8,000 on the other. Thus, this transaction has a two-fold effect i.e.,(i) increase in one asset, and (ii) decrease in another asset. Similarly, if you buy goods worth Rs. 500 on credit, it will increase an asset (stock of goods) on the one hand and increase a liability(creditors) on the other. Thus, every business transaction involves two aspects (i) the receiving aspect, and (ii) the giving aspect. In case of the first example you find that the receiving aspect is machinery and the giving aspect is cash. In the second example the receiving aspect is goods and the giving aspect is the creditor. If complete record of transactions is to be made, it would be necessary to record both the aspects in books of account. This principle is the core of double entry book-keeping and if this is strictly followed, it is called "Double Entry System of Book-keeping'.

Let us understand another accounting implication of the dual aspect concept. To start with, the initial funds (capital) required by the business are contributed by the owner. If necessary, additional funds are provided by the outsiders (creditors). As per the dual aspect concept all these receipts create corresponding obligations for their repayment, In other words, a contribution to the business, either in cash or kind, not only increases its resources (assets), but also its obligations (liabilities/equities) correspondingly. Thus, at any given point of time, the total assets and the total liabilities must be equal.

This equality is called 'balance sheet equation' or 'accounting equation'. It is stated as under :

Liabilities (Equities) = Assets
Capital +Outside Liabilities = Assets

The term 'assets' denotes the resources (property) owned by the business while the term 'equities' denotes the claims of various parties against the business assets. Equities are of two types : (i) Owners' equity, and (ii) outsiders' equity. Owners' equity called capital is the claim of owners against the assets of the business outsiders' equity called liabilities is the claim of outside parties like creditors, bank, etc. against the assets of the business. Thus, all assets of the business are claimed either by the owners or by the outsiders. Hence, the total assets of a business will always be equal to its liabilities.

When various business transactions take place, they effect the assets and liabilities in such a way that this equity is maintained. You will study later in detail under '1.9 Accounting Equation' of this unit how the equity is maintained.

1.10.2 Concept to be Observed at the Reporting Stage

The following concepts have to be kept in mind while preparing the final accounts:

1. Going concern concept
2. Accounting period concept
3. Matching concept
4. Conservatism concept
5. Consistency concept
6. Full disclosure concept
7. Materiality concept

Let us discuss the above concepts one by one.

1) **Going Concern Concept**

According to this concept it is assumed that every business would continue for a long period. Keeping this in view, the investors lend money and the creditors supply goods and services to the concern. For all practical purpose the business is normally treated as a going concern unless there is a strong evidence to the contrary. The current disposal value is irrelevant for a continuing business. Recording of transactions in accounting is judged whether the benefits from expenses are immediate (short period, say less than one year) or a long term. If the benefits from expenses are immediate it is treated as a revenue or if the benefits are for long term, it is to be treated as capital depending upon the nature of expenses. Short term benefits expenses like rent, repairs etc. are limited to one year therefore such expenses are fully debited to profit and loss account of that year. On the other hand, if the benefit of expenditure is available for a longer period, it must be spread over a number of years. Therefore, only a portion of such expenditure will be debited to profit and loss account. The balance of expenditure is shown as an asset in the Balance Sheet. Similarly fixed assets are recorded at original cost and are depreciated in a proper manner and while preparing the balance sheet, market price of fixed asset are not considered. For example, a firm purchased a delivery van for Rs. 1,00,000 and its expected life is 10 years. The accountant has to spread the cost of the van for 10 years and charges Rs. 10,000 being 1/10th of its cost to the profit and loss account every year in the form of depreciation and show the balance in the balance sheet as an asset. While preparing final accounts, a record will also be made for outstanding expenses and prepaid expenses on the assumption that the business will continue for an indefinite period and the assets will be used for its expected life.

This concept will not apply in case of a concern when it has gone into liquidation or it has become insolvent. In such as case the assets are valued at their current values and the liabilities at the value at which they are to be met.

2) **Accounting Period Concept**

You know that the going concern concept assumes that life of the business is indefinite and the preparation of income and positional statements after a long period would not be helpful in taking appropriate steps at the right time. Therefore, it is necessary to prepare the financial statements periodically to find out the profit or loss and financial position of the business. It also helps the interested parties to make periodical assessment of its performance. Therefore, accountants choose some shorter period to measure the results and one year has been generally accepted as the accounting period. However, accounts can also be prepared even for a shorter period for internal management purposes. But one year accounting period is recognised by law and taxation is assessed annually. Acconting period may be a calender year i.e., January 1 to December 31 or any other period of twelve months, say April 1 to March 31 or Diwali to Diwali or Dasara to Dasara. The final accounts are prepared at the end of each accounting period and the financial reports thus, prepared facilitate to make good decision, corrective measures, business expansion etc. and also enable the end users to make an assessment of the progress of the enterprise.

3) **Matching Concept**

Matching concept is based on the accounting period concept. The matching concept is also called Matching of costs against revenue concepts. To ascertain the profit made by the business during a particular period, the expenses incurred in an accounting year should be matched with the revenue earned during that year. The term 'matching' means appropriate association of related revenues and expenses. For this purpose, first we have to recognize the revenues during an accounting period and the costs incurred in securing those revenues. Then the sum of costs should be deducted from the sum of revenues to get the net result of that period. The question when the payment was received or made is irrelevant. In other words, all revenues earned during an accounting period, whether received or not and all costs incurred, whether paid or not have to be taken into account while preparing the final accounts. Similarly, any amount received or paid during the accounting period which actually relates to the previous accounting period or the following accounting period must be eliminated from the current accounting period's revenues and costs. Therefore, adjustments are to be made for all outstanding expenses, accrued incomes, prepared expenses and unearned incomes, etc., while preparing the final accounts at the end of the accounting period. By application of this concept, the owner of the business easily know about the operating results of his business and can make effort to increase earning capacity.

4) **Conservation Concept**

This concept is also known as Prudent Concept. It ensures that uncertainties and risks inherent in business transactions should be given a proper consideration. Conservatism refers to the policy of choosing the procedure that leads to understatement of assets or revenues, and over statement of liabilities or costs. The consequence of an error of understatement is likely to be less serious than that of an error of over statement. On account of this reason, accountants generally follow the rule 'anticipate no profit but provide for all possible losses. In other words, profits are taken into account only when they are actually realized but in case of losses, even the losses which may arise due to a remote possibility should also be taken into account. That is the reason why the closing stock is valued at cost price or market price whichever is less. Similarly, provision for doubtful debts and provision for discounts on debtors are also made. This reflects a generally pessimistic attitude of the accountant, but it is regarded as the best way of dealing with uncertainty and protecting creditors against an unwarranted distribution of the firm's assets as dividends.

This concept is subject to criticism that it is against the convention of full disclosure. It encourages creation of secret reserves and financial statements do not reflect a true and fair view of the affairs of the business.

5) **Consistency Concept**

The principle of consistency means that the same accounting principles should be used for preparing financial statement for different periods. It means that there should not be a change in accounting methods from year to year. Comparisons are possible only when a consistent policy of accounting is followed. If there are frequent changes in the accounting treatment there is little scope for reliability. For example, if stock is valued at 'cost or market price whichever is less, this principle should be followed year to year. Similarly if deprecation on fixed assets is provided on straight line basis, it should be followed consistently year after year. Consistency eliminates personal bias and helps in achieving comparable results. If this principle of consisting is not followed, the accounting information about an enterprise cannot be usefully compared with similar information about other enterprises and so also within the same enterprise for some other period. Consistency principle enhances the utility of the financial statements.

However, consistency does not prohibit change. When a change is desirable, the change and its affect should be clearly stated in financial accounts.

6) **Full Disclosure Concept**

This concept states that the financial statements are to be prepared honestly and all significant information should be incorporated there in because these statements are the basic means of communicating financial information to all interested parties. Therefore, these statements should be prepared in such a way that all material information is clearly disclosed to the persons interested in its affairs . The purpose of this concept is that any body who wants to study the financial statements should not be prejudiced by concealing any facts. It is, therefore, necessary that the disclosure should be fair and adequate to make impartial judgement.

This concept assumes greater importance in respect of Joint Stock Company type of organisations where ownership is divorced from management. The Joint Stock Companies Act, 1956 requires that Profit and Loss Account and Balance Sheet of a company must give a true and fair view of the state of affairs of the company and also provided prescribed form in which these statements are to be prepared so that significant information may not be left out.

7) **Materiality Concept**

This concept is closely related to the full disclosure concept. Full disclosure does not mean that everything should be disclosed. It only means that relevant and material information must be disclosed. American Accounting Association defines the term materiality as "An item should be regarded as material if there is reason to believe that knowledge of it would influence the decisions of informed investor". Materiality primarily relates to the relevance and reliability of information. All material information should be disclosed through the financial statements accompanied by necessary notes. For example commission paid to sole selling agents, and a change in the method of rate of depreciation, if any, must be duly reported in the financial statements.

Further strict adherence to accounting principles is not required for items of little importance or non-material nature. For example, erasers, pencils, stapler, pins, scales etc., are used for a long period, but they are not treated as assets. They are treated as expenses. This does not affect the amounts of profit or loss materially. Similarly, while showing the amounts of various items in financial statements, they can be

rounded off to the nearest rupee or hundreds. There may not be any material effect. For example if an amount of Rs. 145,923.28 is shown as Rs. 1,45,923 or Rs. 1,45,900 it does not make much difference for assessment of the performance of the enterprise.

The materiality and immateriality convention varies according to the company, the circumstances of the transaction and economic significance. An item considered to be material for one business, may be immaterial for another. Similarly, an item of material in one year may not be material in the subsequent years. However, there are no specific rules for ascertaining material or non-material items. They are rather in the category of conventions or rules developed from experience to fulfil the essential and useful needs and purposes in establishing reliable financial and operating information control for business entities. What is required is just a matter of personal judgment.

Check Your Progress B

1) What do you understand by money measurement concept ?

....

....

....

....

2) Explain dual aspect concept.

....

....

....

....

3) List the concepts to be observed at the reporting stage.

....

....

....

....

4) What are the stages in accounting process ?

....

....

....

....

6) State whether each of the following statements is True or False :

   i) In accounting all business transactions are recorded which are having a dual effect.

   ii) It is the basis of a going concern concept that the assets are always valued at cost price.

   iii) Accounting principles are the rules which are adopted by accountants universally while recording transactions.

   iv) A controller is entrusted with the responsibilities of raising funds.

   v) Money measurement concept ignores qualitative aspect of things.

1.11 ACCOUNTING STANDARDS

Accounting standards are generally accepted accounting principles which provides the basis for accounting policies and for preparation of financial statements.
The object of these standards is to provide a uniformity in financial reporting and to ensure consistency and comparability of the information provided by the business firms. Therefore, the standards set for must be easily understandable as well as acceptable by all and significantly reduce manipulation of information in the books of accounts.

Thus, accounting standards provide useful information to the users to interpret published reports. It provides information about the basis on which accounts have been provided and the rules followed while preparing financial statements.

Importance of Accounting Standards

1) It helps the investors in assessing the return and possible risk involved in evaluating the various investment proposals in different enterprises.
2) It raises the standards of audit while reporting the financial statements to the management.
3) It helps the government and other interested parties in formulating economic policies, tax planning, market analysis, investment decisions etc.
4) It helps the Chartered Accountants to deal with their client, in preparing financial statements on a true and fair basis. They can refuse the reports of their clients which are found to be incorrect or misleading.
5) It helps the interested parities to understand the information properly and make meaningful comparisons and interpretations for decision-making purposes.
6) It facilitates inter firm comparison of the financial position and operating results of similar enterprises.
7) It will reduce the scope of manipulation of accounts to suit the requirement of management.
8) It would facilitate the development of international trade and commerce as financial statements are clearly understandable.

Compliance with the accounting standards has been made mandatory. Section 211(3A) of the Companies Act, 1956 requires that every financial statement i.e., profit and loss account and balance sheet shall comply with the accounting standards. For the purpose of this section the accounting standards issued by the Institute of Chartered Accountants of India (ICAI) shall be deemed to be the accounting standards. According section 211 (2B), If the financial statements of any company do not comply with requirements of the accounting standards, it should state the reasons for such deviations from the accounting standards together its financial effect, if any, arising due to such deviation. Therefore, it is advisable for the companies as far as possible to comply with the accounting standards in view of its mandatory nature. In case the mandatory accounting standards are not complied with, it is in contravention of provisions of the Companies Act and the financial statements prepared and presented will not reflect a true and fair view of the state of affairs of the company. These accounting standards also apply in respect of financial statements audited for tax purpose under section 44 AB of Income Tax Act 1961.

These accounting standards are applicable to all commercial, industrial or business activities of any enterprise but not to those enterprises which are not commercial, industrial or business in nature.

1.12 ACCOUNTING ASSUMPTIONS AND POLICIES AS PER ACCOUNTING STANDARDS OF INDIA

Accounting measurements are not always uniform. Some financial quantities can be measured in two or more different ways. The management with the help of company's accountant decides which measurement alternatives are to be used. These choices are known as 'accounting policies'. These accounting polices differ from company to company. Therefore, it is advisable to each company to state in the notes of its financial statements which accounting policy it has followed. The company should not change its policy frequently and when there is a change in the policy, the company should justify the reason for such a change.

The management is not completely free in choosing any accounting policies because selection of policy must fit within the limits set by the measurement guidelines known as 'generally accepted accounting principles' as well as to comply statutory requirements. For example, The Central Board of Direct Taxes requires the following information to be disclosed in respect of change in accounting polices :

1) A change in accounting policy shall be made only if the adoption of different accounting policy is required by statute or if it is considered that the change would result in more appropriate in preparation or presentation of the financial statements of an assessee.
2) Any change in accounting policy which has material effect shall be disclosed in the financial statements of the period in which such change is made. Where the effect of such change is not ascertainable or such change has no material effect on the financial statements for the previous year but has material effect in years subsequent to the previous year, the fact shall be stated in the previous year in which such change is adopted.

Materiality of an item depends on its amount and nature. An item should also be considered material if the knowledge of it would influence the decisions of the investors. Materiality varies from one business to another business. Similarly, an item which is material in one year may not be material in the next year. While preparing financial statements it is, therefore, necessary to give emphasis only on those matters which are significant and thereby ignoring insignificant matters.

In order to bring uniformity for the presentation of accounting results, the Institute of Chartered Accountants of India, established an Accounting Standard Board (ASB) in April, 1977. The Board consists of representatives from industry and government. The main function of ASB is to formulate accounting standards to be followed while preparing and interpreting the financial results. While framing the accounting standards, the ASB will pay due attention to the International Accounting Standards and try to integrate them to the possible extent. It also takes into account the prevailing laws, customs and business environment prevailing in India. To improve quality and bring parity with the presentation of financial statements in India, the ASB has formulated the following accounting standards:

No.	Title
AS 1	Disclosure of Accounting Policies
AS 2	Valuation of Inventories
AS 3	Cash Flow Statements
AS 4	Contingencies and Events occurring after Balance Sheet Date
AS 5	Net Profit or Loss, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Accounting for Construction Contracts

AS 8 Accounting for Research and Development
AS 9 Revenue Recognition
AS 10 Accounting for Fixed Assets
AS 11 Accounting for the Effect of Changes in Foreign Exchange Rates
AS 12 Accounting for Government Grants
AS 13 Accounting for Investments
AS 14 Accounting for Amalgamations
AS 15 Accounting for Retirements Benefits in the Financial Statements of Employers
AS 16 Borrowing Costs
AS 17 Segment Reporting
AS 18 Related Party Disclosures
AS 19 Leases
AS 20 Consolidated Financial Statement
AS 21 Earnings per Share
AS 22 Accounting for Taxes on Income
AS 23 Accounting for Investments in Consolidated Financial Statements
AS 24 Discounting Operations
AS 25 Interim Financial Reporting
AS 26 Intangible Assets
AS 27 Financial Reporting of Interest in Joint Ventures

Check Your Progress C

1) Why accounting practices should be standardised ?

....

....

....

....

2) State whether each of the following statements is True or False:

   i) A management accountant is not the custodian of properties and financial interests of a business enterprise.
   ii) 'Statement of Standard Accounting Practice' were formulated by an Accounting Standard Board in India.
   iii) The generally accepted accounting principles prescribe a uniform accounting practice.
   iv) The materiality concept refers to the state of ignoring small items and values from accounts.
   vi) The avoidance of insignificant things will not affect accounting results.

1.13 LET US SUM UP

In business a number of transactions take place every day. It is not possible to remember all of them. Hence there is a need to record them. The recording of business transactions in a systematic manner is the main function of accounting. It enables to ascertain the profit and loss and the financial position of the business. It also provides necessary financial information to all interested parties.

Accounting is the process of identifying, measuring, recording, classifying and summarizing the transactions and analysing, interpreting and communicating the results thereof. Accounting provides information for three general uses such as i) managerial decision-making, ii) managerial planning control, and internal performance evaluation, and iii) financial reporting and external performance evaluation. To meet the requirements of different people interested in accounting information, accounting is classified as financial accounting, cost accounting and management accounting. Financial accounting refers to the preparation of reports for general purpose whereas management accounting provides information to inside the organisation. Cost accounting provides information about the problems of internal managerial control.

Management accountant plays a significant role in the decision making process and it depends upon his position and requirements of the organisation. The accounting process is divided into four stages: (i) recording the transactions, (ii) classifying the transactions, (iii) summarizing the transactions, and (iv) interpreting the results. The recording of transactions in the books of accounts is based on accounting equation. Accounting equation is a formula expressing equivalence of the two expressions of assets and liabilities. The relationship will remain the same on account of dual aspect of the transaction.

The accountants over a period of time, have developed certain guidelines for all accounting work. These are called basic concepts of accounting. Certain concepts are to be observed at the time of recording the transactions, while others are relevant at the summarizing and reporting stages. The concepts to be observed at the recording stage are : business entity, money measurement, objective evidence, historical record, cost and the dual aspect concept. Concepts to be observed at the reporting stage are : going concern concept, accounting period concept, matching concept, conservatism concept, consistency concept, full disclosure concept and materiality concept. Lack of uniformity in accounting practice makes it difficult to compare the financial reports of different companies. The multiplicity of accounting practices makes it possible for management to conceal material information. To avoid this problem accounting standards are developed by various professional bodies. The object of accounting standards is to provide uniformity in financial reporting and to ensure consistency and comparability of the information provided by the business firms. The management is not absolutely free in choosing any accounting policy. The accounting policy selected must fit within the limits set by generally accepted accounting principles and also comply to the statutory requirements. The Accounting Standard Board (ASB) of India, has developed so far 27 standards to improve quality and parity with the preparation of financial statements.

1.14 KEY WORDS

Accounting Period : A period of twelve months for which the accounts are usually kept.

Balance Sheet : A statement of assets and liabilities as at the end of an accounting period.

Books of Accounts : Books in the form of bound registers or loose sheets wherein transactions are recorded.

Business Unit : A unit formed for the purpose of carrying on some kind of business activity.

Financial Position : Position of assets and liabilities of a business at a given point of time.

Financial Statement : Summary of accounting information such as profit and loss account and Balance Sheet prepared at the end of accounting period.

Profit and Loss Account: An account showing profit or loss of the business during an accounting period.

Transaction : Transfer of money or money's worth between the two business units.

Management Accountant : A staff-functionary who uses accounting information for management planning and control.

Staff Function : It is performed in an advisory capacity without line or decision-making.

Accounting Conventions : Methods or procedures used in accounting

Accounting Equation : Assets = Owners' equity + Liabilities

Accounting Principles : The methods or procedures used in accounting for events reported in the financial statements.

Accounting Standards : Accounting Principles.

Cost Accounting : Classifying, Summarizing, recording, reporting and allocating current or predicted costs.

Double Entry : The system of recording transactions that maintains the equality of the accounting equation.

Generally Accepted Accounting Principles (GAAP) : The conventions, rules and procedures necessary to define accepted accounting practice at a particular time; includes both broad guidelines and relatively detailed practices and procedures.

Internal Reporting : Reporting for management's use in planning and control.

Materiality : The concept that accounting should disclose separately only those events that are relatively important for the business or for understanding its statement.

External Reporting : Production of financial statements for the use of external interest groups like shareholders, investors, creditors, government etc.

1.15 ANSWERS TO CHECK YOUR PROGRESS

A) 6 (i) False (ii) True (iii) False (iv) False (v) True (vi) True (vii) True

B) 5 (i) True (ii) True (iii) True (iv) False (v) True

C) 2 (i) False (ii) True (iii) True (iv) False (v) True

1.16 TERMINAL QUESTIONS

1) What are the objectives of Accounting ? Name the different parties interested in accounting information and state why they want it.
2) Briefly explain the accounting concepts which guide the accountant at the recording stage.
3) What do you understand by Dual Aspect Concept ? Explain the accounting implications.
4) Explain the role of Management Accountant in a modern business organisation.
5) What are the accounting concepts to be observed at the reporting stage ? Explain any two in detail.

6) Discuss in brief the basic accounting concepts and fundamental accounting assumptions.

7) Why do accounting practices be standardized ? What progress has been made in India regarding standardization of accounting ?

8) Is it possible to give a true and fair view of a company's position using accounting information ? Explain.

9) Explain the following :

   i) Accounting equation

   ii) Convention of materiality

   iii) Accounting standards

   iv) Accounting process

   v) Branches of accounting

   vi) Accounting a source of financial information.

1.17 SOME USEFUL BOOKS

Harold Bierman Jr. and Allan R. Drebin, 1978. *Financial Accounting : An Introduction,* W. B. Sounders Company, Philadelphion, London (Chapter 1-3).

Maheswari, S. N., 2002, *An Introduction to Accounting,* Vikas Publishing House : New Delhi (Chapter 1 and 2)

Patil, V.A.,and J. S. Korlahalli, 1986. *Principles and Practice of Accounting,* R. Chand and Co., New Delhi (Chapter 1-3)

Gupta, R. L. and M. Radhaswamy, 1986. *Advanced Accountancy,* Sultan Chand and Sons : New Delhi (Chapter I and II)

Anthony, Robert, N. and James Reece, 1987. *Accounting Principles,* All India Traveler Book Seller, New Delhi (Chapter 1-3)

Meigs, Walter, B. and Robert F. Meirgs, 1987. Accounting : The Basis for Business Decisions, MC Graw Hill : New York (Chapter I)

Sidney Davidson, Michael W. Maher, Clyde P. Stickney, Roman L Weil, 1985. Managerial Accounting, An Introduction to Concepts, Methods, and Uses, Holt-Saunders International Editors, Japan. (Chapter I)

UNIT 2 BASIC COST CONCEPTS

Structure

2.0 Objectives

2.1 Introduction

2.2 Need for Cost Data

2.3 Cost Concept

2.4 Classification of Costs

- 2.4.1 Functional Classification
- 2.4.2 On the Basis of Identifiability with Products
- 2.4.3 On the Basis of Variability
- 2.4.4 On the Basis of Product or Period
- 2.4.5 On the Basis of Controllable and Non-Controllable Costs
- 2.4.6 On the Basis of Relevance to Decision-Making

2.5 Concepts of Cost Unit and Cost Centre

- 2.5.1 Cost Unit
- 2.5.2 Cost Centre

2.6 Elements of Cost

- 2.6.1 Materials
- 2.6.2 Labour
- 2.6.3 Expenses

2.7 Total Cost Build-Up

2.8 Cost Sheet

2.9 Calculation of Recovery Rates

2.10 Statement of Quotation

2.11 Methods of Costing

- 2.11.1 Job Costing
- 2.11.2 Contract Costing
- 2.11.3 Batch Costing
- 2.11.4 Unit Costing
- 2.11.5 Bocess Costing
- 2.11.6 Operating Costing
- 2.11.7 Multiple Costing
- 2.11.8 Uniform Costing

2.12 Types of Costing

- 2.12.1 Marginal Costing
- 2.12.2 Absorption Costing
- 2.12.3 Historical Costing
- 2.12.4 Standard Costing

2.13 Let Us Sum Up

2.14 Key Words

2.15 Answers to Check Your Progress

2.16 Terminal Questions

2.17 Some Useful Books

2.0 OBJECTIVES

After studying this unit, you should be able to :

- describe the need for cost data;
- meaning and classification of costs;
- explain the concept of cost unit and cost centre;
- describe the elements of cost;
- prepare a Proforma of Cost Sheet and identify the components of total cost;
- prepare a statement of quotation and ascertain the price of a tender; and
- describe different methods of costing and identify the industries to which each method is applicable.

2.1 INTRODUCTION

In this unit you will learn about certain basic cost concepts like cost, cost unit, cost centre, classification of costs, elements of costs and components of total cost. Apart from these aspects, the unit also covers preparation of cost sheet showing details of various components of total cost. You will also study about the preparation of statement of quotation. The unit also discusses various methods and types of costing.

2.2 NEED FOR COST DATA

Enterprises may be either profit making or non-profit making organisations. If they are profit making organisations, one of their primary objectives is to operate at a profit. Non profit organisations are generally providers of service. Cost data is required to know how much profit the enterprise is earned. To properly set their prices at a level to ensure a profit for the entity as a whole, the enterprise must know what their costs are. Similarly, decisions regarding adding new products or dropping old products, etc., knowledge of cost data is essential to know how profit changes with various alternatives. In case of non-profit institution, cost data helps to know what level of funding is needed to provide the services. It also helps the management to decide what kind of activities can engage in most efficiently. Thus the management of an organisation requires cost data for the following purposes :

1) To ascertain profit or loss periodically,
2) To plan the operations and performance evaluation,
3) For cost control,
4) To price the products or services,
5) To value inventory and measure the expenses in external financial reports, and
6) In day to day operations of plans and policies,

2.3 COST CONCEPT

In principle, a cost is a sacrifice of resources. According to the terminology of British Institute of Cost and Works Accountants, ''Cost is the amount of expenditure (actual or notional) incurred on or attributable to a given thing''. In other words, cost indicates, (i) an actual or estimated expenditure (ii) a direct or indirect expenditure, and (iii) it relates to a job, process, product or service. Examples of such costs are : Material, labour, factory overheads, administrative overheads, selling and distribution overheads.

Cost is a very broad and flexible term. It does not give an exact meaning unless it is used in some particular context. It varies with time, volume, firm, method or purpose. The meaning of cost may change according to its interpretation and the manner in which it is ascertained. It does not mean the same thing under all circumstances. Therefore, cost must indicate its purpose and the conditions under which it is computed.

Costs and Expenses

Cost information is necessary both for managerial accounting and financial accounting. When costs are used inside the organisation to evaluate its performance we say that costs are used for managerial accounting purposes. On the other hand when costs are used by outsiders (interested parties) to evaluate the performance of management and make investment decisions in the organisation, then costs are used for financial accounting purpose.

It is also important to distinguish between cost as used in managerial accounting, from expense, as used in financial accounting. A cost is a sacrifice of resource to achieve specific objective which has been deferred or not yet utilized for the realisation of revenues. The price paid for the acquisition of fixed assets, materials, etc. are the examples of such deferred costs.

An expense is a cost that is charged against revenue in an accounting period and hence expenses are deduced from revenue in that accounting period. Examples are : Salaries, rent rates, etc. Generally Accepted Accounting Principles and Regulations specify when costs are treated as expenses to be charged to revenues.

In accounting for managerial decisions the focus is on costs, and not on expenses. For external reporting, the term expense is used as defined by Generally Accepted Accounting Principles. But in practice, the terms cost and expenses are sometimes used synonymously.

Cost and Loss : There is difference between 'cost' and 'loss'. You know that cost signifies an expenditure incurred for recurring some benefit to the enterprise. If no benefit is derived from a particular expenditure, it is treated as a loss. Cost of material destroyed by fire, salary paid to a foreman during the period of strike etc., are the examples of loss to the business.

2.4 CLASSIFICATION OF COSTS

Costs may be classified into different categories depending upon the purpose. The following are the various bases according to which costs have been classified :

1) According to functions to which they relate,
2) According to their identifiability with jobs, products, or services,
3) According to their variability with changes in output,
4) According to the association with product or period,
5) According to their controllability, and
6) According to their relevance to decision-making

Let us discuss all the above in detail.

2.4.1 Functional Classification

The most common classification of costs in a manufacturing establishment is on the basis of functions to which they relate because costs have to be ascertained for each of these functions. On the basis of functions, costs are classified into four categories. They are :

i) Manufacturing Costs
ii) Administrative Costs
iii) Selling Costs
iv) Distribution Costs

Manufacturing Costs : Manufacturing costs are those costs related to factory operations which are essential to the completion of the product. It includes direct material costs, direct labour costs and manufacturing overheads. Direct materials are the major components of the finished product and can be easily identified with the product. Direct labour is the labour which is used in actually producing the product. Manufacturing overheads consist of all other costs related to the manufacturing process. These are also termed as 'production costs'.

Administrative Costs: Administrative costs includes all those costs incurred on the general administration and control of the firm. Examples of such costs are : salaries of the office staff, rent of the office building, depreciation and repairs of the office furniture etc. Infact any expenditure which is not related directly to production, selling, distribution, research and development forms part of the administrative costs.

Selling Costs: Selling costs are those costs which are incurred in connection with the sale of goods. Some examples of such costs are : Cost of warehousing, advertising, salesmen salaries etc.

Distribution Costs: Distribution costs are those costs which are incurred on despatch of finished products to customer including transportation. Examples of such costs are: packing, carriage, insurance, freight outwards, etc.

2.4.2 On the Basis of Identifiability with Products

On this basis costs are divided into (i) Direct Costs, and (ii) Indirect Costs:

Direct Costs : Direct costs are those costs which are the major components of the finished products and can be clearly identified with the product being produced. The examples of direct costs are : raw materials, labour and other direct expenses which are exclusively incurred for a particular job, product or process.

Indirect Costs : indirect costs are those costs which cannot be assigned to any particular product, job or process. These costs are usually incurred for the business as a whole and therefore, are to be allocated to various products manufactured in the factory on some reasonable basis. Examples of indirect costs are : factory lighting, rent of factory building, salaries of foreman, etc, Indirect costs are also called as 'overheads' or 'on costs'. These overheads can be further subdivided into factory overheads, administrative overheads, selling and distribution overheads.

2.4.3 On the Basis of Variability

Another classification is based on the cost behaviour. On this basis costs are classified into (i) Fixed Costs, (ii) Variable Costs, and (iii) Semi-variable (or semi-fixed) Costs, (iv) Step Costs.

Fixed Costs: These costs remain fixed irrespective of a change in the volume of output. But fixed cost varies when it is expressed on per unit basis. In other words fixed cost per unit decreases when the volume of production increases and vice versa.

Rent and lease, salary of production manager, salaries of staff, etc., are the examples of fixed cost. It should also be noted that fixed costs do not remain fixed always. They remain fixed only upto a certain level of production activity. If there is a change in the production capacity which require additional building and equipment, staff, etc., such cost will also change. Therefore, fixed costs are fixed within a relevant range of production. For example, if we produce 1000 units or 10,000 units of a particular product during a particular period, the rent of the factory building or the salary of the production manager will remain the same.

Variable Costs: Variable costs are those costs which vary directly or almost proportionately with the level of output. When volume of output increases, total variable cost also increases and when volume of output decreases the variable cost also decreases. But the variable cost per unit will remain unaffected. The examples of variable costs are : direct material, direct wages, power, commission of salesmen etc. Let us see the following example how the variable cost varies with the change in the level of output.

Variable Cost	*Level of Output (Units)*		
	3,000	*4,000*	*5,000*
Unit Costs:	Rs.	Rs.	Rs.
Direct Material (Rs. 1 per unit)	3,000	4,000	5,000
Direct Labour (Rs. 2 per unit)	6,000	8,000	10,000
Direct Expenses (Rs. 1 per unit)	3,000	4,000	5,000
Total Variable Cost	12,000	16,000	20,000
Cost per unit (Total VC ÷ No. of Units)	Rs. 4	Rs. 4	Rs. 4

In the above example the variable cost varies in direct proportion to the activity level but the variable cost per unit is fixed.

The following are the characteristics of variable costs :

i) The variable cost varies direct proportion to the volume of output.

ii) The cost per unit will remain the same irrespective of level of activity.

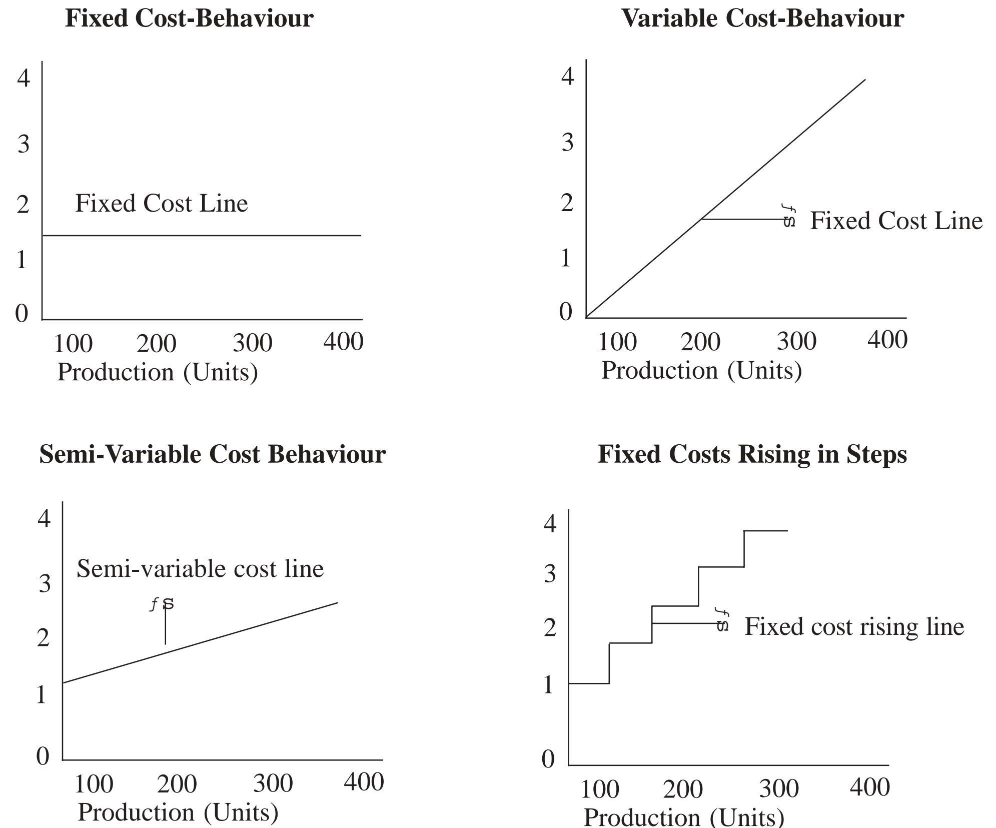
iii) It is easy to accurate allocation and apportionment to different cost centres.

iv) Variable costs can be controlled by functional managers as they incur only when production takes place.

Semi-variable Costs (or semi-fixed costs): These costs are partly fixed and partly variable. These are the costs which do vary but not in direct proportion to output. A part of semi variable costs comprising of fixed cost component , is not expected to change in response to the changes in the level of activity. Thus, semi-variable costs vary in the same direction but not direct proportion to the changes in the volume of output. Telephone bills, power consumption, depreciation, repairs, etc., are the examples of semi-variable costs. In case of telephone bills, there is a minimum rent and after specified number of calls, the charges are according to the number of calls made. Similarly, power costs include a fixed portion of minimum charge will be charged even if the power is not consumed and variable charge is based on the consumption of power. Thus, telephone and power charges increase with an increase in the usage level but not in the same direction.

Step Costs: Fixed cost in general remain fixed over a range of activity and then jump to a new level as activity changes. For example, a foreman can supervise a given number of workers in a particular shift. The introduction of anther shift will require additional foreman and certain costs will increase in lumps. Such costs are known as 'step costs' or 'stair step costs'.

The graphical representation of fixed costs, variable costs semi-variable costs and step costs is shown below:



Identification of costs according to their behaviour into fixed and variable elements is essential for profit planning, cost control, fixation of prices, preparation of budgets and also in various managerial decisions like make or buy or drop out decisions, selection of a product mix, level of activity decisions, etc.

2.4.4 On the Basis of Product or Period

Product costs are those costs which are easily attributable to products. These costs are necessary for the production and will not be incurred if there is no production. Product costs consist of direct material, direct labour and a reasonable share of factory overhead. These costs are also called inventoriable costs because these are included the cost of product as work-in-progress, finished goods or cost of sales. Generally all manufacturing costs are treated as product costs.

Costs which are easily attributable to time interval are known as period costs. These costs do not attach to products. These costs incurred for a time period and generally non-manufacturing costs are treated as period costs. These costs are charged to profit and loss account. The examples of period costs are rent of office building, salary of company executives, etc.

Period costs affect profit as they are charged to profit and loss account after they are incurred whereas product costs will affect profit only when they goods are realized. Thus, classification of costs on the basis of product and period is significant from profit determination point of view.

2.4.5 On the Basis of Controllable and Non-Controllable Costs

Controllable costs are those costs which can be controlled by a specified person or a level of management. Variable costs are generally controllable by the lower level of management like departmental heads. For example cost of raw materials can be controlled by purchasing them in bulk quantities. Uncontrollable costs are those costs which cannot be controlled or influenced by a specified person of an enterprise. For example costs like factory rent, managerial salaries etc. It should be noted that the costs which are not controllable in the short run likely to become controllable in the long run at some level in the organisation. Similarly, when one moves to the higher levels of management in the organisation more and more costs become controllable. Sometimes classification of costs as controllable or non controllable will be a discretionary matter of the management. The classification of costs on the basis of controllability is important for the evaluation of performance of the executives and assigning the responsibility in the organisation.

2.4.6 On the Basis of Relevance to Decision-Making

The following are some important cost concepts which help the management in decision making process.

Differential Costs: The difference in total costs among the various alternatives is termed as differential cost. In other words, differential cost is the result of change in the total cost from an alternative course of action. If the change increases the cost it is called incremental cost and the change decreases the cost it is called decrimental cost. The difference in the total cost may be due to change in the methods of production, change in sales volume, product mix, make or buy or drop out decisions, etc. While assessing the profitability of a proposed change, the incremental costs should be matched with the incremental revenues. Look at the following example :

A company is selling 1500 units @ Rs. 15 per unit. The variable cost per unit is Rs. 7 and the total fixed costs is Rs. 6000. The company receives an export order for the supply of 300 units @ Rs. 12 per unit. If this order is accepted, fixed cost will be increased by Rs. 300.

Solution

The cost and sales before and after accepting the export order is worked out as follows:

Particulars	*Before the Export Order*		*After the Export Order*		*Incremental*	
	Cost Rs.	*Revenue Rs.*	*Cost Rs.*	*Revenue Rs.*	*Cost Rs.*	*Revenue Rs.*
Sales		22,500		26,100		3,600
Less Variable Costs	10,500		12,000			
Fixed Costs	6,000	16,500	6,300	18,900	2,400	
Profit		6,000		7,200		1,200

The proposed export order will result a profit of Rs. 1200. If the proposal is implemented it results an incremental revenue of Rs. 3600 against the incremental cost of Rs. 2400. Thus the differential concept is important for managerial decision making.

Sunk Costs: Sunk costs results from past expenditure. Sunk costs cannot be changed now and management has no control over such costs. The examples of Sunk costs are : past cost of inventory, past costs of long term assets etc. It should be noted that past information is totally irrelevant but can be used to predict differential costs in future course of actions. Further the management uses the past expenditure information in performance evaluation.

Imputed Costs : These costs are also called hypothetical costs or notional costs. These costs are included in cost accounts only for the purpose of taking managerial decisions. For example, interest on capital, rent of own building should be taken into account while evaluating the relative profitability of the projects.

Opportunity Costs : Opportunity cost refers to the benefit foregone as a result of accepting one course of action. The manager, while taking a decision should not only take into account the costs and benefits of the proposed alternative but also the profit scarified by making the decision. For example, if an owned building is proposed to be utilized for housing a new project plant, the likely revenue which the building could fetch, if it is let out, is the opportunity cost which should be taken into account while evaluating the profitability of the project.

2.5 CONCEPTS OF COST UNIT AND COST CENTRE

2.5.1 Cost Unit

The main function of costing is to ascertain cost per unit of output. Each economic activity has to be measured in identifiable units which may serve as the basis of accounting. Such units for the purpose of costing may be as follows :

1) Unit of product, or a group of products (e.g., pair of shoes or one batch of shoes say one dozen)
2) Unit of operating service (e.g., cost of running a bus per one kilometer)
3) Unit of time (e.g., cost of generating electricity per hour)
4) Unit of weight (e.g., cost per one tonne of steel)
5) Unit of measurement (e.g., cost per meter of cloth or one litre of petrol)

Thus a cost unit is 'a unit of product, service or time in relation to which costs may be ascertained or expressed'. In other words cost unit is unit of measurement of cost. It will be normally the quantity of product for which price is quoted to the consumers. The selection of cost unit must be appropriate, natural to the business, easily understandable and acceptable to all concerned. Firstly, it should offer convenience in cost ascertainment. Secondly, it should be easier to associate expenses with cost units. Thirdly, it should be according to the nature and prevailing practice of the business.

Some examples of cost unit for different products and services are given below:

Product/Activity	Cost Unit
Cement	Per-tonne/per bag
Iron	Per-tonne/quintal
Chemicals	Per-tonne/kilogram/litre, etc
Power	Per-kilowatt hour
Coal	Per tonne/kilogram
Bricks	Per thousand
Printing press	Per thousand copies
Paper	Per ream/per kilogram
Transport	Per passenger per kilometer/per kilogram per kilometer
Telephone	Per call
Timber	Per cubic foot/square foot
Pencils	Per dozen or gross

Petrol	Per litre
Television	Per set
Gold	Per gram
Hotel	Per room per day
Nursing Homes	Per bed per day
Cars	Per car

2.5.2 Cost Centre

A cost centre is 'location, person, or item of equipment (or group of these) for which costs may be ascertained and used for the purpose of control'. Thus a cost centre refers to a section of business to which costs can be charged. It may consist of either or a combination of the following :

Location : Factory, Department, Office, Warehouse, Stores, Sales Depot, etc.

Person : Salesman, a machine operator, customer, etc.

Equipment : Machine, Car, Truck, etc.

Types of Cost Centres : Cost centres may be divided into the following four types :

1) Process Cost Centre (Based on sequence of operations)
2) Production Cost centre (for regular production in a factory)
3) Operation Cost Centre (where various operations are involved in the production process)
4) Service Cost Centre (for activities supporting the main production)

Thus identification or selection of cost centres depends on the nature and types of industry. The identification of cost centres helps us in :

i) ascertaining the centre-wise costs,
ii) comparing the centre-wise costs periodically,
iii) finding out the major trends of variance, and
iv) applying the techniques of control to check undue, undesirable or unexpected movements in cost.

A cost centre segregates operations, democrats activities, and distributes expenses. This also helps in fixing responsibilities for every cost centre.

Check Your Progress A

1. What is the concept of Cost ?

   ....

   ....

   ....

2. Distinguish between direct and indirect costs.

   ....

   ....

   ....

3. Give four examples of indirect expenses.

   ....

   ....

   ....

4. Distinguish between cost and loss.

....

....

....

5. Give two examples of semi-variable costs.

....

....

....

6. State whether each of the following statements is True or False

   i) Variable cost remains fixed per unit but varies direct proportion to the volume of output.

   ii) Variable costs are controllable.

   iii) Operating costing is used in transport industry.

   iv) Semi-variable costs vary in the same direction to the volume of output but not direct proportion to the changes in the volume of output.

   v) Fixed costs are also known as period costs.

   vi) Direct Material + Direct wages + Direct expenses = Works cost.

   vii) Works cost + Office overheads = Cost of production.

2.6 ELEMENTS OF COST

In order to understand and interpret the term 'cost', it will be necessary to understand about the elements of cost. The following are the three elements of costs: (1) Materials, (2) Labour, (3) Expenses

These can be further sub-dividend into as direct or indirect as follows :

Direct	**Indirect**
Material	Material
Labour	Labour
Expenses	Expenses

2.6.1 Materials

The term 'materials' refers to those commodities which are used as raw materials, components, or consumables for manufacturing a product. In other words, the substance from which the product is made is known as 'materials'. Materials can be direct or indirect.

Direct Materials: All materials which become an integral part of the finished product and which can be conveniently assigned to specific physical units is termed as 'Direct Materials'. Direct material generally becomes a part of the finished product. The following are some examples of direct material :

i) All materials or components specifically purchased, produced or requisitioned from stores (e.g., sugar can for sugar, cloth for ready-made garments, cotton for cloth, tyres for car, etc.)

ii) Primary packing material (e.g., wrapping, cardboard, boxes etc.)

iii) Partly produced or purchased components

Indirect Materials: All materials which are used for purposes ancillary to the business and which cannot conveniently be assigned to specific physical units is termed as 'indirect materials'. These materials cannot be conveniently identified with individual cost units. Their cost is insignificant in the finished product. Pins, screws, nuts, bolts etc., are some examples. There are some other items which do not physically become part of the finished product. Examples are : Consumable stores, lubricating oil, Greece, printing and stationery etc., These items do not form part of the finished product.

2.6.2 Labour

The workers employed for converting material into finished product or doing various odd jobs in the business are known as 'Labour'. Labour can be direct as well as indirect.

Direct Labour: The workers who are directly involved, in the production of goods are known as 'direct labour'. They may be labourers producing manually or workers operating machinery. Direct labour costs can be conveniently identified with a particular product, job or process. For example, the wages paid to a machine operator engaged in the manufacture of goods. The wages paid to such workers are known as 'manufacturing wages'.

Indirect labour : The workers employed for carrying out tasks incidental to production of goods or those engaged for office work and selling and distribution activities are known as indirect labourí. The wages paid to such workers are known as 'indirect wages'. Indirect labour is of general character in nature and cannot be conveniently identified with a particular unit of output. The examples of indirect labour costs are : wages of storekeepers, foremen, directors' fees, salaries of salesman, etc.

2.6.3 Expenses

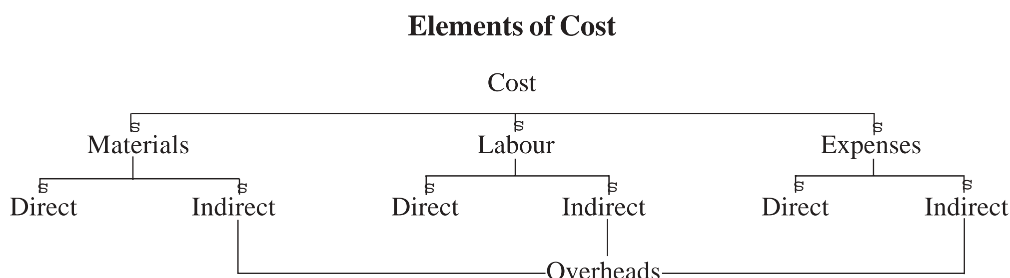
All expenses other than material and labour are termed as 'expenses'. Expenses may be direct or indirect.

Direct Expenses : Expenses which can be identified with and allocated to cost centres or units are called direct expenses. These are the expenses which are specifically incurred in connection with a particular cost unit. Direct expenses are also called as 'chargeable expenses'. The examples of such expenses are : Carriage inwards, production royalty, hire charges of special equipment, cost of special drawings, designs and layouts, experimental costs, etc.

Indirect Expenses : These are expenses which cannot be directly or wholly allocated to cost centres or cost units. In other words, all expenses other than indirect material and labour which cannot be directly attribute to a particular product, job or service are called indirect expenses. Examples of such expenses are : Rent and Rates, lighting and heating, advertising, insurance, repairs, carriage, etc.

The above elements of cost may be shown in the form of a chart as shown below:

Elements of Cost



All materials, Labour, expenses which cannot be identified as direct costs are termed as 'indirect costs'. The three elements of indirect costs viz., indirect materials, indirect labour and indirect expenses are collectively known as 'overheads' or 'on costs'. Overheads are grouped into three categories:

1) Factory (or manufacturing) overheads,
2) Office (or administrative) overheads, and
3) Selling and distribution overheads.

1) **Factory Overheads**

All indirect manufacturing costs which cannot be identified with specific unit of output are called factory overheads. It includes:

i) Indirect material such as lubricants, oil, consumable stores etc.,
ii) Indirect labour a such as gate-keepers' salary, works manager's salary etc., and
iii) Indirect expenses such as factory rent, depreciation on factory building and equipment, factory insurance, factory lighting etc.,
iv) Factory overheads are also known as manufacturing overheads, indirect production costs, factory on cost, overhead expenses etc.

2) **Office Overheads**

Indirect expenses incurred in connection with the general administration like formulating policies, planning and controlling of a firm for attainment of its goal, are included in these overheads. They include (i) indirect material used in office such as printing and stationary material, brooms and dusters etc. (ii) Indirect labour such as salaries payable to office manager, clerks, etc. and (iii) indirect expenses such as rent, insurance, lighting of the office etc.,

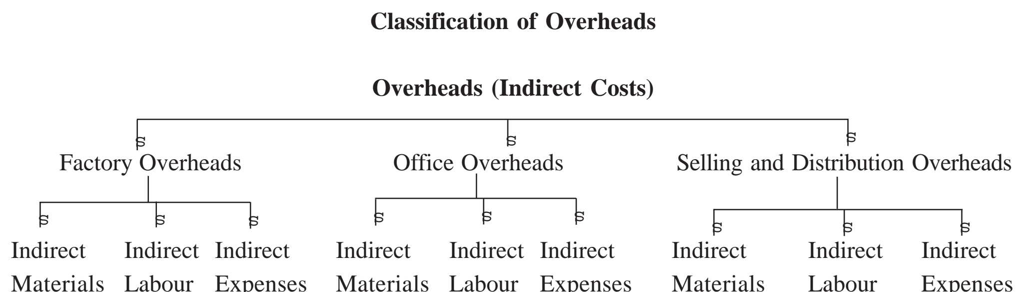
3) **Selling and Distribution Overheads**

Selling and distribution overheads include all those costs which are incurred for promoting and marketing the products. These include :

(i) Indirect material used such as packing material, printing and stationary material etc, (ii) Indirect labour such as salaries of salesmen, sales manager, etc. and (iii) Indirect expenses such as rent, insurance, advertising expenses etc.

The above classification of overheads can be shown with the help of the following Figure:

Classification of Overheads



2.7 TOTAL COST BUILD-UP

Components of Total Cost

Total cost of a product is the combination of direct costs and indirect costs. Direct Costs, as you know, consist of direct materials, direct labour and direct expenses and it is also known as prime cost. Indirect Costs known as overheads consists of factory overheads, office overheads and selling and distribution overheads. Thus, the two main components of total cost are: 1) Prime cost, and (2) Overheads.

If we add various costs one by one, we get the framework of total cost build up as follows :

1) **Prime Cost:** It consists of cost of direct material, direct labour and direct expenses. It is also known as basic, first or flat cost. Thus,

   Prime cost = Direct material + Direct Labour + Other direct expenses

2) **Factory Cost :** It includes Prime Cost and factory overheads which consists of indirect material, indirect labour and indirect factory expenses. The factory cost is also known as works cost, production or manufacturing costs. Thus,

   Factory Cost = Prime Cost + Factory Overheads

3) **Cost of Production:** It comprises factory cost and office and administrative overheads. It is also known as office cost. Thus,

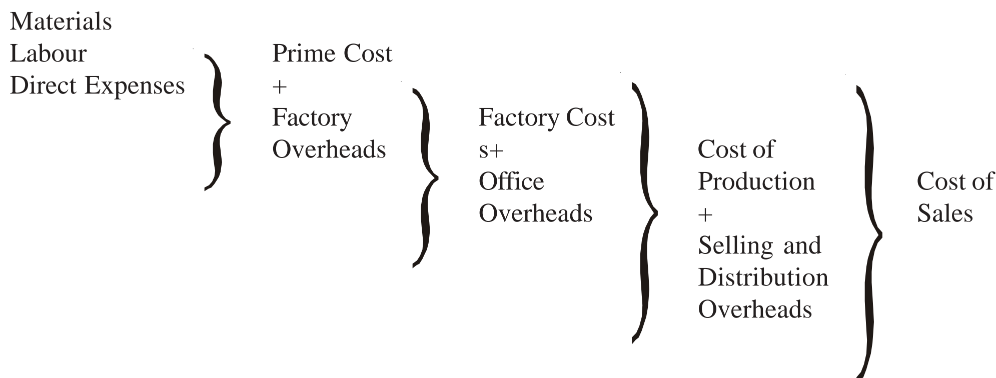
   Cost of Production = Factory Cost + Office and Administrative Overheads

4) **Total Cost:** It comprises cost of production and selling and distribution overheads. It is also called as cost of sales.

   Total Cost = Cost of Production + Selling and Distribution overheads

The above framework of total cost building-up is shown in the following Figure :

Total Cost Build Up



Thus, the components of total cost are :

Prime Cost, (2) Works Cost, (3) Cost of Production, and (4) Cost of Sales.

2.8 COST SHEET

The elements of cost can be presented in the form of a statement called ‘Cost Sheet’. A cost sheet is a statement showing the various components of total cost of output for a certain period which acts as a guide to pricing decisions and cost control. It has been defined as “a document which provides for the assembly of the detailed cost of a cost centre or cost unit”. The cost sheet should be prepared properly and at frequent intervals, i.e., weekly, monthly, quarterly, yearly etc. Cost sheet may be prepared separately for each cost centre. Additional columns can also be provided for the purpose of comparison of current data with the previous data.

Cost Sheet, generally serves the following purposes :

i) It provides total cost and cost per unit of production,

ii) It gives the details regarding various elements of total cost, i.e., material, labour, overheads, etc.,

iii) It gives scope for a comparative study of cost of production of the current period with that of the previous period.

iv) It helps the management in taking managerial decisions relating to pricing decisions, quotation of tenders, cost control etc.

The information to be shown in the cost sheet will depend upon the nature and requirement of the enterprise. Generally, following information may be incorporated into a cost sheet :

1) Name of the product, cost centre or cost unit
2) Period to which the statement relates
3) Output of the period
4) Details of various components of total cost
5) Item-wise cost per unit
6) Changes in stock position
7) Cost of goods sold
8) Profit or loss position

The Proforma of Cost sheet is given below :

Proforma of Cost Sheet

COST SHEET OF...

For the month ending...

Output.................nits

	Total Rs.	*Per Unit Rs.*
Raw Materials consumed :		
Opening Stock of Raw of materials		
Add : Purchases of Raw Materials		
Less : Closing stock of raw materials		
Direct Labour		
Direct Expenses		
PRIME COST		
Factory Overheads :		
Rent		
Depreciation on premises		
Power and light		
Indirect material		
Indirect wages		
Telephone Charges		
Insurance etc.		
WORKS COST		

Office and Administrative Overheads: Office salaries Office rent Office expenses, etc		
COST OF PRODUCTION (................units)		
Add Opening Stock of Finished goods (................units)		
Less Closing Stock of Finished Goods (................units)		
COST OF GOODS SOLD (................units)		
Selling and Distribution Overheads : Salaries and commission Advertising Packing expenses Travelling expenses Warehouse charges Carriage outwards, etc.		
COST OF SALES (................units)		
PROFIT (LOSS)		
SALES/SELLING PRICE		

Look at the following illustration and see how a Cost Sheet is prepared with the following information:

Illustration 1

From the following particulars of a manufacturing firm prepare a cost sheet showing different components of total cost for the year ending 31st March, 2003.

Particulars	Amount (Rs.)
Stock of material (April 1, 2002)	80,000
Purchase of Raw materials	12,00,000
Stock of finished goods on 1-4-2002 (10,000 units)	1,00,000
Direct wages	8,00,000
Direct chargeable expenses	8,000
Finished goods sold (1,80,000 units)	25,40,000
Factory rent rates and power	20,000
Indirect wages	5,000
Depreciation on Plant and Machinery	2,000
Carriage Outwards	20,000
Carriage Inwards	2,000
Office rent and taxes	1,500
Telephone charges	3,000
Travelling expenses	60,000
Advertising	10,000
Depreciation on office premises	1,500
Stock of materials on 31.3.2003	1,60,000
Stock of finished goods on 31.3.2003 (12,000 units)	1,20,000

Solution

Firstly, we have to find out the number of units produced during the year, before preparing the cost sheet.

	No. of Units
Closing Stock (31.3.2003)	12,000
Add: Number of Units sold	1,80,000
	1,92,000
Less : Opening Stock (1.4.2002)	10,000
Number of units produced during the year	1,82,000

COST SHEET
for the year ending 31.3.2003

Output: 1,82,000 Units

Particulars		*Total Rs.*	*Per Unit Rs.*
Raw Materials Consumed:			
Opening Stock (1.4.2002)	80,000		
Add: Purchase of Raw material	14,21,000		
Add : Carriage inwards	2,000		
	15,03,000		
Less : Closing stock of raw material	1,60,000		
(as on 31.3.2003)		13,43,000	
Direct wages		8,00,000	
Other direct chargeable expenses		8,000	
Prime Cost		21,51,000	
Works Overheads:			
Indirect wages	5,000		
Factory rent, rates and power	20,000		
Depreciation on plant and machinery	2,000		
		27,000	
Works Cost		21,78,000	
Office and Administrative Overheads:			
Office rent and taxes	1,500		
Telephone charges	3,000		
Depreciation on office premises	1,500		
		6,000	
Cost of Goods Sold		21,84,000	12.00
(1,82,000 units @ Rs.12 per unit)			
Add : Opening stock of Finished goods			
(10,000 units @ Rs.12 per unit)		1,20,000	12.00
		2,30,000	
Less : Closing stock of Finished goods		1,44,000	12.00
(12,000 units @ Rs.12 per unit)			
		21,60,000	

	Cost of Goods Sold			
	(180,000 units)			
Selling and Distribution Overheads:				
Travelling expenses		60,000		
Carriage outwards		20,000	90,000	0.50
Advertising	**Cost of Sales**	10,000		
	Profit		22,50,000	12.50
			6,30,000	3.50
		SALES	28,80,000	16.00

2.9 CALCULATION OF RECOVERY RATES

Sometimes, you are required to calculate overheads recovery rates based on the cost sheet prepared by you. Such rates are usually in respect of factory overheads and administration overheads. Factory overhead rate is usually calculated as a percentage of direct wages as follows:

$$\text{Factory Overhead Rate} = \frac{\text{Factory Overheads}}{\text{Direct wages}} \times 100$$

Administration overhead rate is usually calculated as a percentage of works cost as follows:

$$\text{Administration Overhead Rate} = \frac{\text{Office Administration Overheads}}{\text{Factory or Works Cost}} \times 100$$

Selling and distribution overheads rate may be computed either as a percentage of Works cost or as a percentage of sales as follows :

$$\text{Selling and Distribution Overhead Rate} = \frac{\text{Selling and Distribution Overheads}}{\text{Works Cost or Sales}} \times 100$$

Let us see the following illustration how the recovery rates are calculated :

Illustration 2

The following is the cost data relating to a manufacturing company for the period ending December 31, 2002 :

	Rs.
Raw material purchased	1,20,000
Stock of raw material on 1-1-2002	25,000
Direct wages	1,00,000
Factory overheads	60,000
Carriage inwards	1,00,000
Selling and distribution overheads	72,800
Administration overheads	67,200
Stock of raw material on 31.12.2002	35,000
Sales during the year	6,12,000

Find out
- a) Cost of Production
- b) Cost of Sales
- c) The Net Profit for the year
- d) The percentage of factory overheads on direct wages
- e) The percentage of administration overheads on works cost
- f) The percentage of selling and distribution overheads on works cost and
- g) The percentage of profit to cost of sales.

Solution

Cost Sheet for the period ending December 31, 2002

	Rs.	Rs.
Cost of Raw material consumed :		
Stock of Raw Material (as on 1-1-2002)	25,000	
Add : Raw material purchased	1,20,000	
Add : Carriage inwards	1,00,000	
	2,45,000	
Less : Stock of Raw Material (as on 31-12-2002)	35,000	
		2,10,000
Direct Wages		1,00,000
PRIME COST		3,10,000
Factory Overheads		60,000
WORKS COST		3,70,000
Administration Overheads		67,200
(a) COST OF PRODUCTION		4,37,200
Selling and Distribution Expenses		72,800
(b) COST OF SALES		5,10,000
(c) PROFIT		1,02,000
SALES		6,12,000

(d) Percentage of Factory Overheads to Direct Wages

$$= \frac{\text{Factory Overheads}}{\text{Direct Wages}} \times 100$$

$$= \frac{60,000}{1,00,000} \times 100$$

$$= 60\%$$

(e) Percentage of Administration Overheads to Works Cost

$$= \frac{\text{Administration Overheads}}{\text{Works Cost}} \times 100$$

$$= \frac{67,200}{3,70,000} \times 100$$

$$= 18.16\%$$

(f) Percentage of Selling and Distribution Expenses on Works Cost

$$= \frac{\text{Selling and Distribution Expenses}}{\text{Works Cost}} \times 100$$

$$= \frac{72{,}800}{3{,}70{,}000} \times 100$$

$$= 19.68\%$$

(g) Percentage of Profit to Cost of Sales

$$= \frac{\text{Profit}}{\text{Cost of Sales}} \times 100$$

$$= \frac{1{,}02{,}000}{5{,}10{,}000} \times 100$$

$$= 20\%$$

2.10 STATEMENT OF QUOTATION

A manufacturer, sometimes, may be asked to quote a price for supply a particular article with certain specifications. The term 'Quotation' refers to quoting the minimum price for obtaining a specific order. Such a price is quoted before the commencement of actual production in anticipation of obtaining a particular order. While quoting the price the manufacturer has to keep in view the likely impact of inflationary trends on the input. Before submitting a tender or fixing price he must have full information regarding cost of inputs like raw materials, wages, different overheads and a reasonable amount of profit. On the basis of past records, he can prepare a cost sheet incorporating inflationary trends in price levels of various components of production. While quoting the price for such specific order, he has to be cautious that the price is neither too high nor too low. In case the price is too high, the tender will be rejected outright. On the other hand, if the price is too low, it will result in either lower profit or loss. Therefore, it is important to estimate the cost as accurately as possible.

Statement of quotation is prepared in the same manner as Cost Sheet as shown in illustration 3

Illustration 3

A manufacturing company receives a quotation for the supply of 10,000 units of its products. The costs are estimated as follows :

Raw material 80,000 kgs. @ Rs. 4 per kg.
Direct wages 10,000 hours @ Rs. 2 per hour
Variable overheads :
Factory @ Rs. 2.50 per labour hour
Selling and Distribution Rs. 30,000
Fixed Overheads :
Factory Rs. 10,000
Office and Administration Rs. 75,000
Selling and Distribution Rs. 20,000

The company adds 10% to its cost as its margin of profit. Prepare a Statement of Quotation showing the price to be quoted.

Solution

Statement of Quotation showing the price to be quoted for 10,000 units

		Total Rs.	*Per Unit Rs.*
Estimated cost of Direct Materials (80,000 kgs X Rs. 4 per kg)		3,20,000	32.00
Estimated Cost of Direct Labour (10,000 hours X Rs. 2 per hour)		20,000	2.00
Estimated Prime Cost		3,40,000	34.000
Add : Estimated Factory Overheads :			
Variable (10,000 hours X Rs. 2.50)	25,000		
Fixed	10,000	35,000	35.00
Estimated Factory Cost		3,75,000	37.50
Add:Estimated Office and Administrative Overheads		75,000	45.00
Estimated Cost of Production		4,50,000	45.00
Add: Estimated Selling and Distribution Overheads			
Variable	Rs. 30,000		
Fixed	Rs. 20,000	50,000	5.00
Estimated Cost of Sales		5,00,000	50.00
Add: Deserved Profit @ 10% on cost price		50,000	5.00
Estimated Selling Price		5,50,000	55.00

Sometimes, cost records for a particular period are given and the estimated cost of material and labour of a work order are provided for the purpose of ascertaining its selling price to be quoted. In such a situation, you should prepare the cost sheet first and ascertain the recovery rates for factory overheads as a percentage to direct wages, for administrative overheads as a percentage of works costs, and for selling and distribution overheads as percentage of cost of goods sold or as suggested in the given question. These rates must be duly adjusted with the anticipated changes, if any, before preparing the statement of quotation. Look at the following illustration and how the statement of quotation for a work order is prepared with the help of a give cost data.

Illustration 4

The following figures have been obtained from the cost records of a manufacturing company for the year 2002 :

Cost of Materials	1,20,000
Wages for Direct labour	1,00,000
Factory overheads	60,000
Distribution expenses	28,000
Administration expenses	67,200
Selling expenses	44,800
Profit	84,000

A work order was executed in 2003 and the following expenses were incurred :

Cost of Materials	16,000
Wages for labour	10,000

Assuming that in 2003 the rate for factory overheads went up 20%, distribution charges went down by 10% and selling and administration charges went up by 12 $\frac{1}{2}$,

at what price should the product be quoted so as to earn the same rate of profit on the selling price as in 2002. Show the full workings.

Factory overheads are based on direct wages while administration, selling and distribution expenses are based on factory cost.

Solution

Statement of Cost for the year 2002

	Rs.
Cost of Direct Materials	1,20,000
Direct wages	1,00,000
PRIME COST	2,20,000
Factory Overheads	60,000
WORK COST	2,80,000
Administration Overheads	67,200
COST OF PRODUCTION	3,47,200
Selling Overheads	44,800
Distribution Overheads	28,000
COST OF SALES	4,20,000
Profit	84,000
SALES	5,04,000

$$\text{Factory Overhead Rate} = \frac{\text{Factory Overheads}}{\text{Direct Wages}} \times 100$$

$$= \frac{60,000}{1,00,000} \times 100$$

$$= 60\%$$

$$\text{Administrative Overheads Rate} = \frac{\text{Administration Overheads}}{\text{Works Cost}} \times 100$$

$$= \frac{67,200}{2,80,000} \times 100$$

$$= 24\%$$

$$\text{Selling Overheads Rate} = \frac{\text{Selling Overheads}}{\text{Works Cost}} \times 100$$

$$= \frac{44,800}{2,80,000} \times 100$$

$$= 16\%$$

$$\text{Distribution Overhead Rate} = \frac{\text{Distribution Overheads}}{\text{Works Cost}} \times 100$$

$$= \frac{28,000}{2,80,000} \times 100$$

$$= 10\%$$

$$\text{Rate of Profit} = \frac{\text{Profit}}{\text{Cost of Sales}} \times 100$$

$$= \frac{84{,}000}{4{,}20{,}000} \times 100$$

$$= 20\% \text{ cost of sales}$$

Statement of Quotation showing the price to be quoted for a work order

		Rs.
Cost of Direct Materials		16,000
Direct wages		10,000
PRIME COST		26,000
Factory Overheads : 60% of wages	6,000	
Add 20% increase	1,200	7,200
WORK COST		33,200
Administration Overheads: 24% of works cost	7968	
Add: $12\frac{1}{2}$ increase	996	8,964
COST OF PRODUCTION		42,164
Selling Overheads : 16% of works cost	5312	
Add: $12\frac{1}{2}$ increase	664	5,976
Distribution Overheads : 15% of works cost	3320	
Less : 10% decrease	332	2,988
COST OF SALES		51,128.00
Profit (20% of Cost of Sales)		10,225.50
SALES		61,353.50

Check Your Progress B

1) What is a cost Sheet ?

....

....

....

....

2) Name the basic methods of costing

....

....

....

....

3) Name different types of costing.

....

....

....

4) What do you mean by quotation? Why is it necessary ?

....

....

....

5) State whether each of the following statement is True or False

   i) Selling and distribution overheads are recovered on the basis of percentage to cost of production.

   ii) Office and administrative overheads are recovered usually on the basis of percentage to factory cost.

   iii) Factory overheads rate is usually calculated as a percentage of direct wages.

   iv) Cost of sales = Factory cost + Selling and Distribution overheads.

   v) Selling price = Cost of sales + Profit.

2.11 METHODS OF COSTING

Business enterprises are not alike. They are different from another in some way or other. The basic principles and procedures of costing remains the same in all industries but the method of analysis and presentation of cost of their products and services vary from industry to industry. Therefore, the choice of a particular method of costing depends upon the nature and types of the product or service provided by a business unit. The various methods of costing can be summarized as follows :

2.11.1 Job Costing

Under this method, costs are ascertained for each job or work order separately. The job may consist of a single unit or it may consist of identical or similar products under a single work order. This method applies where work is undertaken against customers' requirements. Job costing is suitable to industries like printing, repairs, foundries, interior decorators, building construction etc. Non profit organisations like rehabilitation or street repair programmes also use job costing to ascertain cost of individual projects. It can also be used in industries where different product lines are manufactured. For example, a furniture manufacturer may produce a batch of similar chairs, a batch of tables and so on. Each batch can be treated as a job for accounting purposes. Job costing also found in service organisations like engineering, consultancy and accounting firms. Job costing procedure is the same both in manufacturing and service organisations, except that service units use no direct material.

The purpose of job costing is to ascertain the cost of production of each job for fixing selling prices, bidding, controlling costs and evaluating performance. It also provides information for negotiating price increase with the customers.

2.11.2 Contract Costing

This method is used in case of big jobs and therefore, the principles of job costing are applied to contract costing The contract work usually involves heavy expenditure, spreads over a long period and is usually undertaken at different sites. Hence, each contract is treated as a separate unit for the purpose of cost ascertainment and control. Contract costing is also termed as terminal costing as the cost can be terminated at some point and related to a particular job. Contract costing is employed in business undertakings engaged in construction of buildings, roads, bridges, ship building and other civil and mechanical engineering works.

2.11.3 Batch Costing

This method of costing is used in industries where the production is carried on in batches. Each batch consist of identical products which maintains its identity throughout one or more stages of production. Each batch cost is used to determine the unit of cost of products. On completion of the batch the cost per unit can be calculated by dividing the 'total batch cost' by the number of units produced. This method of costing is suitable to industries where production consists of repetitive production in nature and specified number of products are produced in one batch. It is generally used in industries like engineering component industry, pharmaceuticals, footwear, bakery, readymade garments, toy manufacturing, bicycle parts etc.

2.11.4 Unit Costing

Unit Costing is a method of cost accounting where costs are determined per unit of a single product. This method is also called single or output costing. This method is suitable to industries where production is continuous and uniform and engaging in the production of a single product in two or three varieties. The cost per unit is found by dividing the total cost by the total number of units produced. Where the product is produced in different grades, costs are ascertained grad wise. It is suitable for industries like collieries, quarries, brick works, flour mills, paper mills, cement, textile mills, diaries etc.

2.11.5 Process Costing

Where a product passes through different processes and each process is distinct and well defined the method employed for ascertaining the cost at each stage of production is called process costing. Process costing is used in those industries where the production is continuous and the final product is the result of sequence of operations or processes. The finished product of one process will become the raw material of the next process and the output of the last process will be the finished stock. The cost per unit at each process will be calculated by dividing the total cost by the number of units produced at each stage and the cost per unit of the final product is the average cost of all the processes. During the course of processing of raw material, loss of some raw material is unavoidable or it may give rise to the production of several products called joint products or by products. Process costing is used in case of chemicals, paints, textiles, bakeries, oil refining, food products, etc. Standardization of processes helps the management to submit quotations in time without any delay. As actual and budgeted costs are available in each process it facilitates managerial control by evaluating the performance at each process level.

2.11.6 Operating Costing

Operating Costing is also called as 'service costing' because this method is used in those undertakings which provide services and are not engaging in manufacturing tangible products. It is used for ascertaining the cost of operating a service such as railways, roadways, airways, hotels, nursing homes, power supply, water supply etc. In these undertakings the cost unit is a service unit which is as follows:

Undertaking	**Cost Unit**
Canteen	per cup of tea
Cinema	per seat
Electricity	per kilo watt
Hospital	per bed
School/College	per student
Transport	per passenger kilometer/per tonne kilometer

A large amount of capital is invested in fixed assets and comparatively less working capital is required in these industries. Operating costing is different from operation costing. Operating costing is used to determine the cost of providing a service whereas operation costing is used to find out cost of each operation in those of industries which produce goods consisting of a number of operations.

2.11.7 Multiple Costing

It is an application of more than one method of costing in respect of the same product. This method is suitable in industries where a number of components are manufactured separately and then assembled into a finished product. In cases of motor car, type writer, television, refrigerators, etc., costs are to be ascertained for each component as well as for finished product. This involves use of different methods of costing for different components and so it is known as 'multiple' or 'composite costingí.

2.11.8 Uniform Costing

The practice of using a common method of costing by a number of firms in the same industry is known as 'uniform costing'. Thus it is not a separate method of costing. It simply refers to a common system using agreed concepts, principles and standard accounting practices. This helps in making inter-firm comparisons and fixation of prices.

It should be noted that there are two basic methods of costing. They are : (i) Job costing, and (ii) Process costing. The other methods discussed above are simply variants of these two methods.

2.12 TYPES OF COSTING

2.12.1 Marginal Costing

It is also known as Variable Costing. It may be defined which methods of costing rebers to the process and practice of ascertaining costs of products and serrices, the types of costing rebers to the techniqu of analysing and presenting costs for the purpose of control and managerial decisions. The hypes of costing (also known as techniques of costing) generally used are as follows:

as "the ascertainment of marginal costs and of the effect on profit of changes in volume or type of output by differentiating between fixed costs and variable costs." It is a technique of costing which emphasizes the distinction between product costs and period costs. Only variable costs (direct material, direct labour, other direct expenses and variable overheads) are allocated to products without taking into account fixed costs. Fixed costs are treated as period costs and are charged to costing profit and loss account of the period in which they are incurred. The profitability of the product is based on the amount of contribution made by each product. Contribution is the difference between selling price and marginal cost of sales. The price of a product will be determined on the basis of marginal cost plus contribution. The difference between the total contribution and total fixed cost represents the profit (Profit = Contribution – Fixed cost).

The technique of marginal costing is a valuable tool to management in making managerial decisions like fixation of selling price, selection of suitable product mix, selection of alternative methods of production, make or buy decisions, and also for cost control.

2.12.2 Absorption Costing

Absorption costing is a principle whereby fixed as well as variable costs are allotted to cost units. It is a technique of charging all costs, both fixed and variable costs, to production of a product. Absorption costing does not require a break-down of costs into fixed and variable costs. As such fixed costs are treated as product costs under absorption costing. The reports prepared under absorption costing can be used for external use.

2.12.3 Historical Costing

It refers to a system of cost accounting under which costs are ascertained only after they have been incurred. In other words, accounting is done in terms of actual costs and not in terms of predetermined and standard costs. In the initial stages of development of cost accounting, historical costing is the only system available for ascertaining costs. This system is not useful for cost control and measuring the performance efficiency of the concern. Moreover, it is not useful in price quotations and production planning.

2.12.4 Standard Costing

It refers to the system of cost accounting under which costs are determined in advance on certain predetermined standards. These are known as standards which indicate the level of costs that should be attained under a given set of operating conditions. The standard costs are compared periodically with the actual costs and underlying causes for variances are analysed so that corrective action may be taken in time wherever necessary. The Standard Costing is helpful to the management for cost control, production planning, formulation of policies, measuring efficiencies, eliminating inefficiencies, etc.

2.13 LET US SUM UP

Cost data is required by an organisation for the purpose of ascertaining profit or loss periodically, to plan its future operations as well as to evaluate its performance and cost control. It also requires to price its products or services, to value its inventory and day to day operations of plans and policies. Costs indicates (i) an actual or estimated expenditure (ii) a direct or indirect expenditure and (iii) it relates to a job, process, product or services. Cost is a flexible concept. It varies with time, volume, firm, method or purpose. There is difference between 'cost' and 'loss'. Cost signifies an expenditure incurred for recurring some benefit and if no benefit is desired from a particular expenditure, it is treated as loss.

Cost can be classified in various ways. On the basis of functions to which they relate, costs are classified into manufacturing costs, administrative costs, selling and distribution costs. On the basis of Identifiability with products costs can be classified into direct costs and indirect costs. On the basis variability costs can be classified into fixed costs, variable costs and semi variable costs. Costs can also be classified on the basis of product or period. Product costs are those costs which are easily attributable to products where as costs which are easily attribute to time interval are known as period costs. Costs can also be classified on the basis of controllable and non-controllable costs.

A cost unit is a unit of product, service or time in relation to which costs may be ascertained or expressed. A cost centre is a location, person or item of equipment (or group of these) for which costs may be ascertained and used for the purpose of control. There are three elements of costs : (i) Materials (ii) Labour and (iii)

Expenses. These costs can be further sub-dividend into as direct or indirect costs. Indirect costs are : indirect material, indirect labour, and indirect expenses. Indirect costs are known as 'overheads'. Overheads can be classified into factory overheads, office overheads, selling and distribution overheads.

The main components of total cost are prime cost, works cost, cost of production and cost of sales. The elements of cost can be presented in the form of a statement called 'cost sheet' A cost sheet is a statement showing the various components of total cost of output for a certain period which acts as a guide to pricing decisions and cost control. Overhead recovery rates are based on the cost sheet. Sometimes, a statement of quotations is required to be prepared in order to find out the price to be quoted to the prospective buyer for obtaining a specific order. Such a price is quoted before the commencement of actual production after taking into consideration the inflationary trends in the price levels of various components of production.

There are various methods of costing. These are: (i) Job costing (ii) Contract costing (iii) Batch costing (iv) Unit costing (v) Process costing (vi) Operating costing (vii) Multiple costing (viii) Uniform costing. The types of costing refers to the techniques of analysing and presenting costs for the purpose of control and managerial decisions. The types of costing generally used are: (i) Marginal costing (ii) Absorption costing (iii) Historical costing, and (iv) Standard costing.

2.14 KEY WORDS

Allocation: Distribution of expenditure among various cost centres.

Costing: The technique and process of ascertaining costs.

Cost Sheet: A statement showing different elements of cost relating to a particular product or a job for a particular period.

Cost Centre: A location, person, equipment or department for which costs may be ascertained and used for purpose of control.

Direct Expenses: Expenses or decrease in the same proportion on the increase or decrease in the output.

Cost of Sales: Total cost of a product including selling and distribution expenses.

Prime Cost: Cost of direct expenses including direct materials and wages.

Semi-variable costs: Expenses which change with changes in output, but not in the same proportion.

Works cost: Prime cost plus factory overheads.

Chargeable expenses: Other direct expenses.

By-product: A product of relatively small value produced incidentally from processing the raw material for the main product.

Joint Product: Two or more products resulting from processing a particular raw material.

Process Costing: A method of ascertaining the cost of a product at each stage or process of manufacturing.

Contract Costing: A special form of job costing applicable to big projects which involves huge cost to complete and is usually site-based.

Job Costing: Specific order costing involving accumulation of costs relating to a single cost unit - the job - when each order is of comparatively short duration.

2.15 ANSWERS TO CHECK YOUR PROGRESS

A) 6 i) True (ii) False iii) True (iv) True (v) True (vi) False (vii)True

B) 4 i) False (ii) True iii) True iv) False v) True

2.16 TERMINAL QUESTIONS

1) Distinguish among variable, fixed and semi-variable costs. Why is this distinction important?

2) "fixed Costs are really variable. The more you produced the less they become". Comment the statement.

3) Describe briefly the different methods of costing and state the particular industries to which they can be applied.

4) Distinguish between the following :

   i) Product cost and period cost

   ii) Controllable and uncontrollable cost

   iii) Variable and fixed costs

   iv) Direct and indirect costs

5) Costs may be classified according to their nature and characteristics' Explain.

6) Cooling Ltd manufactured and sold 1,000 refrigerators in the year ending 31st March, 2002. The summarized Trading and Profit & Loss Account is set out below :

	Rs.		Rs.
To Cost of Sales	8,00,000	By Sales	40,00,000
To Direct Wages	12,00,000		
To Other Manufacturing Cost	5,00,000		
To Gross Profit c/d	15,00,000		
	40,00,000		40,00,000
To Management and Staff Salaries	6,00,000	By Gross Profit b/d	15,00,000
To Rent, Rates and Insurance	1,00,000		
To Selling Expenses	3,00,000		
To General Expenses	2,00,000		
To Net Profit	3,00,000		
	15,00,000		15,00,000

For the year ending 31st March, 2003, it is estimated that

a) Output and sales will be 1,200 refrigerators.

b) Prices of Material will go up by 20% on the level of previous year.

c) Wages will rise by 5%

d) Manufacturing costs will rise in proportion to the combined cost of Material and wages.

e) Selling cost per unit will remain unaffected

f) Other expenses will also remain constant

You are required to submit a statement to the Board of Directors showing the price at which the refrigerators should be marketed so as to show profit of 10% on selling price.

(Answer : Estimated selling price Rs. 51,00,000 Profit Rs. 5,10,000)

7) The following particulars have been made available from the Cost Ledger of a Company :

	Rs.
Stock of Raw materials on 31.12.2000	25,600
Stock of finished Goods on 31.12.2000	56,000
Purchase of Raw materials	5,84,000
Direct wages	3,97,000
Sales	11,84,000
Stock of Raw Materials on 31.12.2001	27,200
Stock of Finished goods on 31.12.2001	60,000
Works Overheads	88,072
Office and general Charges	71,048

The company is required to submit a tender for a large machine. The Cost Department estimates that the materials will cost Rs. 40,000 and wages to fabricate the machine Rs. 24,000. The tender is to be made at a net profit of 20% on selling price.

Prepare a statement showing a) Cost of materials used, b) total cost, c) percentage of factory overheads to direct wages, and d) percentage of office overheads to works cost.

Also prepare a statement of quotation showing the price at which the tender of the machine can be submitted.

(Answer : Cost of materials used Rs. 5,82,400; Total Cost Rs. 11,38,520; Percentage of Factory overheads to Direct Wages 22%; Percentage of Office Overheads to Works Cost 6.65%; Price to be quoted in tender : Rs. 92,360)

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

2.17 SOME USEFUL BOOKS

Arora, M. N. 2000, *A Text Book of Cost Accountancy.* Vikas Publishing House Pvt. Ltd., New Delhi (Chapter 1-2).

Bhar, B. K. 1990. Cost Accounting : Methods and Problems. Academic Publishers, Calcutta (Chapter 1-2)

Maheswari, S. N. and Mittal, S. N. 1990. *Cost Accounting : Theory and Problems.* Shree Mahavir Book Dept, Delhi (Chapter I)

Nigam B. M. L. and Sharma G. L. 1990. *Theory and Techniques of Cost Accounting*. Himalaya Publishing House, Bombay (Chapter 1-3)

Owler. L. W. J. and J. L. Brown 1984. *Wheldon's Cost Accounting.* ELBS, London (Chapter 1-2)

UNIT 3 FINANCIAL STATEMENTS

Structure

3.0 Objectives

3.1 Introduction

3.2 Natural of Financial Statements

3.3 Contents of Financial Statements

- 3.3.1 Manufacturing Account
- 3.3.2 Trading Account
- 3.3.3 Profit and Loss Account
- 3.3.4 Profit and Loss Appropriation Account
- 3.3.5 Balance Sheet

3.4 Concept of Capital and Revenue

3.5 Revenue Recognition

- 3.5.1 Revenue Recognition in Case of Sale of Goods
- 3.5.2 Revenue Recognition in Case of Rendering of Services

3.6 Format of Financial Statements – Non-corporate Entities

- 3.6.1 Conventional Format
- 3.6.2 Vertical Format

3.7 Corporate Financial Statements

- 3.7.1 Items Peculiar to Corporate Balance Sheet
- 3.7.2 Items Peculiar to Corporate Income Statement

3.8 Requirements for Corporate Financial Statements as per Schedule VI

3.9 Basic Principles Governing the Preparation of Financial Statements

3.10 Preparation of Corporate Financial Statements

3.11 Let Us Sum Up

3.12 Key Words

3.13 Terminal Questions

3.0 OBJECTIVES

After studying this unit you should be able to:

- state the nature and contents of financial statements;
- know the differences between capital and revenue;
- know the prepration of non-corporate financial statements;
- be acquainted with the items peculiar to corporate financial statements; and
- prepare the profit and loss account and the balance sheet of a company as per the requirements of the Companies Act.

3.1 INTRODUCTION

Accounting involves the collection, recording, classification and presentation of financial data for the benefit of management and external agencies. For this purpose, the transactions recorded in the books of accounts are periodically summarised and presented in the form of two financial statements. One is the Balance Sheet or Positional Statement and the other is Profit and Loss Account or Income Statement.

These are periodical reports which reflect the financial position and operating results of the entire business for an accounting period, generally one year. These financial statements are the basis for decision making by the management as well as outsiders. However, the information presented in these statements must be analysed and interpreted carefully before drawing conlcusions. In this unit we shall study the preparation of financial statements both corporate and non-corporate entities as well as the salient points involved in the preparation of these statements in the light of Sections 210 to 223 and Part I and II of Schedule VI of the Companies Act, 1956.

3.2 NATURE OF FINANCIAL STATEMENTS

Financial Statements are prepared by all forms of business organizations to ascertain the result of operating, financial and investment activities and to know the financial position on the date of closing of books of accounts. In case of sole trade or a partnership firm, maintenance and preparation of financial statements is not mandatory but desirable. However, in case of Joint Stock Company, Sections 209 and 210 of the Companies' Act 1956 make it obligatory and compulsory to maintain and prepare financial statements by the end of each accounting period. Thus, main objective of financial statements is to serve the information needs of users of accounting information. These financial statements are the basis for decision making by the management as well as to the outsiders like investors and share holders, creditors and Financiers, government authorities, etc.

Objectives of Financial Statements

The primary objective of financial statement is to assist in decision making. These statements enable the users:

i) To make rational investment, credit and similar other financial decisions.

ii) To estimate future cash flow and bankruptcy risk assessment.

iii) To ascertain NAV (Net Assets Value) or Net worth of the enterprise after evaluating the value of assets, resources owned and the claims thereon (liabilities) in order to make share purchase and sale decisions, takeovers and merger decisions.

iv) Collective bargaining decision relating to wages, working conditions and job security.

v) To make assessment of economic and financial decisions.

(vi) To form appropriate taxation and subsidy policy, regulatory policy and employment policy.

Besides, the financial statements are tools of judging earning capacity and managerial efficiency to facilitate comparison and help evaluate its own performance. Thus, these provide necessary inputs for forecasting and other relevant decision-making purposes.

According to American Institute of Certified Public Accountants "Financial statements are prepared for the purpose of presenting periodical review or *report on progress* by management and deal with the status of the investment in the business and the *results achieved during the period* under review. Financial statements reflect a combination of *recorded facts, accounting-conventions* and the *personal judgment and the judgments and conventions applied affect them materially.* The soundness of the judgments necessarily depends on the competence and integrity of those who make them and on their adherence to generally accepted accounting principles and conventions.

Hence, these financial statements must give sufficient analysis of the figures, without unnecessary details to enable the users to understand its financial implications. This calls forth for "convention of materiality" i.e. every material fact has to be disclosed

which affect the decisions of the users of financial statements. It also demands that any departure from previous year's practice should clearly be indicated. In other words the "convention of consistency" should strictly be adhered to. An enterprise has to be consistent with reference to depreciation policy, inventory valuation policy and other policy to facilitate horizonal and vertical comparison. Financial statements are based on fundamental accounting assumptions of "going concern", "consistency" and accrual and are guided by major considerations governing the selection and application of accounting policies.

3.3 CONTENTS OF FINANCIAL STATEMENTS

3.3.1 Manufacturing Account

Business concerns engaged in the activities of manufacturing or production of goods which involves purchase of raw materials and in incurring of other manufacturing expenses, prepare Manufacturing Account which shows the cost of raw materials consumed, cost of conversion of raw materials into finished product and the cost of goods produced. The cost of goods produced charged to Trading Account. The cost of conversion includes–Direct Expenses, Frieght or Carriage Inward, direct labour. Productive wages/Factory wages and factory expenses, such as factory rent, fuel, power and gas, etc.

Cost of goods produced = Raw materials consumed + Cost of conversion

If, however, there is opening and closing work in progress due adjustment is made accordingly. Similarly, value of material residue, which is sold as scrap, is credited to Manufacturing Account.

Thus, we can say

Cost of goods produced = opening work-in-progress = cost of raw materials consumed + cost of conversion – closing work in progress – sale of scrap

Points to note regarding Manufacturing Account

1) ***Work in progress:*** It refers to the value of incomplete or semi-finished goods which includes cost of raw materials, and proportionate wages and direct expense incurred till this stage of semi completion. Opening and closing balances of the same are shown to the debit and credit side respectively.

2) ***Raw materials consumed:*** This shows the cost of materials used in the production process. This is arrived at by *Adding* the net purchases to the opening balance of raw materials and deducting the closing balance of raw materials at hand by the end of accounting period.

3) ***Direct expenses:*** These expenses are incurred either on procurement or purchases of raw materials and on conversion thereof into finished product. It includes productive wages, freight inward, cartage or carriage inward, etc. That is, it includes direct labour and direct expenses (factory).

4) ***Factory overheads or indirect expenses:*** Factory overheads refer to indirect material, indirect labour and indirect expenses. These include cotton waste, lubricating of machine oil, works manager, supervisor or foreman's salary, fuel and power, repairs and maintenance of factory machine, depreciation of factory assets, rent, rates and taxes of the factory building, factory insurance, etc.

5) ***Scrap:*** It denotes the value of material residue coming out of certain types of processes. It is sold as scrap and credited to Manufacturing Account to arrive at the correct cost of production.

6) ***Cost of production:*** Manufacturing Account ascertains the cost of goods manufactured during any accounting period as shown in the format of Manufacturing Account. The cost of production of goods produced is transferred to Trading Account.

3.3.2 Trading Account

Trading Account is prepared to know the result of trading operations. It shows the gross profit or gross loss arising from buying and selling of goods in which the business enterprise deals in. Gross profit or gross loss is the difference between 'sales' and 'cost of goods sold'.

Cost of goods sold = opening stock + purchases (less returns) + direct expenses – closing stock

It is to be noted that Trading Account shows the result of trading operations under **normal** conditions only. Abnormal losses (items) if any – such as loss of stock due to fire, theft or accident are credited to Trading Account, at cost.

Analysis of Items Appearing to the Debit Side of Trading Account

1) **Opening Stock:** It refers to the value of goods at hand at the end of last accounting year. It becomes the opening stock for the current accounting year. It represents the value of goods in which business deals in.

2) **Purchases:** It denotes the value of goods (in which the concern deals in) purchased either for cost or on credit for the purpose of resale. However, if the goods so purchased are *returned* or *used by proprietor* for self consumption, or *distributed as free samples* or *taken up by the employer* for their use, or *given as charity*, or to be *sent on consignment*, or used for any other purpose, except for resale, such amounts shall be deducted from the total purchases.

3) **Director Expenses:** These expenses are incurred in connection with purchase, procurement or production of goods. It also includes expenses which bring the goods up to the point of sale. Examples of direct expenses are:

a) Carriage Inwards (carriage paid on purchases)
b) Freight – Railways, Airways and Shipping
c) Transit – Insurance
d) Loading charges
e) Packing
f) Import duty
g) Export duty
h) Custom duty
i) Dock dues
j) Octroi
k) Warehousing wages

However, for a manufacturer in addition to above direct expenses include –

l) Wages and salaries
m) Fuel, coal, power, gas and water
n) Factory heating*
o) Factory insurance*
p) Factory lighting*

q) Foreman's and Supervisor's salary*

r) Other factory expenses*

s) Royalty on production*

t) Depreciation on Factory Building and machine*

* These are also known as Factory overheads or Factory indirect expenses from cost accounting point of view but for financial accounting purposes these are treated as direct expenses.

It is to be noted that a manufacturer prepares a Manufacturing Account where all the above mentioned direct expenses are debited. However, if in any case Manufacturing Account is not prepared, then all such expenses will be charged to Trading Account.

Analysis of Items Appearing to the Credit Side of Trading Account

1) **Sale:** It refers to the sale of goods in which business deals and includes both cash and credit sales. It does not include sale of old, obsolete or depreciated assets which were acquired for use in business. Similarly, goods returned by customers or goods sent to customers on approval basis or sales tax, if any, included in sales price should be excluded.

2) **Abnormal Loss:** It refers to abnormal loss of stock due to fire, theft or accident. Since Training Account is prepared under normal conditions of the business, abnormal loss, if any, is credited fully to the Trading Account.

3) **Closing Stock:** It refers to the value of goods lying unsold at the end of any accounting year. The stock at the end is valued either at cost or market price, whichever is less. Since Trial Balance generally does not include closing stock, the following entry is recorded to incorporate the effect of closing stock in the Trading Account.

Closing Stock A/c Dr
To Trading A/c

However, if closing stock forms the part of Trial Balance it will not be transferred to Trading Account but taken to Balance Sheet only.

In case goods have been sent to customer on approval (Sale/Return) basis, such goods should be included in the value of closing stock if no approval has been received from them.

Constituents of closing stock are:

i) Stock of Raw materials

ii) Work-in-progress or semi-finished goods

iii) Finished goods – remaining unsold at the end of the year,
– lying unsold at different branches, if any,
– lying unsold with the consignee

iv) Stores supplies = goods, materials required for converting the raw materials into finished product, such as machine oil, cotton waste, chemicals and machine spares (as per As-2)

Points to Remember

- It is to be noted that Income Statement + (viz. Manufacturing/ Trading/Profit and Loss Account) is parepared on Accrual) (Mercantile) basis (Accrual concept) covering an accounting period (accounting period concept) during which expenses are matched with revenue (Matching Concept) to ascertain the profit or loss of an enterprise. That is why unpaid expenses are added as outstanding in the Income Statement and shown as liability in the Balance Sheet. Similarly income accrued but not received are credited to Income Statement and shown as asset in the Balance Sheet.

- It is important to remember that "Outstanding" Accrued or "Prepaid", if forming part of Trial Balance, then such items will be shown in the Balance Sheet only and no treatment required in the Income Statement.

- Conversely, "prepaid expenses" are shown by way of deduction in the Income Statement and treated as an asset in the Balance Sheet, whereas income received in advance are subtracted from the income received and shown as a liability in the Balance Sheet.

3.3.3 Profit and Loss Account

This account is prepared to ascertain the net profit earned or net loss incurred by the business concern during an accounting period. It starts with gross profit or gross loss as disclosed by the Trading Account. It takes into account all the remaining direct (normal and abnormal) expenses and losses related to or incidental to business. These operating and non-operating expenses are charged to Profit and Loss Account and shown to the debit side of the Profit and Loss Account.

The **operating expenses** include:

i) All office or Administrative overheads such as rent, rates and taxes, office staff salaries, printing and stationary, postage, telephone, office lighting, depreciation on office equipment, etc.

ii) Selling and Distribution overheads such as Salesmen's salaries, commission on sales, travelling expenses, advertisement and publicity, trade expenses, carriage outward, bad debts, warehouse expenses, delivery van expenses, packing expenses and rebate to customers.

Non-operating expenses include financial expenses such as interest, bank charges, discount on bill, abnormal losses (loss of goods due to fire, theft or accident) and loss on sale of fixed assets, etc.

Whereas Non-operating incomes include income from investment and financing activities, such as Interest Received, Rent Received, Dividend Received, Profit on Sale of Investment, and Insurance Claims and other Miscellaneous Receipts, like duty drawback and subsidy and apprenticeship premiums, etc. These incomes are credited to Profit and Loss Account.

It is to be noted that if an enterprise prepares a Manufacturing Account, the factory expenses (both direct and indirect) are charged to Manufacturing Account. If a Manufacturing Account is not prepared, then direct factory expenses are charged to

Trading Account and indirect factory expenses to Profit and Loss Account. *Royallties* paid on *production* should be treated as *direct expenses* and *royalties* based on *sales* as *indirected expenses.*

Some Important Points

1) ***Salaries:*** Salaries paid/payable to employees including Directors' salaries, Managers' salaries (except Work Managers salaries) should be debited to Manufacturing Account. In case a concern does not prepare Manufacturing Account, the same should be charged to Trading Account. Similarly, salaries and wages should also be charged to Profit and Loss Account. But wages and salaries be charged to Trading Account.

2) ***Brokerge:*** This refers to brokerage paid on the items in which the business trades in. Such as brokerage on buying and selling of goods in which the enterprise deals in is shown to the debit of Profit and Loss Account. However, any brokerage paid on sale or purchase of assets is treated as of capital nature and hence it is deducted from sale proceeds of the asset sold or added to the cost of the asset required.

3) ***Trade Expenses:*** These expenses are of miscellaneous nature and of small amount and sometimes termed as Sundry expenses or Miscellaneous expenses or even Petty expenses. These are debited to Profit and Loss Account.

4) ***Advertisement:*** Expenses on advertisement which are of revenue and recurring nature are charged to Profit and Loss Account. Whereas cost of heavy advertisement the benefit of which is likely to cover more than one accounting year is treated as deferred revenue expenditure. For example, a company incurs Rs. 1,00,000 on advertisement and it is estimated that the benefit of this advertisement expenditure is likely to extend over a period of four years. In this case Rs. 25,000, i.e. one-fourth of total cost of advertisement will be charged to current year's Profit and Loss Account whereas three-fourths, i.e. Rs. 75,000, will be taken to Balance Sheet to be treated as 'Deferred Revenue Expenditure'. However, advertisement expenses incurred for purchase of goods should be charged to Trading Account. Advertisement expenses paid for acquiring a capital asset are capitalised. Again, cost of advertisement in respect of sale of any capital asset is deducted from the sale proceeds of the asset concerned and hence not charged to profit and loss account.

5) ***Rebate to Customers:*** It is an allowance given to a customer when his purchases from the concern exceeds the certain limits say Rs. 200. In such cases all those customers who make purchases from the company exceeding Rs. 200 will be entitled to rebate of 1% or 2% depending upon the policy declared by the company. The amount of rebate so allowed is charged to Profit and Loss Account.

6) ***Duty drawback and subsidy:*** It is a refund of duties levied on purchases made by exporter. It serves as an incentive to exporter. The duty drawback and cash subsidy should be deducted from the purchases. But in practice it is treated as 'income'.

7) ***Apprenticeship Premium:*** It is the fee charged by the business enterprise to train persons in various trades. It is treated as revenue receipts and credited to Profit and Loss Account.

8) ***Factory Expenses:*** Factory expenses are of two types, viz. direct and indirect, and both are shown in the Manufacturing Account. If a concern does not prepare Manufacturing Account, then direct expenses are charged to Trading Account and indirect expenses are debited to Profit and Loss Account.

9) ***Royalties:*** Royalties are paid by the business concerns to the landlord, author of a patentee for the right to use their land, copyrights or patents right. Payment of such royalty sum based on sales is debited to Profit and Loss Account. However, if royalty is paid on the basis of production, it is charged to Trading Account.

10) ***Free Samples and Publicity Expenses:*** These expenses are incurred to attract cumtomers for increasing the volume of sale and as such are charged to Profit and Loss Account. Similarly, money spent on prizes given to customers under the scheme of 'sales promotion' such as 'Bumper sales', 'Dhamaka sales' are treated as selling and distribution expenses. If a large sum is incurred on heavy advertisement under a contract or whose benefits may accrue over a period of more than one year, say four years, such expenses are spread over the period of its benefits and a proportionate part is charged to Profit and Loss Account and remaining is taken to Balance Sheet as deferred revenue expenditure.

11) ***Abnornal Losses and Insurance Claims:*** As a rule, the entire amount of abnormal losses either arising from accident, fire or tgheft are credited to Trading Account and debited to profit and loss account irrespective of the insurance claims. The amount so received/settled/receivable from the insurance company is credited to Profit and Loss Account.

    Alternatively, Trading Account may be credited with the net abnormal loss (abnormal loss insurance claim, if any) and insuracne claims and Profit and Loss Account may be debited by net abnormal loss only.

3.3.4 Profit and Loss Appropriation Account

This account shows the distribution or appropriation of profit after the same has been earned and computed. In case of sole proprietor, since entire amount of profit belongs to him, no Profit and Loss Appropriation is prepared. However, this account is prepared by partnership firms and Joint Stock Companies where there are several claimants in the net profit. A partner shares earnings of the firm in the form of salary, commission, interest and profit and credited to Profit and Loss Appropriation Account.

However, a company's Profit and Loss Appropriation account shows the transfer from Profit and Loss Account an amount equivalent to "currnet year's profit after tax". This account is further credited by the reserves and provisions made last year, now no longer required, such as Development Rebate Reserve and Provision for Tax, etc. The following items are debited to Profit and Loss Appropriation Account:

– Transfer to General Reserve
– Transfer to Capital Reserve
– Dividend Paid
– Proposed Dividends
– Bonus to Shareholders
– Excess of actual tax liability over the provisions made last year
– Corporate Dividend Tax, if any.

However, a detailed explanation of Profit and Loss Appropriation Account is to be made under Corporate Financial Statements under 3.7 of this unit.

3.3.5 Balance Sheet

Balance sheet is a statement of assets and liabilities which helps us to ascertain the financial position of a concern on a particular date, i.e. on a date when financial

statements or final accounts are prepared or books of accounts are closed. In fact, it treats the balances of all those ledger accounts standing to the debit or credit column of the Trial Balance and which have not been squared up. These accounts relate to assets owned, expensed incurred but not paid or not due, expenses due but not paid, incomes accrued but not received or certain receipts which are not due or accrued. In fact it deals with all those "real" and "personal accounts" which have not been accounted for in the Manufacturing, Trading and Profit and Loss Accounts. Besides, the balance sheet also treats all those items in the adjustments, whch affect Real or Personal Accounts. The Nominal Accounts are treated in the Income Statement (P&L A/c). A Balance Sheet aims to ascertain nature and amount of different assets and liabilities so that the financial position could clearly be known to all those concerned. Thus, the main function of the Balance Sheet is to depict the true picture of the concern on a particular date.

Preparation and Presentation of Balance Sheet

The process of preparation and presentation of balance sheet involves two steps: (i) Grouping and (ii) Marshalling. The first step refers to proper grouping of the various items, which are of similar nature. For example, amount due from persons who were sold goods on credit basis must be shown under the heading 'Trade Debtors' and must be distringuished from money owing other than due to credit sales of goods. The second step involves 'marhsalling' of assets and liabilities. It means orderly arrangement in which assets and liabilities are presented or shown in the Balance Sheet. There are two methods of presentation: (i) In order of "Liquidity, and (ii) In order of "permanence".

Under the "Liquidity Order", assets are shown on the basis of liquidity or realisability. These are arranged in order of "most liquid", more liquid", "liquid", "least liquid" and "not liquid" (fixed) assets. Similarly, liabilities are arranged in the order in which these are to be paid or discharged. The liquility form is suiable for banking and other financial companies.

Under the ''Order of Permanence", the assets are arranged on the basis of their useful life. The assets which are to serve business for the longest period of time are shown first, i.e. Fixed Assets, Semi Fixed, Current, Liquid and Most Liquid. Similarly, in case of liabilities, after Capital, the liabilities are arranged as long term, medium term, short term and current liabilites. The Companies Act has adapted permanency form preparing balance sheet.

Some Important Items

1) **Fixed Assets:** Fixed assets are those assets, which are reuired for the purposes of producing goods or rendering services. These are not held for resale in normal course of business. Fixed assets are used for the purpose of earning revenue and these are held for a longer period of time. These are also treated as 'Gross Block' (Fixed assets after depreciation) and 'Net Block' (Fixed assets after depreciation). Investment in these assets is known as 'Sunk Cost'. Examples of fixed assets are Land and Building, Plant and Machinery, Furniture and Fixtures, Tools and Equipments, Motor Vehicles, etc. All fixed assets are 'tangible' by nature.

2) **Intangible Assets:** Intangible assets are those capital assets which do not have any physical existence. Though cannot be touched or seen yet they have long life and help to generate income. Such assets have value by virtue of the rights conferred upon the owner by mere possession. Goodwill, trademarks, copyrights and patents are the examples of intengible assets.

3) **Current Assets:** Current assets include cash and other assets which are converted or realized into cash within a normal operating cycle or say within a year.

These are acquired either for the purpose of resale, or assisting and helping process of production or rendering of service or supplying of goods. These assets constantly keep on changing their form and contribute to routine transactions and operations of business. Examples are, Cash in Bank, Bills Receivables, Debtors, Stock, Prepaid Expenses, etc. Current assets are also known as floating assets or circulating assets.

4) **Liquid or Quick Assets:** Those current assets whch can be converted into cash at a very short notice or immediately without incurring much loss or exposing to high risk. Quick assets can be worked out by deducting Stock (Raw materials, work in progress or finished goods) and prepaid expenses out of total current assets.

5) **Fictitious Assets:** These are the non-existent worthless items which represent unwritten off losses or cost incurred in the past which cannot be recovered in future or realized in cash. Examples of such assets are preliminary expenses (formation expense), Advertisement suspense, Underwriting - commission, discount on issue of shares and debentures, Loss on issue of debentures and debit balance of Profit and Loss Account. These fictitious assets are written off or wiped out by debiting to Profit and Loss Account.

6) **Wasting Assets:** Assets with limited useful life by nature deplete over a limited period of time are called wasting assets. These assets become worthless once its utility is over or exhaust fully. Such assets are natural resources like, timer, coal oil, mineral deposits, etc.

7) **Contingent Assets:** Contingent assets are probable assets which may or may not become assets as it depends upon occurrence or non-occurrence of a specified event or performance of a specified act. For example, a suit is pending in the court of law against ownership title of any dispsuted property and if the suit is decided in favour of the business concern it becomes the asset of the concern. On the other hand, if the decision goes against the concern, the company cannot claim to enjoy ownership rights. Thus, it remains a contingent asset as long as the judgment is not pronounced by court. Such assets are shown by means of footnote and hence do not form part of assets shown in the Balance Sheet. Beside this hire purchase contract, uncalled share capital etc. are the other examples of contingent assets.

8) **Classification of Liabilities**

Long Term Liabilities: These are the obligations which are to be met by the business enterprise after a relatively long period of time. Such liabilities do not become due for payment in the ordinary course of business operation or within normal operating cycle. Debentgures, long term loans from Bank or financial institutions are the examples of long-term liabilities.

Current Liabilities: Current liabilities are those liabilities which are payable within normal operating cycle, i.e. within an accounting year. These may arise either out of realization from current assets or by creating fresh current liability (obligation). Trade creditors, Bill payable, Bank overdraft, Outstanding expenses, Short-term loan (payable within twelve months or within accounting year) are examples of current liabilities.

Contingent Liability: It is not an actual liability but an anticipated (probable liability which may or may not become payable). It depends upon happending of certain events or performance of certain acts. An element of uncertainty is always attached. A contingent liability, thus, may or may not become a sure liability. Examples are, liability for bills discounted, liability for acting as surety, liability arising on a suit for damages pending in the court of law, liability for calls on partly paid shares, etc. Contingent liabilities are shown as footnote under the Balance Sheet.

3.4 CONCEPTS OF CAPITAL AND REVENUE

You know that a firm prepares Profit and Loss Account for ascertaining the net result of business operations and the Balance sheet for determining the financial position of the business. These are prepared with the help of Trial Balance which shows the final position of all ledger accounts. All items appearing in the Trial Balance are transferrd either to the Profit and Loss Account or to the Balance Sheet. As per rules, the items of revenue nature are taken to the Profit and Loss Account and the items of capital nature are shown in the Balance Sheet. In other words whether an item appearing in the Trial Balance is to be taken to the Profit and Loss Account or the Balance Sheet depends upon the capital and revenue nature of the item. If any item is wrongly classified i.e., if an item of revenue nature is treated as a capital item or vice versa, the Profit and Loss Account will not reveal the correct amount of profit and the Balance Sheet will not reflect the true and fair view of the affairs of the business. It is therefore necessary to determine correctly whether an item is of capital nature or of a revenue nature and record it in the books accordingly. There are certain rules governing the allocation of expenditures and receipts between capital and revenue which should be clearly understood.

Capital and Revenue Expenditures

You incur expenditure on various items every day. You buy food items, stationery, cosmetics, utensils, furniture, etc. Some of them are consumables and some are durables. The benefit of expenditure on consumables like stationery, cosmetics, etc. is derived over a short period. But in case of durables like furniture, utensils, etc., the benefit spreads over a number of years. Same is true of business also. In business you incur expenditure on two types of items: (i) routine items like stationery, and (ii) fixed assets like machinery, builing, furniture, etc., whose benefit is available over a number of years. In accounting terminology the first category of expenditure is called revenue expenditure and the second one is called capital expenditure. Let us now study the exact nature of capital and revenue expenditures.

Capital Expenditure: As stated above, when the benefit of an expenditure is not exhausted in the year in which it is incurred but is available over a number of years it is considered as capital expenditure. The following expenditures are usually treated as capital expenditures:

1) Any expenditure which results in the acquisition of fixed assets such as land, buildings, plant and machinery, furniture and fixures, office equipment, copyright etc. you should note that such capital expenditure includes not only the purchase price of the fixed asset but also the expenses incurred in connection with their acquisition. Thus, the brokerage or commission paid in connection with the acquisition of an asset, the freight and cartage paid for transportation of machinery, the expenses incurred on its installation, the legal fees and registration charges incurred in connection with purchase of land and buildings are also treated as capital expenditure.

2) Any expenditure incurred on a fixed asset which results in (a) its expansion, (b) substantial increase in its life, or (c) improvement in its revenue earning capacity. Improvement in the revenue earning capacity can be in the form of (i) increased production capacity, (ii) reduced cost of production, or (iii) increased sales of the firm. Thus, cost of making additions to buildings and the amount spent on renovation of the old machinery are also regarded as capital expenditures. If you buy a second hand machinery and incur heavy expenditure on reconditioning it, such expenditure is also to be treated as capital expenditure. Similarly, expenditure on structural improvements or alterations to existing fixed assets whereby their revenue earning capacity is increased, is also treated as capital expenditure.

3) Expenditure incurred, during the early years, on development of mines and land for plantations till they become operational.

4) Cost of experiments which ultimately result in the acquisition of a patent. The cost of experiments which are not successful is not to be treated as capital expenditure. It is treated as a deferred revenue expenditure which is written off within two to three years.

5. Legal charges incurred in connection with acquiring or defending suits for protecting fixed assets, rights, etc.

Revenue Expenditure: When the benefit of an expenditure is not likely to be available for more than one year, it is treated as revenue expenditure. So all expenses which are incurred during the regular course of business are regarded as revenue expenditures. The examples of such expenses are:

1) Expenses incurred in day-to-day conduct of the business such as wages, salaries, rent, postage, stationery, insurance, electricity, etc.

2) Expenditure incurred for buying goods for resale or raw materials for manufacturing.

3) Expenditure incurred for maintaining the fixed assets such as repairs and renewals of building, machinery, etc.

4) Depreciation on fixed assets. This can also be termed as revenue loss.

5) Interest on loans borrowed for running the business. You should note that any interest of loan paid during the initial period before production commences, is not treated as revenue expenditure. It is treated as capital expenditure.

6) Legal charges incurred during the regular course of business such as legal expenses incurred on collection from debtors, legal charges incurred on defending a suit for damages, etc.

Deferred Revenue Expenditure

Sometimes, certain expenditure which is normally treated as revenue may be unusually heavy and its benefit is likely to be available for more than one year. In such a situation, it is considered appropriate to spread the cost of the expenditure over a number of accounting years. Hence, it is capitalised and only a portion of the total amount spent is charged to the Profit and Loss Account of the current year. The balance is shown as an asset which wil be written off during the subsequent accounting years. Such expenditure is called a Deferred Revenue Expenditure because its charge to Profit and Loss Account has been deferred to future years. Some example of such expenditure are:

1) Expenditure incurred on advertising campaign to introduce a new product in the market.

2) Expenditure incurred on formation of a new company (preliminary expenses)

3) Brokerage charges, underwriting commission paid and other expenses incurred in connection with the issue of shares and debentures.

4) Cost of shifting the plant and machinery to a new site which may involve dismantling, removing and re-erection of the plant and machinery.

Let us take the case of expenditure on advertising campaign. It is not a routine advertisement and the amount involved is unusually heavy. Its benefit will not completely exhaust in one accounting year but will contunue over two to three years. Hence, it is not proper to charge such expenditure to the Profit and Loss Account of

one year. It is better to distribute it carefully over three years. So, in the first year we may charge one-third of the amount spent to the Profit and Loss Account and show the balance in the Balance Sheet as an asset. In the second year again we may charge a similar amount to the Profit and Loss Account and show the balance as an asset. In the third year. we may charge this balance to the Profit and Loss Account. Every expenditure which is regarded as deferred revenue is treated in this way in the final accounts.

Look at Illustration 1 and note how each expenditure has been treated and why.

Illustration 1

State whether the following items of expenditure would be treated as (a) capital expenditure, (b) revenue expenditure, or (c) deferred revenue expenditure:

i) Carriage on goods purchased Rs. 25.

ii) Rs. 2,000 spent on repairs of machinery.

iii) Rs. 5,000 spent on white washing.

iv) Rs. 8,000 paid for import duty and cartage on the purchase of machinery from west Germany.

v) Rs. 25,000 spent on issue of equity shares.

vi) Rs. 14,000 spent on spreading new tiles on factory floors.

vii) Rs. 4,000 spent on dismantling, transportation and reinstalling plant and machinery to new site.

viii) Rs. 60,000 spent on construction of railway siding.

ix) Rs. 20,000 spent on some major alterations to a theatre which made it more comfortable and attractive.

x) A second hand maching was bought for Rs. 10,000 and an amount of Rs. 6,000 was spent on its overhauling.

Solution

i) It is a revenue expenditure as it relates to the goods for resale.

ii) It is a revenue expenditure as it relates to the maintenance of a fixed asset.

iii) Same as no. (ii).

iv) It is a capital expenditure as it is spent in connection with the purchase of a fixed assets.

v) It would be treated as deferred revenue expenditure. It is a heavy amount incurred in connection with reising of capital for the company and so capitalised. Even under the Indian Companies Act and the Indian Income Tax Act this expenditure is allowed to be written off over a number of years.

vi) It is a revenue expenditure so it is treated as a sort of repairs not leading to any increase in the earning capacity of a fixed asset.

vii) Normall expenditure on transportation etc. is revenue in nature. But this expenditure has been incurred on shifting to new site which is non-recurring in nature and involves a heavy amount. Hence it shall be treated as a deferred revenue expenditure.

viii) It is a capital expenditure as it is incurred on the construction of railway siding, a fixed asset.

ix) It is a capital expenditure as the alterations made the theatre more comfortable and attractive which is likely to increase its collections.

x) It is a capital expenditure as it is incurred on making the newly bought second hand machinery operational.

Capital and Revenue Receipts

Receipts refer to amounts received by a business i.e., cash inflows. Receipts may be classified as Capital Receipts and Revenue Receipts. It is necessary to note this distinction clearly because only the revenue receipts are taken to the Profit and Loss Account and not the capital receipts.

Capital Receipts: Capital receipts are the amounts received in the form of (a) additional capital introduced in the business, (b) loans received, and (c) sale proceeds of fixed assets. You are aware that a loan taken by the business is repayable sooner or later. Similarly, additional capital received represents an increase in the proprietor's claim over the business assets. Thus these two items represent increase in liabilities of the business and obviously are not incomes or revenues. These are capital receipts and should be treated as such. The sale proceeds of a fixed asset are also treated as a capital receipt because the amount received is not revenue earned in the normal course of business. The capital receipts increase the liabilities or reduce the assets. They do not affect the profit or loss.

Revenue Recipts: Revenue receipts are the amounts recived in the normal and regualr course of business. They take the form of (a) sale proceeds of goods, and (b) incomes such as interest earned, commission earned, rent received, etc. These receipts are on account of goods sold or some services rendered by the business and as such they are not repayable. All revenue receipts are treated as incomes and shown on the credit side of the Profit and Loss Account.

3.5 REVENUE RECOGNITION

Revenue arises in the ordinary course of business activities of an enterprise from:

– sales of goods,
– rendering of services, and
– use by others of enterprise resources yielding interest, royalties and dividends.

Revenue recognition is mainly concerned with the timing of recognition revenue in the statement of profit and loss. According to AS-9, "revenue is the gross in flow of cash, receivables, or other consideration arising in the course of ordinary activities of an enterprise."

The basic problem of revenue recognition lies in identifying of the "accounting period" during which revenues are earned. There are several stages or activities in a business before the revenues are earned and realized. Hence the problem arises – should revenue be recognized at the point of production, sale, delivery or receipt of cash. According to "Realisation Concept" revenues are recognized at the point of sale or services are rendered. However, there is no single uniform practice to recognize various types of revenues according to one common principle. There are guidelines, which help us in recognizing operating revenues and non-operating revenues. Non-operating revenues include interest, dividend and rent and other incomes which are not related to normal course of operation of the enterprise.
It is advisable to show operating and non-operating revenues separately in the Profit and Loss Account.

Following are some of the established practices to recognize revenue as per AS-9.

3.5.1 Revenue Recognition in Sale of Goods

Trading and Manufacturing organizations, in general, recognize revenue when sale is effected. However, the following conditions should be satisfied:

i) The "property in goods" is transferred for a price.

ii) All significant risks and rewards have been transferred and no effective control is retained by the seller.

iii) No significant uncertainty exists regarding the collection of amount of consider-ation.

Special Cases of "Sale of Goods" and applicability of AS-9

a) **Delivery of goods delayed at buyer's request and buyer takes title and accepts billing:** Revenue should be recognized and the "goods to be delivered" at any subsequent date should not be included in the inventory.

b) **Goods delivered subject to installation and inspection:** Revenue should be recognized only after the installation and inspection is completed.

c) **Sale on Approval**: In case of sale on approval or return basis, revenue should be recognized only when acceptance is received from buyer.

d) **Sale subject to warranty**: If sales are subject to a warranty, revenue recognition should not be deferred but a provision should be made to cover the liability which may arise under the terms and period of warranty.

e) **Guaranteed Sales:** Sometimes goods are sold and delivery is made giving the buyer the unlimited right to return. This is under "Money back guarantee", if not completely satisfied. Under this situation it is apparent to recognize the 'revenue' at the point of sale and to make provisions for returns as well.

f) **Consignment Sales:** Revenues are recognized when the goods are sold to customers by the consignee and at the time of dispatch of goods of consignor.

g) **Cash on delivery Sales:** If a sale has been effected under the terms of "Cash-on-delivery", revenue should be recognized only when cash is received by seller.

h) **Installment Sales:** Revenues are recognized on delivery to the extent of normal cash down price. However, interest on deferred payment should be recognized in the ratio of amount outstanding.

I) **Special Order:** Where payment is received against the specific order of goods, which are not in stock. Revenue from such sale should be recognized only when goods are purchased or manufactured and are ready for delivery.

j) **Sale/Repurchase Agreement:** Where seller concurrently agrees to repurchase the same goods at some late date, the flow of cash under such a situation will not be recognized as revenue.

k) **Sales to Distributors to Dealers for Resale**: Revenues are recognized only if significant risks of ownership have passed on distributors/dealers.

3.5.2 Revenue Recognition in Case of Rendering of Services

Revenue recognition in case of rendering services care based on the following conditions:

i) Revenue recognized either on completed service method or 'proportionate completion' method.

ii) No significant uncertainty exists regarding amount of consideration.

iii) It is reasonable to expect ultimate collection of consideration.

Under **completed service method** revenue are recognized only on completion of service. In cases there are more than one act involved, revenue are recognized on execution of all these acts.

Proportionate completion method recognized revenue proportionate with the degree of completion of services. If there are more than one act involved revenue are recognized on execution of certain acts. Some examples of recognition of service revenue are –

1) **Installation Fee:** In cases where installation fees are other than incidental to sales, the revenue should be recognized only when the equipment is installed and accepted by the customer.

2) **Advertising and Insurance Agency Commission:** Revenue should be recognized when service is completed. For advertising agencies, media commission will normally be recognized when the related advertisement or commercial appears before the public, and the necessary intimation is received by the agency. Insurance agency commission should be recognized on the effective commencement renewal dates of the related policies.

3) **Financial Service Commissions:** A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charge for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made or added to a loan or other account and settled in stages.
The recognition of revenue should therefore have regard to:

   a) Whether the service has been provided one and for all or in an continuing basis.

   b) The incidence of cost relating to service.

   c) Commission charged for arranging and granting of loan or other facilities, should be recognized when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or service should normally be recognized over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the service provided and timing of the costs relating thereto.

Admission Fees: Revenue from artistic performance, banquets and other special events should be recognized when the event takes place. When fees to a number of events, it should be allocated to each event on a systematic and rational basis.

Tution Fees: Revenue should be recognized over the period of instruction.

Entrance and Membership Fees: AS.9 recommends capitalization of entrance fees. If membership fee permits only membership and all other services of products are paid for separately or if there is a separate annual subscription, the fee should be recognized as revenue when received. If the membersyhip fee entitles the member to services or publications to be provided during the year, it should be recognized on a systematic and rational basis having regard to the timing and nature of all services provided.

Subscription for Publications: Revenue received or billed should be deferred and recognized either on straight-line basis over time or where the items delivered vary in value from period to period revenue should be based on the sales value of the items delivered in relation to total sales value of all items covered by the subscription.

Exceptions to General Rule

1) **Revenue recognition at the point of production (Completed Production Method):** Under this method revenue are recognozid at the point of production. It applies to case of agriculture. Extractive industries like gold, silver, uranium, other metals and oil (crude) etc. revenue are recognized just after completion of production even before the sales take place.

2) **Cash Basis:** Under this, revenue are not recognized at the point of sale but when cash is realized including outstanding, if any. This basis is applicable in case of hire-purchase system where revenue are recognized on the basis of cash received and installments due during the year.

3) **Revenue Recognition during the production period on percentage of completion method:** Under this method revenue are recognized on the basis of contract value, associated costs, number of acts or other susitable basis. It is applicable in case of long-term construction contracts where revenue are recognized on the basis of degree of completion or what work certified bears to cash received by the contractor.

4) **Time Basis:** In many cases revenue are realized on the basis of time or period. For example, interest on fixed deposits is credited to Profit and Loss Account on time proportion basis, i.e. interest accrued yet not payable.

It is to be noted that revenue in case of "Royalties" are recognized on an **accrual basis** in according with terms of agreement and, **Dividends** are recognized when the right to receive payment is established.

3.6 FORMAT OF FINANCIAL STATEMENTS (NON-CORPORATE ENTITIES)

The financial statements may be prepared and presented either in conventional (also known as 'T' form) or Vertical form. The basic purpose is to serve the information needs of the users of accounting information. The idea is to present these accounting figures in such a way that provides maximum input for decision-making purposes. The income statement gives the clear picture operating efficiency of the enterprises by disclosing the amount of gross profit or loss through Trading Account. At the same time Profit and Loss Account reveals the overall 'net' result – the "net profit" or "net loss". The Balance Sheet, which is also known as "position statement" is required to depict the true and fair view of state of affairs of business enterprise. Sole traders and partnership firms are not requqired to comply any legal provisions as far as presentation and formats of financial statements are concerned. However, these income statements, meant basically for self consumption, must be prepared in conformity with the accounting concepts, conventions and applicable accounting standards.

The financial statements of non-corporate entities may be presented either of the following ways:

1) Conventional Format, and

2) Vertical Format

3.6.1 Conventional Format

Following are the conventional formats of 'Income' and 'Position statements':

Format of a Manufacturing Account
For the year ended 31st March....

Dr.			Cr
	Rs.		*Rs.*
To Opening Work-in progress	-----	By Closing Work-in- Progress	-----
To Raw materials consumed	-----	By Sale of Scrap	-----
Operating stock of Raw material		By Cost of goods	
Add: Purchases		produced-transferred	
Less: Closing stock of	-----	to Trading Account	-----
Raw material			
To Direct Expense			
Productive Wages	-----		
Freight Inward Raw material	-----		
Cartage/Carriage Inward	-----		
To Factory overheads			
Salary of Works Manager	-----		
Gas, Fuel and Power	-----		
Factory Light	-----		
Rent, Rates and Taxes	-----		
Insurance of factory assets	-----		
Repairs of factory assets	-----		
Depreciation of factory assets			
Other Factory Expenses	-----		
	***		***

Trading Account (A format)
For the year ended 31st March ....

Dr.			Cr
	Rs.		*Rs.*
To Opening Stock (Finished Goods)	-----	By Sales less Returns	-----
To Transfer from Manufacturing A/c	-----	By Abnormal Loss:	
or/and Purchases less returns		(Transferred to	
To Direct Expense		Profit and Loss A/c)	
Carriage/cartage Inward		Loss by Fire	
Freight		Loss by Accident	
Insurance-in-transit	-----	Loss by Theft	-----
Wages	-----	By Closing Stock	-----
* Fuel and Power	-----	By Gross Loss A/c	
* Coal, Gas and Water	-----	(Balancing figure)	
Packing (essential)	-----		
Octroi	-----		
Import duty			
* Consumable Stores	-----		
Royalty (based on output)	-----		

	Rs.		Rs.
* Manufacturing Expenses	-----		
* Excise Duty	-----		
Dock dues			
To Gross Profit A/c (Balance fiture)**	-----		
	* * *		* * *

* Concerns not preparing Manufacturing Account separately
** Balancing figure will be either gross profit or gross loss.

Profit and Loss Account (A format)
For the year ended 31st March ....

Dr. Cr

	Rs.		Rs.
To Gross Loss* b/d	-------	By Gross Profit b/d*	------
To **Office & Administration Expenses:**		By Interest Received	------
Salaries of Office Staff		By Dividend Received	------
Office Rent, Rates and Taxes		By Rent Received	------
Printing and Stationery	-------	By Discount Received	------
Postage and Telephone	-------	By Profit on sale of fixed assets	------
Fire Insurance Premium	-------	By Profit on sale of Investment	------
Audit Fees	-------	By Insurance Claims	------
Repairs and Maintenance	-------	By Duty–Draw Backs	------
Legal Expenses	-------	By Apprenticeship Premium	------
Office Lighting	-------	By Miscellaneous Receipts	------
Depreciation-office assets	-------	By Bad debts Recovered	------
Other Office Expenses	-------	By Net loss transferred	------
To **Selling and Distribution Expenses:**		to Capital account	
Salesmen's Salaries		(Balancing figure)**	------
Commission on Sales			
Travelling Expenses			
Brokerage			
Trade Expenses			
Advertisement and Publicity			
Sales Promotion Expenses			
Carriage Outward			
Bad Debts			
Provision for Bad Debts			
Repairs of Vehicles			
Depreciation on Vehicles			
Warehouse Expenses			
Warehouse Insurance			
Warehouse Rent			
Delivery Van Expenses			
Packing Expenses			
Rebate to Customers			
Royalty on Sales			
To **Financing Expenses:**			
Discount Allowed			
Interest on Capital			
Discount of Bills			
Bank Charges			

To **Abnormal Losses:** Transferred from Trading Account – (loss by – Fire – Accident – Theft) To Loss on sale of Fixed Assets To Miscellaneous Expenses To Net Profit Transferred to Capital A/c (Bal. Figure)**			
	* * *		* * *

* Balancing b/d may be either Gross Profit or Gross Loss

** The Balancing figure may be either Net Profit or Net Loss

Profit and Loss Appropriation Account (A format)

For the year ended 31st March ....

Dr. Cr

	Rs.		Rs.
To Profit and Loss A/c (Net Loss)*	——	By Profit and Loss A/c (Net Profit)*	——
To Interest on Partner's Capitals	——	By Interest on Drawings	——
To Salary to Partners	——	By Balance (transferred to Partner's Capital Account)	——
To Commission to Partners			
To Balance (Transferred to Partner's Capital Accounts)**			
	* * *		* * *

* There will either be Profit or Loss

** Represent balancing fiture – a residual profit or loss to be shared by partners in the profit sharing ratio.

Balance Sheet of .... (A format)

as on 31st March ....

Liabilities		*Rs.*	*Assets*	
Capital	-----		**Fixed Assets:**	-------
Add Profit or less Loss	-----		Goodwill	-------
Less Drawings	-----	-----	Land and Building	-------
			Plant and Machinery	-------
Long Term Liabilities			Tools and Equipments	-------
Mortgaged Loan		-----	Motor Vehicles	-------
Loan from Bank		-----	Furniture and Fixtures	-------
			Patents and Trademarks	-------
Current Liabilities			Investment (Long Term)	-------
Sundry Creditors		-----	**Current Assets:**	-------
Bills Payable		-----	Stock	-------
Income Received in Advance		-----	Accrued Income	-------
Outstanding Expenses		-----	Prepared Expenses	-------
Bank Overdraft		-----	Sundry Debtors	-------
			Bills Receivable	-------
			Short Term Investment	-------
			Marketable Securities	-------
			Cash and Bank Balance	-------
			Fictitious Assets:	-------
			Advertisement	-------
			Profit and Loss Account	-------
			Miscellaneous Expenditure	-------
		* * *		* * *

*The items in the above format have been shown in order of permanence. Alternatively, this can be presented in order of liquidity as explained earlier.

2. From the following Trial Balance of Trader, you are required to prepare Trading and Profit Account for the year ended 31st March 2001 and a Balancing Sheet as on that date.

Trial Balance as on 31st March 2001

Dr. Cr.

Particulars	*Amount Rs.*	*Particulars*	*Amount Rs.*
Drawing Account	7,500	Capital	1,50,000
Plant and Machinery (1.4.2000)	1,25,000	Returns Outward	1,250
Plant and Machinery	6,250	Sundry Creditors	22,500
(1.4.2000)	19,250	Sales	2,00,000
Stock (1.4.2000)	1,02,500	Porivision for Bad	
Purchases	2,500	and Doubtful debts	500
Returns Inward	25,750	Discount Received	1,000
Sundry Debtors	6,200	Rent (up to 30.9.2002)	1,500
Furniture	12,500		
Freight	625		
Carriage Outward	5,750		
Rent, Rates and Taxes	1,000		
Printing and Stationary	500		
Trade Expenses	875		
Insurance Charges	26,625		
Salaries and Wages	25,675		
Cash in Bank	7,250		
Cash in Hand	1,000		
Postage and Telegram			
	3,76,750		3,76,750

Adjustments:

1) Stock on 31st March 2001 was valued at Rs. 15,000
2) Write off Rs. 750 as bad debts.
3) Provision for Bad and doubtful debt is to be maintained at 5% on sundry debtors.
4) Create a provision for discount on debtors and also reserve for discount on creditors @ 2%.
5) Charge depreciation @ 2% p.a. on Plant and machinery and @ 5% on furniture.
6) Insurance prepaid was Rs. 125.
7) Goods worth Rs. 6,250 were totally demaged in an accident. The insurance company admitted claim of Rs. 5,000 on 28.3.2001.

Solution

Trading Account
For the year ended 31st March 2001

Dr. Cr.

	Particulars		Amount Rs.		Particulars		Amount Rs.
To	Opening Stock		19,250	By	Sales	2,00,000	
To	Purchases	1,02,500			Less Returns	2,500	1,97,500
	Less Returns	1,250	1,01,250	By	Closing Stock		15,000
To	Freight		12,500	By	Insurance Claims		5,000
To	Gross profit transterred			By	Profit & Loss A/c		1,250
	to Profit & Loss A/c		85,750		(Abnornal Loss)		
			2,18,750				2,18,750

Profit and Loss Account

Dr. Cr.

	Particulars		Amount Rs.		Particulars		Amount Rs.
To	Rent, Rates & Taxes		5,750	By	Gross Profit b/d		85,750
To	Printing and Stationary		1,000	By	Discount Received		1,000
To	Trade Expenses		500	By	Rent Received	1,500	
To	Insurance	875			*Less* Prepaid	750	750
	Less Prepaid	125	750				
To	Salaries & Wages		26,625	By	Reserve for discount		450
To	Postage & Telegram		1,000		on creditors		
To	Bad debts		750				
To	Provision for Bad and doubtful debts		750				
	(New reserve Rs. 1250-Old						
	reserve Rs. 500)						
To	Provision for discount on debtors		475				
To	Carriage outward		625				
To	Abnormal loss (Accident)		1,250				
To	Depreciation on:						
	Furniture	310					
	Plant & Machinery	25,625	25,935				
	(Rs. 25000 + Rs. 625)						
	To Net profit transfered A/c	540					
	to capital		87,950				87,950

Balance Sheet As on 31st March 2001

Dr. Cr.

	Liabilities		Amount Rs.		Assets		Amount Rs.
Add.	Capital	1,50,000			Plant & Machinery	1,25,000	
	Net Profit	22,540			Additions	6,250	
		1,72,540				1,31,250	
Less	Drawings	7,500	1,65,040	*Less*	Dereciation	25,625	1,05,62
	Sundry Creditors	22,500			Furniture	6,200	
Less	Provision	450	22,050	*Less*	Depreciation	310	5,89
	Advance Rent		750		Closing Stock		15,00
					Sundry Debtors	25,750	
				Less	Bad Debts	750	
						25,000	
				Less	Provision @ 5%	1,250	
						23,750	

		Less	Provision for discount 475	23,27
			Cash at Bank	25,67
			Cash in hand	7,25
			Insurance Claims	5,00
			Prepaid Insurace	12
	1,87,840			1,87,84

Illustration 3

The following is the Trial Balance of Mr. Mahesh as 31st December 2003. Prepare a Trading and Profit & Loss Account for the year ended 2003 and Balance Sheet as on 31st December 2003.

Dr. Cr

	Rs.		*Rs.*
Purchases	1,80,000	Sales	2,05,000
Opening Stock	10,000	Loan (10% interest)	10,000
Salaries Less Provident Fund	5,400	Creditors	15,000
Drawinges	5,000	Capital	55,000
Provident fund remittances including Proprietor's contribution 50%	1,200		
Rent Rs. 250 per month	2,750		
Machinery	29,000		
Wages	3,000		
Furniture & Fittings	5,000		
Electricity	550		
Trade Expenses	1,500		
Debtors	10,500		
Interest on Loan	900		
Commission	200		
Building	30,000		
	2,85,000		2,85,000

Wages include Rs. 1,000 Paid for machinery erection charges. Purchases include cost of moped scooter for Rs. 5,000 Proprietor has taken goods costing Rs. 1,000 for which no entry has been made, Electricity outstanding Rs. 50. Goods costing Rs. 5,000 were destoyed by fire and insurance claim was receied for Rs. 4,000 Provide depreciation at 10% on machinery, furniture & moped. Provide depreciation 5% on Bulding. Closing stock is Rs. 12,000

Solution

Trading And Profit and Loss Account
For the year ended 31st December 2003

Dr. Cr

	Particulars		Amount Rs.		Particulars	Amount Rs.
To	Opening Stock		10,000	By	Sales	205,000
To	Purchases	180,000		By	Loss by fire transferred to P&L A/c	5,000
Less	Purchase of Scooter	5,000				
Less	Drawings (goods used)	1,000	174,000	By	Closing Stock	12,000
To	Wages	3,000				
Less	Erection charges	1,000	2,000			
To	Gross Profit c/d		36,000			
			222,000			222,000
To	Salaries	5,400		By	Gross Profit b/d	36,000
Add	Subscription	600		By	Insurance claims	4,000
	Contribution	600	6,600			

To	Rent	2,750			
Add	Outstanding	250	3,000		
To	Electricity	550			
Add	Outstanding	50	600		
To	Commission		200		
To	Trade Expenses		1,500		
To	Bad debts		500		
To	Interest	900			
Add	Outstanding	100	1,000		
To	Provision for Bad debts		1,000		
To	Loss by fire (Trading A/c)		5,000		
To	Depreciation on:				
	Building		1,500		
	Machinery		3,000		
	Furniture		500		
	Scooter		500		
To	Net Profit		15,100		
			40,000		40,000

Balance Sheet
As on 31st December 2003

Dr. Cr

	Liabilities		*Amount Rs.*		*Assets*		*Amount Rs.*
	Capital	55,000			Building	30,000	
Add	Net Profit	15,100		*Less*	Depreciation	1,500	28,500
Less	Drawings (5000 + 1000)	6,000	64,100		Machinery	29,000	
				Add	Erection Charge	1,000	
						30,000	
	10% Loan		10,000	*Less*	Depreciation (10%)	(3,000)	27,000
	Creditors		15,000		Furniture	5,000	
	Rent outstanding		250	*Less*	Depreciation	500	4,500
	Interest outstanding		100		Scooter	5,000	
	Electricity Changes O/s		50	*Less*	Depreciation	500	4,500
					Closing Stock		12,000
					Debtors	10,500	
				Less	Bad debts	500	
				Less	Provision @ 10%	1,000	9,000
					Insurance claims		4,000
			89,500				89,500

3.6.2 Vertical Format

Under vertical form various items of incomes and expenses, assets and liabilities are arranged vertically to get some additional information about the operating efficiency and financial position of the business enterprise. The vertical form of Income Statement shows the gross profit, operating profit, net profit. The impact of non-operating incomes and expenses cannot be ascertained if the Trading & Profit and Loss Account is not prepared under vertical form. Similarly the Balance Sheet discloses owner's capital, borrowed capital, net working capital, etc. It is to be noted that sole traders and partnership firms hardly adopt vertical form of financial statements. Following formats will bring about a clarity of understanding of vertical form of financial statements.

Income Statement (A format)
For the year ending 31st March .....

	Particulars	*Figures at the end of*	
		Previous Year	*Current Year*
		Rs.	Rs.
	Sales/Turnover	--------	--------
Less	Cost of Goods Sold*	--------	--------
	Gross Profit	****	****
Less	Administrative Expenses*	--------	--------
Less	Selling and Distribution Expenses*	--------	--------
	Operating Profit	****	****
Add	Other Incomes* (Non-operating Incomes)	--------	--------
Less	Financial Expenses (Non-operating Expenses)	--------	--------
	Net Profit	****	****
Less	Transfer to General Reserve and/or capital account/accounts (in the form of profit, salary, commission, etc.)	-------- --------	-------- --------
	* Explained earlier under conventional form.		

Operating vs Non-operating

Operating Profit/Loss

The excess of operating incomes over operating expenses represents operating profit, whereas when operating expenses exceed operating income it results in operating loss.

Operating incomes are those incomes which arise from operating activities in which the enterprise deals in. For a trading concern, revenue arising from sale of goods in which the enterprise deals in is treated as operating income. In fact, operating activities are the principal revenue-producing activities of the entertprise. Operating income measures the efficiency of a business enterprise, because these activities make-up the main business of the enterprise and are of recurring in nature. The operating activities may be:

- Purchasing and selling of goods.
- Services and even securities by a Trading concern.
- Exploration of natural resources by Extracting & Trading entity.
- Granting of loans and advances by a 'Financial Institution'.
- Construction and development of colonies by construction enterprise.

Operating expenses are those expenses which are incurred in connection with main revenue producing activities. These operating expenses may be classified under various heads, such as **office and administrative expenses** and **selling and distribution expenses**. A detailed list of these expenses has already been given under conventional format of Profit and Loss Account under 3.6.1 of this unit. These expenses are necessary to run the business enterprise but which are not directly related to trading or manufacturing activities. These directly related expenses are termed as direct expenses, which are charged to Manufacturing/Trading/Account. Hence Operating Profit = Gross Profit – Operating Expenses (Office and Selling Distribution).

Non-operating Incomes

Such incomes arise from other than major or principal revenue earning activities. These are in the form of, in case of a manufacturing and trading concern, rent received, interest received, dividend received, which are credited to Profit and Loss Account. Profit on sale of fixed assets and the revenue arising from activities which are incidental to main business, are treated as non-operating incomes. Such types of incomes arise when unused portion of building used for business purposes is let-out or idle funds of business invested either in shares, debentures, government securities or deposited in a fixed deposit account. Since such incomes have nothing to do with the business operation of the enterprise, these incomes are treated as non-operating incomes.

> It is to be noted that "Interest" and "Dividend" received by a "Financial Institution" is treated as operating income because these incomes arise from main/principal revenue earning activity.

Non-operating Expenses

These expenses are incurred on activities other than main or principal revenue earning activities. These may be in the form of non-operating losses. Interest paid on borrowings (financial overheads), loss on sale of fixed assets, loss on sale of investment (held as an asset) are some of the examples of non-operating expenses. Such expenses are also charged to Income Statement to ascertain the overall net profit.

Balance Sheet of .... (A format)
As on 31st March ....

Assets	Figures at the end of	
	Previous Year	Current Year
Fixed Assets	--------	--------
Less Depreciation	--------	--------
Net Fixed Assets	(a) --------	--------
	****	****
Stock-in Trade	--------	--------
Sundry Debtors	--------	--------
Bills Receivables	--------	--------
Cash and Bank balance	--------	--------
Total Current Assets*	(b) ****	****
TOTAL ASSETS (a+b)	--------	--------
Liabilities and Capital		
Capital	--------	--------
Add Profit (Retained Earnings)	--------	--------
Less Drawings	--------	--------
Owner's Equity	(c) --------	--------
Sundry Creditors	--------	--------
Bills Payable	--------	--------
outstanding Expenses	--------	--------
Total Current Liabilities	(d) --------	--------
TOTAL (c + d)	--------	--------

** The list is not exhaustive*

Activity

1) What are operating and non-operating profits?
2) What do you understand by “Grouping” and “Marshalling” of assets and liabilities?
3) Write short notes on the following:
   a) Outstanding of Expenses
   b) Accrued Incomes
   c) Intangible Assets
   d) Fictitious Assets
   e) Cost of Conversion
   f) Cost of Goods Sold
   g) Direct vs Indirect Expenses
4) Draw an imaginary Balance Sheet.

3.7 CORPORATE FINANCIAL STATEMENTS

The process of preparation of financial statements of companies is similar to that of non-corporate entities except for certain peculiar items and legal requirements. The corporate reporting has assumed great importance in recent years. The Company Law Board, the Institute of Chartered Accountants of India and whole corporate world are trying to bring about a total transparency in the matter of reporting. The fundamental objective of corporate reporting is to communicate economic information about the resources and performance of the reporting entity to the users of financial statements. The professional bodies have also developed several (till date – 28) accounting standards for the purpose of preparing and disclosing accounting information in order:

1) To serve the varied needs of users for decision-making purposes.
2) To harmonise the diverse accounting practices.
3) To ensure transparency, consistency, comparability, adequacy and reliability of information-contents.
4) To make accounting information more meaningful and useful.
5) And to improve overall quality of presentation and reporting.

Since every interested party has a right to information which is merely not the outcome of statue but is based on the principle of public accountability. The financial statements which are prepared on the basis of various accounting postulates, concepts and conventions, are supposed to endowed with many qualitative characteristics, viz. understandability, relevance, materiality, reliability, faithful representation, substance over form, neutrality, prudence, completeness and comparability.

General and Legal Requirements

Section 209 to 223 of the Companies Act, 1956 deal with provision governing maintenance and preparation of financial statements.

Section 209 deals with the maintenance of proper books of accounts in respect of

1) Receipts and disbursements of money,
2) Sales and purchases of raw materials/goods,
3) Description peratining to usage of raw material and labout, etc., and
4) All assets and liabilities.

Section 209 also requires that books of accounts must show the "True and fair" view of state of affairs of the company. Section 211 requires that the Balance Sheet must give true and fair view of the results of operations. It simply implies that financial statements should disclose every material information without any concealment of facts and figures and in such a manner that working results and financial position of the reporting enterprise, may correctly be interpreted in true spirits. It should be free from personal biases and mis-statements. It will be possible only if financial statements are prepared in accordance with generally accepted accounting principles and in conformity with the various accounting standards as applicable to the reporting enterprise. Companies (Amendment) Act 1999 has made it mandatory for companies to comply with accounting standards set by ICAI. In case company fails to comply with any of generally accepted accounting assumptions or standards, the fact should be disclosed.

Section 210 requires that financial statements should be presented to shareholders at every Annual General Meeting along with the Auditor's and Directors' Reports. Every Balance Sheet and Profit and Loss Account must be duly authenticated. These statements must be signed by Manager or Secretary and by two directors, at least one of whom must be managing director (Section 215).

3.7.1 Items Peculiar to Corporate Balance Sheet

Share Capital: Under this head following details are required to be disclosed:

1) Details of Authorised, Issued and Subscribed Capital along with number and nominal value of the shares with respect to preference and equity shares.
2) Calls-in-Arrears must be deducted from Called-up Capital. However, Calls-in-arrears on shares held by directors are to be shown separately. Similarly, Calls-in-Advance should be treated as a separate items and shown accordingly.
3) Forfeited Shares Account, if any, should be added to paid-up Capital which forms the part of total of Balance Sheet. It is to be noted that the Authorised, Issued and Subscribed capitals are not considered for the purpose of total of Balance Sheet.
4) Shares issued for consideration other than cash must be disclosed. Such as shares allotted to transferor company under the agreement of takeover/merger, Issue of bonus shares and the source thereof.
5) If preference shares have been issued, the terms of redemption or conversion along with the earliest date of redemption/conversion must be specified.
6) Excess application money on account of over-subscription not requiring any adjustment, should be refunded. If not, the money refundable must be shown as part of current liabilities.

3.7.2 Reserves and Surplus

This may be in the following forms:

i) **Capital Reserves:** It refers to those profits which are not earned from normal business operations. Such profits are not available for the purpose of distribution as dividend. It is created out of profit on sale of-fixed assets or investments held as asset, profit on reissue of forfeited shares, pre-incorporation profit, profit on revaluation of fixed assets, profit on purchase/acquisition of assets or profit on purchase of business (excess of net assets over purchase price).

ii) **Capital Redemption Reserve:** It is created when fully paid preference shares are redeemed out of divisible profits of the company. This reserve may be utilized for the purpose of issuing fully paid bonus shares to the members of the company.

iii) **Securities Premium:** When a company issues shares or debentures at a price which is more than its face value, it is said to have issued shares/debentures at a premium. The premium so received is transferred to "Securities Premium Account".

According to Section 78 of Companies Act, the premium may be utilized for – issuing fully paid bonus shares, writing off preliminary expenses, discount on issue of shares or debentures, and providing premium on redemption of preference shares or debentures.

iv) **Revenue Reserves:** These may be in the form of **specific reserves** or **free reserves** and are created out of revenue profits of the company. Usually such reserves are formed from annual appropriation. **Specific Reserves** are created for specific purpose. For example, Dividend Equalisation Reserve is created to meet the shortfall in the divisible profits of the company intends to follow a stable dividend policy. Or to redeem the debentures, a sinking fund or a debenture redemption reserve may be created. Other specific reserves are Development Rebate Reserve, Investment Allowance Reserve, Export Incentive Reserve, etc.

The term 'Fund' is used when the money earmarked for any specific purpose is invested in ourside securities. For example, if money appropriated for the purpose of redemption of debentures is invested outside and business is termed as Debenture Redemption Fund, if not invested outside but retained or ploughed back in the business, it is called Debenture Redemption Reserve.

Surplus

The Credit balance of Profit and Loss Account or P&L Appropriation Account (i.e. after making necessary transfer to reserves and appropriating for proposed interim or final dividend including bonus, if any) is shown under the heading as surplus. If a company has a debit balance of Profit & Loss Account, the same should be adjusted under this head.

3) **Secured Loans:** This refers to mortgaged loan or other loans, which are fully secured either by a fixed or floating charge on the assets of the Company. It includes loans from bank, financial institutions or from other companies provided these are secured against the specific or all assets of the company. Debentures are assumed to have first floating charge on the assets of the company. It is to be noted that interest accrued and due on secured loans is to be treated as and shown under Secured Loans. Loan from or guaranteed by directors should be disclosed and shown separately. In case of debentures, the terms of redemption/conversion and its earliest date of redemption/conversion be stated.

4) **Unsecured Loans:** These are the loans against which no security stands a pledged or mortgaged. It also includes amount not covered by the value of security provided in respect of partly secured loans. It covers all loans which are not at all secured such as –

- Fixed Deposits from public
- Loans and Advances from Subsidiaries
- Short-term loans and Advances from Banks and others
- Other Loans and Advances
- It may include creditors for purchase of an asset.

5) **Current Liabilities and Provisions:** This heading is split in two sub-headings : current liabilities and prosvisions.

Current Liabilities: It refers to those liabilities which are to be paid or payable within a period of twelve months. It includes, Sundry Creditors, Bills Payable, Outstanding Expenses, Income Received in Advance, Amount payable to Subsidiaries.

It is to be noted that short-term loans and interest outstanding thereon are to be shown under "Secured" or "Unsecured Loan" as the case may be and not under Current Liabilities.

Provisions: Provisions such as Proposed dividend, Provision for Depreciation, Repairs and Renewals, Provision for Doubtful Debts, Investment Fluctuation Reserve, Provident Fund, Pension Fund etc. are shown separately under this head.

> * Provision for Depreciation and Provision for Doubtful Debts may be shown on the "Assets side" as a deduction from the asset concerned.

Contingent liabilities: As explained earlier, these liabilities are shown as a footnote and include the following:

- Liability for bills discounted
- Claims against the company not acknowledged as debt
- Uncalled liability on partly paid shares
- Arrears of fixed cumulative preference dividends
- Guarantee given by the Company on behalf of directors or other officers of the Company
- Estimated amount of contracts remaining to be executed on capital account not provided for, and
- Other money for which company is contingently liable.

> It is to be noted that if any provision is made against any contingent liability, the same is to be shown under the head provisions.

Fixed Assets

Under this head there are eleven types of "fixed assets" starting from goodwill to vehicles. According to AS-10 a fixed asset is an "asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business." Even assets which are not legally owned but held for the purpose of production are treated and shown under this head. These include assets acquired under hire-purchase agreement and assets taken on lease, after considering the addition and disposal, if any. Valuation of fixed assets is made at cost less depreciation after considering the addition and disposal, if any.

It is worth remembering that "goodwill" should be shown in the books only when it is acquired for some consideration. According to AS–26 internally generated goodwill should not be recognized as an asset.

*As per Schedule VI the fixed assets are classified as follows:

1) Goodwill
2) Land
3) Building
4) Leasehold
5) Railway Slidings
6) Plant and Machinery
7) Furniture and Fittings
8) Development of Property
9) Patents, Trade Marks and Designs
10) Live Stock
11) Vehicles

In case of revaluation of fixed assets, every balance sheet subsequent to such revaluation must show the revised figures with the date of increase or decrease in place of original cost. In ascertaining the cost of an asset all expenditures incurred in bringing the asset to its working condition should be included. This includes cost of transportation, expenditure on trial runs. In case of land and building, stamp duty, registration fee and architects fees should be capitalised.

Investments

As per AS-13 (Accounting for Investments), "Investments are assets held by an enterprise for earning income by way of dividends, interest and rentals, for capital appreciation or for other benefits to the investing enterprise". Assets held as stock-in-trade are not investments. Money invested outside business is termed as investments which may be long term, current investment or an investment property.

According to AS-13, a "**current investment** " by its nature as readily realizable is intended to be held for not more than one year, whereas an "investment propery" is an investment in land or building that are not intended to be occupied substantially for use by the enterprises.

Schedule VI requires investments to be shown as follows:

i) Investments in Government or Trust Securities.

ii) Investments in shares, debentures or bonds, fully paid up and partly paid up and also different classes of shares.

iii) Immovable properties

iv) Investments in the Capital of partnership firms.

The following details about the investments must be given:

a) Nature of investment.

b) Mode of valuation of Investments.

c) Aggregate amount of company's quoted investments and its market value.

d) Aggregate amount of company's unquoted investments.

e) Amount of fully paid and partly paid shares.

f) Investment in subsidiary companies.

Current Assets, Loans and Advances

This is subdivided in two sub-headings:

A) **Current Assets:** As per the Guidance note issued by ICAI, "current assets means cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering or services in the normal course of business and include:

i) Stock-in-trade (inventories of raw materials, work-in-progress finished goods, stores and spare parts to be shown separately) including mode of valuation.

ii) Debtors should show the age-wise and security-wise classification such as Debts outstanding for a period of more than six months and other debts.

   Debtors considered good in respect of which company holds no security other than the debtor's personal security.

   Debts considered doubtful or bad.

   Debts due by directors on other officers

   Debts due from other companies (subsidiaries)

Maximum amount due by directors or other officers of the company (footnote through)

Provision for doubtful debts is required to be deducted from sundry debtors

Provision should not exceed the amount considered from sundry debtors.

Provision should not exceed the amount considered doubtful or bad. Any excess provision be shown under "Reserve and Surplus".

iii) Cash and Bank balances should be shown separately. Bank balances should be classified into balances with scheduled banks and other banks along with details of current account, saving bank and fixed deposits. Bank overdraft, if any, should be shown under Sundry Creditors. This information of inclusion be disclosed in a footnote that the Sundry Creditors include bank overdraft amounting to Rs....

B) **Loans and Advances**

The disclosure rules which are applicable to sundry debtors, the same should be applied to "Loans and Advances", i.e. these should be shown in age-wise, security-wise and reliability-wise classification. In addition the following should be shown:

i) Advances and loans to subsidiaries

ii) Advances and loans to partnership firms in which the company or subsidiary is a partner

iii) Bills of Exchange

iv) Advances recoverable in cash or kind or for value (Rent, Rates and Insurance)

v) Balance with customers, port trust, etc. which are payable on demand

Miscellaneous Expenditure

These are the expenses incurred in earlier years but not written off. These include:

i) Preliminary expenses (Formation expenses incurred on preparation of Memorandum and Articles of Association, legal fees, registration fee, etc.)

ii) Share and Debentures issue expenses, such as brokerage, underwriting commission, discount on issue of share and debentures.

iii) Interest paid out of Capital during construction.

Such miscellaneous expenditure is written off over a period for which benefit is available.

Profit and Loss Account (Debit balance)

This represents past unwritten-off losses. These are adjusted and written off against the free reserves (divisible profits/revenue profits) to the available extent. Unabsorbed amount is shown under this head.

3.7.2 Items Peculiar to Corporate Income Statement

Salient Features

Though the procedure and the process of preparation of "Income Statement" of a Company and that of non-corporate entities are similar in principles, there are some differences in the method of presentation and some additional items which form the part of a corporate income statement. These differences are as under:

1) **Heading:** Non-corporate entities name income statement as "Trading and Profit and Loss Account", while companies call it "Income Statement" or Profit and Loss Account only. The items of Trading Account become the part of "Income Statement". No separate Trading Account is prepared.

2) **Appropriation:** Sole trader does not prepare any appropriation account, while partnership firms and companies do. A company's Profit and Loss Account is split up in to two parts – **"above the line"** and **"below the line"**. All items of appropriations are shown "below the line" and the remaining balance is transferred to the liabilities side of the balance sheet. A partnership firm prepares a separate Profit and Loss Appropriation Account.

3) As per AS–5 extraordinary items (abnormal nature), prior period items are shown separately whereas in case of non-corporate entities, such items are stated along with the normal and routine items.

4) **Requirement:** The Profit and Loss Account of a company should conform to the requirements of Schedule VI of Companies Act 1956 and adhere to AS–1; AS–4 and AS–5 recommendations, whereas non-corporate enterprises are not required to do so.

5) **Income Tax:** It is treated as an expense for the companies while for firms and sole trade enterprise, it is treated as drawings.

6) Companies' Profit and Loss Account should disclose the figures for the previous year along with the current year's whereas non-company enterprises are not required to show figures relating to previous year.

Treatment of Special Items of Profit and Loss Account

1) **Interest on Debenture and Loans:** This item includes interest paid and payable for the financial period for which accounts are prepared and shown to the debit side of Profit and Loss Account. Likewise, interest due but remaining outstanding is taken to the liability side of the Balance Sheet. Interest on Debentures and interest on secured loan outstanding, if any, is shown under the heading "Secured Loans" whereas interest outstanding on unsecured loan is shown under "unsecured loans".

> It is to be noted that interest on loan for the construction period should be capitalized and added to the cost of the asset concerned.

2) **Tax on Interest on Debentures:** As per Income Tax Act 1961, every company must deduct tax at source (TDS) while paying interest to the debenture holders. The amount so deducted shall be deposited with the Government treasury. The current rates for TDS are as follows:

Debentures (listed)	10.5% including surcharge
Debentures (unlisted)	21% including surcharge

If A ltd. has to pay interest on its 9% debentures (listed) of the face value of Rs. 5,00,000, then gross interest will be Rs. 45,000 and tax deducted at source Rs. 4,725 balance shall be paid to the Debenture holders Rs. 40,275. The following entry is recorded –

Interest on Debentures A/c	Dr	45,000	
To Debenture Holders A/c			40,275
To Income Tax Payable A/c			4,725

Income Tax deducted but not deposited with the Government is to be shown in the Balance Sheet under the heading "Current Liabilities".

> It should be remembered that Profit and Loss Account will always be debited with the gross amount of interest.

3) **Discount on Debentures/Loss on Issue/Debenture Issue Expenses:** Discount on issue of debentures, debenture issue expenses such as commission, brokerage, etc. are premium payable on redemption (treated as loss on issue which may include discount also) are to be written off as early as possible, or over the life span of the debentures, depending upon the policy of the company in the absence of any specific instructions in the question, such amount should be written off on the basis of debentures outstanding. The unwritten off balance is to be shown on the assets side of the Balance Sheet under the heading of 'Miscellaneous Expenditure'.

It should be remember that only written off amount is charged to Profit and Loss Account.

4) **Prelimiary Expenses:** As already explained under Balance Sheet items, it appears on the assets side of the Balance Sheet under the heading 'Miscellaneous Expenditure' as long as it is not written off. The amount written off is charged to Profit and Loss Account. If there is no specific instructions relating to the amount to be written off, then the entire amount should be shown in the Balance Sheet.

5) **Corporate Income Tax:** This is shown under three stages.

   i) ***Advance Income Tax:*** As per Income Act 1961, the companies are required to pay income tax on the profits earned. They have to deposit advance tax under PAYE (Pay As You Earn) scheme on specific dates during the financial year. The advance tax so paid is adjusted against income tax liability. The unadjusted amount of advance income tax is shown as an asset under the heading Current Assets, Loans and Advances.

   ii) ***Provision for Taxation:*** While preparing Profit and Loss Account, a provision for income tax is created on the basis of current year's profit to meet the actual tax liability. The amount so provided depends on the prevailing tax rate. The current rate of corporate tax is 35% plus 5% surcharge for domestic companies and 40% plus 5% surcharge for foreign companies. The following entry is recorded.

   Profit and Loss Account Dr.
   To Provision for Taxation A/c

AS–22 "Accounting for Taxes on Income" recommends that the net balance, i.e. excess of "Advance Tax" may be shown on the assets side or liabilities side of the Balance Sheet as the case may be, till the final assessment is made and actual tax liability is determined by the tax authorities.

   iii) ***Determination of Actual Tax Liability:*** As per Income Tax rules, income (profits) for the previous year is assessed and taxed in the assessment year. When the assessment is completed the provision for taxation so created may either fall short of actual tax liability or may exceed the tax liability. Such a shortfall or excess is treated as prior period item (AS–5) and therefore its adjustment is made in the Profit and Loss Account but "below the line", either to the debit side (for shortfall) or to the credit side (for excess).

   On the other hand, the actual tax liability is compared with advance income tax paid. In case actual tax liability is more than the amount of advance tax paid the same may be paid or shown as a current liability in the Balance Sheet and if advance tax paid exceeds, the difference being refund should be stated under Current Assets Loans and Advances in the Balance Sheet.

Illustration 4

Extracts from a Trial Balance of a Company
As on 31st March, 2003.

	Dr. (Rs.)	Cr. (Rs.)
Provision for Taxation (2001-02)		2,50,000
Advance Income Tax (for 2001-02)	2,60,000	
Advance income Tax (for 2002-03)	3,00,000	

Additional Information

i) The actual tax liability for the year 2001-2002 amounted to Rs. 2,75,000

ii) provision for Taxation for the year 2002-03 of Rs. 2,85,000 is required to be made.

Show the relevant information in the relevant ledgers.

Solution

Profit and Loss Account (Extracts)
for the year ended 31st March 2003

	Rs.		
To Provision on for Taxation (2002-03)	285,000		above the line
	______	______	
To provision for Taxation (2001-02) (Rs 2,75000-2,50000) Tax Liability-Provision	25,000		below the line

Balance Sheet (Extracts)
As on 31st March 2003

Liabilities	Rs.	**Assets**	Rs.	Rs.
		Loans & Advances		
		Advance Tax	3,00,000	
Current Liabilities		(Current Year)		
		Less Provision for		
Income Tax payable (2001-02) (Tax liability–Advance Tax) Rs. 2,75,000 – Rs. 2,60,000)	15,000	Taxation	2,85,000	15,000

Provision for Taxation (2001-02)

	Rs.		Rs.
To Income Tax (Tax liability)	275,000	By Balance b/d	250,000
		By Profit & Loss A/c (below the line)	25,000
	275,000		275,000

Provision for Taxation (2002-03)			
	Rs.		Rs.
To Balance C/d	2,85,000	By Profit and Loss A/c (above the line)	2,85,000
	2,85,000		2,85,000

Illustration 5: From the following extract of a Trial Balance and the additional information, show the treatment of taxation, in the relevant ledger accounts:

Trial Balance (Extracts)
As on 31st March 2002

	Dr. (Rs.)	Cr (Rs.)
Provision for Taxation		1,20,000
Income Tax	1,10,000	

Additional information: Provide Rs. 1,50,000 for provision for taxation.

Solution

Provision for Taxation A/c (old)

To Income Tax	1,10,000	By balance b/d	1,20,000
To Profit and Loss A/c. (below the line)	10,000		
	1,20,000		1,20,000

Provision for Taxation A/c (New)

	Rs.		Rs.
To balance c/d (To be taken to liabilities) side of B/S	150,000	By Profit and Loss A/c. (above the line)	150,000
	150,000		150,000

Profit and Loss Account (Extracts)

	Rs.		Rs.	
To provision for Taxation (New)	150,000			-Above the line
		By Provision for Taxation	10,000	- below the line

Balance Sheet (Extracts)
As on 31st March 2002

liabilities		Assets	Rs.
Current liabilities and Provision			
B. Provisions:			
provision for Taxation	15,000		

Illustration 6

From the following particulars prepare necessary accounts for the year ending 31st March 2003:

Trial Balance (Extracts)
As on 31st March 2003

	Dr. *Rs.*	*Cr.* *Rs.*
Provision for Taxation (1.4.2002)		4,59,000
Advanced Tax Paid (1.4.2002)	4,20,000	
Tax Deducted at Source (1.4.2002)	3,500	

On 1.1.2003, the assessment was completed and tax liability of Rs. 5,30,000 was determined Advance payment of tax for the year 2002-03 amounted to Rs. 5,10,000. A provision for taxation is to be made for Rs. 5,75,000 for the year ended 31st March 2003.

Solution

Provision for Taxation Account

	Rs.		Rs.
To Income Tax A/c (Tax liability)	5,30,000	By Balance b/d	4,50,000
		By profit & Loss A/c (below the line)	80,000
	5,30,000		5,30,000
To Balance C/d	5,75,000	By Profit & Loss A/c	5,75,000

Advance Income Tax account

	Rs.		Rs.
To Balance b/d	4,20,000	By income Tax A/c	4,20,000
	4,20,000		4,20,000

Income Tax Account (Tax liability)

Rs.	Rs.		
To Advance Income Tax A/c	4,20,000	By Provision for	5,30,000
To Tax Deducted at source A/c	3,500	Taxation A/c	
To Bank A/c. (Balance Paid)	1,06,500		
	5,30,000		5,30,000

Profit and Loss Account
For the year ended 31st March 2003

	Rs.		Rs.
To Provision for Taxation (2002-03)	5,75,000	} Above the line	
To Provision for Taxation (2001-02)	80,000	} below the line	

6) **Managerial Remuneration**

The payment of managerial remuneration is governed by the provisions of sections 198 and 309 either by the Articles or by a ordinary/special resolution passed by the company in general meeting. Managerial personnel refers to managing director, whole-time director, part-time director and manager. The provisions of Companies Act shall apply to a public company and private company and a private company which is a subsidiary of a public company but to no other private company.

The over all managerial remuneration payable by a public company or a private company which is a subsidiary of a public company to it's managerial personnel shall not exceed 11% of the net profits for that financial year. **Remuneration limit does not include fees**. Within the maximum limit of 11% a company may pay a monthly remuneration to its managing or whole-time director in accordance with the provisions of Section 309 or to its manager in accordance wit the provisions of Section 386 of the Companies Act. In case there is no profit or inadequate profit for any year, the company may pay remuneration as per the provisions of Schedule XIII of the Company Act.

7) **Contribution/donation to a Political party**

Any contribution or donation to any political party must be disclosed separately in the Profit and Loss Account. According to section 293, Government companies and companies with less than three years are not allowed to make any political contribution or donation. Those allowed can make such contribution up to 5% of it's average profit. The average net profit for this purpose are to be determined on the basis of the three immediately preceding financial years' profit as determined in accordance with the provision of Section 349 of the Company Act.

8) **Prior Period Items**

The nature and amount of prior period items should be separately disclosed in the Profit and Loss Account in a manner that there impact on the current profit or loss can be perceived. In case, accounts are adopted in the annual general meeting and if some adjustments relating to previous year are to be made, these should be stated below the line, i.e. in the Profit net Loss Appropriation account as per AS-5.

9) **Extra-Ordinary items**

Extraordinary items are incomes or expenses that arise from events or transactions which are clearly distinct from the ordinary activities of the enterprise and therefore, are not expected to recur frequently or regularly, these items should be disclosed in the statement of profit and loss as a part of profit or loss for the period (AS-5). "Fixed assets destroyed in an earthquake" is an example of "Extraordinary items".

10) **Contingencies and Events occurring** after balance Sheet Date

As per AS-4, the amount of a contingent loss should the be provided for by a charge in the statement of Profit and loss if:

i) it is possible that future events will confirm that an asset has been impaired or a liability has been incurred as at the Balance Sheet date and

ii) A reasonable estimate of the amount of the resulting loss can be made.

The existence of a contingent loss should be disclosed in the financial statements if either of the above condition is not met, unless the possibility of loss is remote. **Contingent gains** should not be disclosed in the financial statements. Only virtually certain gains should be recognized.

11) **Appropriation and Disposition of Profits**

Once the profits have been ascertained as per the statement of profit and loss, the next step is the appropriation and disposition of the available profit. It includes:

i) Transfer to general reserve and other reserves such as capital redemption reserve. Development rebate reserve etc.

ii) Transfer to sinking fund.

iii) Transfer to Dividend Equalization fund.

iv) Providing for interim or final dividend, and

v) Paying bonus to share holders.

All these items are treated “below the line” or a separate “Profit and loss Appropriation Account” is prepared.

12) **Dividends**

Dividends refers to that amount of divisible profits which is distributed among the share holders of the company. A member (shareholder) is entitled to receive dividend when it is declared by the Board of directors as per the provisions of the Article. The Board has absolute right to recommend the rate of dividend to the declared subject to the approval of shareholders and provisions of Articles of Association. However, the shareholders cannot compel the Board recommend & declare dividend. It is to be noted that dividend is always declared for the working of one financial year at the annual general meeting. In case the dividend could not be declared at the annual general meeting the same can be declared at the Extraordinary meeting. The power to declare dividend is implied and does not require express authority either in the Articles or Memorandum of Association. It should be remembered that, where a dividend has been declared at Annual General Meeting, neither he company nor the directors can declare a further dividend for the same year at the subsequent general meeting. It is known as Final Dividend.

No devidend should be paid out of capital. Dividends should be paid in proportion to the amount paid up on each share. No dividend shall be payable on calls in advance unless authorised by the Articles. Dividend should be payable in cash except when it is adjusted towards unpaid amount on shares or where bonus shares are issued. According to Section 205 (2A) no company shall declare or pay dividend for any financial year out of the profits from that year unless certain percentage of profit as prescribed by Central Government not exceeding 10% has been transferred to reserve. However, the company may voluntarily transfer higher percentage of the profit to its revenue subject to the rules laid down under the Companies (Transfer of Profits to Revenue) Rules 1975 as amended in 1976. A newly incorporated company is prohibited to transfer more than 10% of its profits to revenue for the initial three years.

i) **Preference Dividend:** The preference dividend is paid to Preference shareholders at a pre-determined fixed rate on priority basis. These holders are entitled dividend in preference to equity shareholders. However the preference shareholders can claim dividend only out of profits and if it is declared at the annual general meeting. If preference shares are of cumulative nature, the arrears of preference dividend if any, shall be payable to preference shareholders before any equity dividend. It should be noted that preference shareholders cannot force the company to pay all the dividends including arrears. If equity shareholders are not paid any dividend, preference shareholders cannot claim any dividend from the company. It is to be noted that the arrears of preference dividend are treated as a contingent liability which appears as a foot note under the Balance Sheet.

Not–cumulative preference shares are not entitled to any arrears resulting from non-payment of dividend due to losses or inadequate profits. If a company has issued participating preference shares with a right to participate in the balance of profits, left after paying fixed preference dividend and a certain percentage of equity dividend, then the participating preference shareholders are entitled against a certain percentage out of the balance (residua) profit as per the items of issue. For example 9% preference shares may be issued with a further right to 40% of the excess dividend over 20% paid to equity shareholders. If a company declares 25% dividend to equity to equity shareholders, the preference shareholders will get 11% dividend. (9% plus 40% of (25%-20%) i.e., 2%).

ii) **Unclaimed Dividend:** According to Section 205 A of the companies Act 1956 dividends remaining unpaid must be deposited in the "unpaid unclaimed Dividend account within 42 days of declaration of dividend. Any claim thereafter, must be met out of the unclaimed dividend account. Money so transferred to the aforesaid account which remains unpaid or unclaimed for a period of seven years from the date of such transfer, shall be transferred to "Investor Education and Protection Fund" maintained u/s 205 of Companies (Amendment) Act 1999.

Unclaimed dividend appears on the liabilities side of Balance Sheet under the head **"Current liabilities & Provisions"**.

iii) **Proposed Dividend:** Dividend recommended by the directors to be paid to shareholders for any accounting period on or after the close of books of accounts but before the Annual General Meeting, is known as proposed dividend. Once it is approved by the shareholders in the General meeting, it becomes final dividend. It is to be noted that rate of dividend declared cannot exceed the proposed dividend. Proposed dividend is an appropriation of profit, hence it is shown to the debit side of profit and loss Appropriation Account and on the liabilities side of balance sheet under the heading **"Current liabilities and Provisions"**.

iv) **Final Dividend:** It is a dividend which is declared at the annual general meeting of the shareholders. Such dividend is declared only after the close of books of accounts; the share holders may reduce the rate of final dividend but cannot increase it. Once the final dividend is declared it becomes the liability of the company. It should be noted that when a final dividend is declared then interim dividend is not adjusted unless there is any specific resolution for such adjustment. Final dividend is paid on paid up Capital for the whole year as against the interim dividend, which is usually paid only for six months. For example N Ltd. has 5,00,000 shares of 10 each Rs. 8 paid, declares 5% p.a. interim dividend and final dividend @ 10% p.a., then the total dividend will be Rs. 5,00,000 i.e. (Rs. 1,00,000 interim dividend + Rs. 4,00,000 final dividend)

I.D. = (4, 00,000 5/100 × 6/12 = 1,00,000) + F.D. = (4,00,000 × 10/100)

v) **Interim Dividend:** A dividend declared by the Directors between two annual general meetings of the company is known as interim dividend, where the directors believe that the company will have sufficient profits available for dividends at the end of the year, they may distribute a part of the profit as a part payment on account. Payment so made in anticipation and on account of total dividend to be paid for the year is treated as interim dividend. However, such payment must be authorised by the Articles. Interim dividend should be declared only when the company has even a better prospects for the second half as well. Regulation 86 of Table–A provides that "Board may from time to time pay to the members such interim dividend as it appears to be justified by the profits of the company." Thus, there is no limit on the number of interim dividend the company may pay in a year. The payment of interim dividend does not require approval of general meeting.

Companies (Amendment) Act 2000 has granted statutory recognition to the right of directors to declare interim dividend. The term dividend now includes interim dividend also. All provisions the Companies Act which apply to dividends have now become applicable to interim dividends also. A company cannot declare any interim dividend unless it has made:

i) necessary provision for depreciation for the whole year.

ii) prior adjustment of accumulated losses, if any

iii) and transfer to general reserve as required u/s 205 (2A)

Once an interim dividend is declared it becomes legally enforceable debt against the Company. Prior to the Amendment Act 2000 the interim dividend was not an enforceable debt Board had right to rescind the resolution already passed.

The period, for which an interim divided is paid, is usually six months. However, students should note that whether the rate of dividend includes the words "per annum" or not. For example the directors of a company declare an interim dividend @ 12% per annum, the interim dividend shall be calculated only for six months. If the rate declared by directors is 12% and the words "per annum" are not mentioned, then the dividend shall be calculated @ 12% without reference to time. i.e. 12% x amount of paid up Capital. If the Capital of the company is Rs. 10,00,000 then in the first case interim dividend will amount to Rs. 60,00 and in the second case Rs. 1,20,000.

vi) **Corporate Dividend Tax**

Finance Act 1997 had exempted the dividend in the hands of shareholders and introduced corporate dividend tax to be paid by the dividend paying company. Thereafter, the corporate dividend tax was withdrawn by the Finance Act 2002 and the burden of tax was shifted on the shareholders and hence company was not liable to pay any tax on dividend declared, distributed or paid between 1.4.2002. to 31.3.2003.

The Finance Act 2003 has again shifted the liability of such tax on the domestic companies who shall be liable to pay additional tax on the amount declared, distributed or paid by way of dividends on or after 1.4.2003. The rate of tax being 12.5% plus surcharge @ 2.5% which is equal to 12.8125%* This rate is applicable for the financial year 2003-04.

Note: Students should verify the rate applicable because this rate may be changed by the Finance Act 2004 or by the subsequent Finance Act. It is further to be noted that dividends from domestic companies in the hands of shareholders are totally exempt again. As per guidance not it is be treated as appropriation.

13) **Transfer to General Reserve**

According to section 205 (2A) no company shall declare or pay dividend for any financial year out of the profits for that unless a certain percentage of profits as prescribed by the Central government not exceeding 10%, has been transferred to reserve. As per the Central Government rules transfer to revenue should be made as follows:

The Central Government has prescribed the following rules under the companies (Transfer of profits to reserve) Rules 1975 as amended in 1976.

	Rate of Dividend				Percentage of profits* to be transferred to reserve
(i)	If the rate of dividend exceeds	10%	but not	12.5%	2.5%
(ii)	"	12.5%	to	15%	5%
(iii)	"	15%	to	20%	7.5%
(iv)	If the rate of dividend exceeds	20%			10%

Accounting Treatment of Dividend

Illustration 7

X Ltd. has a paid up capital of Rs. 30,00,000 dividend into 2,00,000 equity shares of Rs. 10 each and 10% 1,00,000 preference shares of Rs. 10 each. Other particulars were as under.

	Rs.
Opening balance of Profits and loss Appropriation Account	57,500
Net profit earned during the year (after Tax)	7,50,000
Dividend Declared for the year	22%

Prepare Profit and Loss Appropriation Account. Comply with necessary statutory provisions.

Solution

Profit and Loss Appropriation Account

		Rs.		Rs.
To	General Reserve (1)	75,000	By Balance b/d	57,500
To	Preference Dividend (2)	1,00,000	By Net Profit	7,50,000
To	Equity Dividend	4,40,000		
To	Corporate Dividend (3)	67,500		
	Tax	1,25,000		
To	Balance c/d			
		8,07,500		8,07,500

Working notes

(1) As per the provisions of the section 205 on a dividend of 22% a statutory transfer of 10% on the net profit to be made.

(2) Declaration of equity dividend will automatically make the company liable to pay preference dividend. No equity dividend can be paid without paying preference dividend.

(3) A corporate dividend Tax (C.D.T.) @ 12.5% has been provided. A surcharge of 2.5% has been ignored for the sake of simplicity. However, the effective rate of C.D.T. is 12.8123% including surcharge.

Illustration 8

Victor Ltd. disclosed the following particulars:

		Rs.
9% 80,000	Preference shares of Rs. 10 each fully paid	8,00,000
50,000	Equity shares of Rs. 10 each fully paid	5,00,000
30,000	Equity shares of Rs. 10 each Rs. 8 paid up	2,40,000
20,000	Equity shares of Rs. 10 6 paid up	1,20,000

The directors proposed a dividend of 15% or equity shares and resolved to make the following appropriations:

- Transfer to general reserve as per the provisions of the section 205
- Transfer to dividend equalisation fund Rs. 1,75,000
- Transfer to debenture Redemption Fund Rs. 1,00,000
- Transfer to Investment Allowance Reserve Rs. 1,25,000

The net–profit (before tax) for the year amounted to Rs. 12,50,000 you are required to prepare Profit and Loss Appropriation Account. Provide for income tax @ 50% and Corporate Dividend Tax @ 12.5%

Solution

Profit and Loss Appropriation Account

		Rs.		Rs.
To	General Reserve[1]	31,250	By Net Profit (After tax)	6,25,000
To	Dividend Equalisation fund	75,000		
To	Debenture Redemption Fund	1,00,000		
To	Investment Allowance Reserve	1,20,000		
To	Proposed Dividend			
	– Preference Dividend	72,000		
	– Equity Dividend	1,29,000		
To	Corporate Dividend Tax[2]			
	On Rs. (72000 + 1,29,000)	25,125		
To	Balance c/d	67,625		
		6,25,000		6,25,000

Working

1. As per the statutory requirement, a transfer of 5% of the net profit after tax" has been made to General Reserve
2. Corporate dividend tax has beesn provided on the total dividend.

3.8 REQUIREMENTS FOR CORPORATE FINANCIAL STATEMENTS AS PER SCHEDULE VI

The Balance Sheet of a company like any other business organisation is a statement of assets and liabilities. However, in the case of a company, the nature of the details to be shown and the order of the arrangement of the items must conform to the requirements prescribed in Schedule VI, Part I of the Companies Act. There items are already discussed under 3.7.1 of this Unit.

The requirements as to Profit and Loss Account are as follows:

i) The Profit and Loss Account shall be so made out as clearly to disclose the result of the working of the company during the period covered by the P&L account and shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transaction or transactions of an exceptional nature.

ii) The Income Statement is not required to be split in the parts, such as Trading Account, profit earned and appropriated. Schedule VI only recommends to disclose gross profit, net profit and it's appropriation there of. This may be shown under one head of Income Statement or Profit and Loss Account. Chargeable items are shown *"above the line"* whereas appropriations *"below the line"*.

iii) Figures relating to previous year should also be shown along with the current year's figures in a separate column.

iv) As far as possible information given in the statement must be complete in all respects. Such as the details of "turnover" made by the company should disclose sales in respect of each class of goods & their quantities separately. Likewise commission paid to sole selling agents and to other agents should be shown along with the brokerage.

v) The Account should disclose quantities and values of various types of raw-material purchased and quantities and values of various products produced/ purchased including opening and closing balances there of and that of work-in-progress.

vi) The amount provided for depreciation, renewals or diminution in value of fixed assets and the method adopted for making such provisions.

If no such provision has been made- the fact should be disclosed by way of note including arrears of depreciation.

vii) The amount of interest on company's debentures and on other fixed period loans be stated separately, including interest paid or payable to directors.

viii) The amount of Income Tax on profits as per Income Tax Act 1961 at the pre-scribed rate including other taxes if any, should be shown separately.

ix) Expenditure incurred on each of the following items be disclosed separately–

a) Consumption of stores and spare parts

b) Power and fuel

c) Rent

d) Repairs to Building

e) Repairs to Machinery

f) i) Salaries, Wages and bonus

ii) Contribution to provident and other funds

iii) Workmen and staff welfare expenses

g) Insurance

h) Rates and Taxes (excluding income tax)

i) Miscellaneous expenses provided any item exceeds 1% of revenue of Rs. 5,000

Whichever is higher be shown separately.

j) Payment to Auditor

a) as auditor

b) as advisor in respect of

i) Taxation matter

ii) Company law matters

iii) Management services

k) Remuneration received by managing directors or managers either from the company or it's subsidiaries should be indicated separately including it's computation.

x) The Profit and Loss Account should disclose the various items of incomes arranged under appropriate heads.

a) *Turnover* giving details in respect of each class of goods indicating quantities of such sales for each class separately.

b) *Amount of income from interest* specifying the nature of the income

c) *Income from investment* stating from trade investments & other investments

d) Profit or losses or investments

e) *Dividends* including dividends from subsidiary companies

f) *Miscellaneous* incomes such as royalty, fees etc.

g) *Foreign exchange* earnings, if any

The Profit and Loss Account must be made out in such a manner that discloses "true and fair" view of the profit or loss of the company for the current accounting year. This means that items of extraordinary nature or those unrelated to company's business or items relating to previous years (Prior Period items) should be separately stated, if these are material.

Similarly amount drawn from reserves, profits from revaluation of assets or profits arising due to change in method of accounting or major policy change in the method of valuation higher the operating efficiency or position much better that it actually is would be contraray to the spirit of law.

3.9 BASIC PRINCIPLES GOVERNING THE PREPARATION OF FINANCIAL STATEMENTS

1) **Materiality:** It is a relative term. What is material for one company may be immaterial for other. According to American Accounting Association (AAA) an item should be regarded as material if there is reason to believe that knowledge of it would influence the decision of informed investors, banks, creditors & other interested parties. AS-5 sates that all material information and items should be disclosed which are necessary and vital to make the financial statements more clear and understandable – operating efficiency — wise and financial-position-wise. Treatment of certain expenditure as capital by one company and revenue by the other is a clear example of it. Hence materiality is purely matter of personal judgment which is guided by size and nature of enterprise.

2) **Prior Period Items: (AS-5)**

As a matter of fact the Profit and Loss Account should disclose the profit or loss for the period for which accounts are prepared, that is for the reported (current) period. If, however, some items were omitted to be accounted for in the preparation of financial statements then it is not possible to reopen the accounts for the previous year after it has been adopted by the shareholders in the annual general meeting. The ICAI defines "Prior Period Items" as incomes or expenses which arise in the current period as a result of errors or omissions in the preparation financial statements of one or more periods". The errors may occur as a result of mathematical mistakes, oversight (omissions), misinterpretation of facts and wrong application of accounting policies or a wrong or inaccurate estimate. Hence these items should be shown "below the line" i.e. in the Profit and Loss Appropriation Account. However, prior period adjustments do not cover–

- Minor omissions of accruals and prepayments
- Prior period's revenue which was not accounted for on the ground of prudential practice.
- Recovery of bad debts written off earlier
- Adjustments to the useful life of the depreciable assets

3) **Extra Ordinary Items: (AS–5)**

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently and regularly (AS-5). These items are shown in the Profit and Loss Account for the period but the nature of such items should be disclosed separately. These include

- Write down of inventories to "net realizable value"
- Profit or loss on sale of fixed assets or long-term investments.
- Reversals of provisions
- Reversals of writing off of the fixed assets
- Losses sustained on account of an earthquake.

4) **Change in Accounting Policies: (AS-5)**

Accounting policies are the specific accounting principles and the methods of applying these principles adopted by an enterprise in the preparation and presentation of financial statements. A change in accounting policy is required by statue or by the accounting standard setting body or if it is considered that the change will result in a more appropriate presentation of the financial statements of the enterprise. Any material effect of such a change in the current or subsequent periods should be quantified and disclosed together with the reasons for the change. Following are the change in policy:

- A change in the method of charging depreciation from written down value (WDV) to straight line method (SLM) and vice versa.
- A change in the method of valuation of inventories.

  However, a change in the estimated life of a machine is not a change in policy but a change in estimate.

3.10 PREPARATION OF CORPORATE FINANCIAL STATEMENTS

As already stated, the Board of Directors of the company shall present a Balance Sheet as at the end of the period; and a Profit and Loss Account for that period at the annual general meeting. In case of company not carrying on business for profit, an Income and Expenditure Account shall be laid at the annual general meeting instead of Profit and Loss Account. Every Profit and Loss Account shall also give a "true and fair" view of profit or loss of the company for the financial year and shall comply with the requirements of schedule VI. Every Insurance or Banking company or any company engaged in the generation of electricity or any other class of company for which the Profit and Loss Account has been specified under the Act governing such class of company need not follow the Form given in Schedule VI to this Act. Similarly every Balance Sheet shall give a "true & fair" view of the state of affairs of the company as per Schedule VI. Any Insurance or Banking company or any company engaged in generation or supply of electricity or any other class of company for which a form of Balance Sheet has been prescribed under the Act governing such class of company need not to follow such form.

Recently the Companies (Amendment) Act 1999 has made the compliance of accounting standards mandatory. Accordingly every Profit and Loss Account and Balance Sheet of the Company shall comply with the "Accounting Standards". However, in case of non-compliance the company must disclose the 'deviation' from the accounting standards. It should also state "reasons" for such deviation; and "financial effect" if any, due to such deviation.

On the basis of requirements of Schedule VI and accounting standards following is the format of Profit and Loss Account of a Company.

Profit and Loss Account of ....

For the year ended 31st March ....

Figure for the previous year Rs.		Figures for the current year Rs.	Figure for the Previous year Rs.		Figures for the current year Rs.
...	To Opening Stock		...	By Sales Less Returns	...
...	Raw Material	...	...	By Income from Services	...
...	Finished Goods	...	...	By Closing Stock	...
...	To Purchases (Raw materials)	...	...	Raw Materials	...
...	Less Returns	...	...	Work-in-progress	...
...	To Stores & Spares (consumed)	...	...	Finished Goods	...
...	To Power and Fuel	...			
...	To Wages (Productive)	...			
...	To Manufacturing Expenses	...			
...	To Gross Profit c/d				
		xxx			xxx
...		...	...	By Gross Profit b/d	...
...	To Rent	...	...	By Income from Investments	...
...	To Repairs to Building	...		By Profit on Sale of Investment	...
...	To Repairs to Machinery	...		By Dividend Income	...
...	To Salaries & Bonus	...		By Miscellaneous Incomes	...
...	To Contribution to Provident Fund	...			
...	To Staff Welfare Expenses	...			
...	To Contribution to Pension/Gratuity Fund	...			
...	To Insurance	...			
...	To Rates & Taxes	...			
...	To Printing & Stationery	...			
...	To Postage, Telegrams, Fax & Telephone	...			
...	To Commission, Brokerage and Discount	...			
...	To Bank Charges & Interest	...			
...	To Depreciation	...			
...	To Loss on sale of Investments	...			
...	To Remuneration payable to	...			
...	Directors & other	...			
...	Managerial Personnel	...			
...	To Auditor's Fee	...			
...	To Provision for Taxation	...			
...	To Net Profit (transferred to Profit & Loss Account)	...			
xxx		xxx	xxx		xxx

Schedule VI
(Part I - Form of Balance Sheet)
(Conventional Format)

Balance Sheet of...............
As on 31st March.............

Figure for the previous year Rs.	*Liabilities*	*Figures for the current year Rs.*	*Figure for the Previous year Rs.*	*Assets*	*Figures for the current year Rs.*
	Share Capital **Authorised***.... shares of Rs. ...... each. **Issued**..... shares of Rs. Each (*Various classes of shares and their called up amount including details of - Shares issued for consideration other than Cash - Bonus Issue made, if any Less Call Unpaid (i) By Directors (ii) By Other Add. Forfeited shares (amount actually paid) **Reserves & Surplus** (1) Capital Reserve (2) Capital Redemption Reserves (3) Securities Premium (4) Others Reserves & specifying the nature of each reserve and amount in respect there of **Loss** Debit balance of P&L A/c (5) Surplus-Balance in Profit and Loss Account after providing for proposed allocation namely Dividend-Bonus, or Reserves (6) Proposed Additions to Reserves (7) Sinking Fund **Secured Loans** (1) Debentures (2) Loans & Advances from Banks (3) Loans & Advances from subsidiaries (4) Other loans & Advances * Interest accrued and due should be Included in the respective sub-head) * Nature of security to be specified in each case) * Terms of redemption or conversion of debentures to be stated together with earliest date of conversion/redemption. **Unsecured Loans** (1) Fixed Deposits (2) Loans & Advances from subsidiaries (3) Short-term loans & advances (a) From Banks (b) From Others (4) Other loans and advances (a) From Banks (b) From Others			**Fixed Assets** Goodwill Land Building Leasehold Railway sidings Plant and machinery Furniture and Fittings Development of Property Patents, Trade Marks and Designs Live Stock and Vehicles etc. **Investments** Showing nature of Investment and mode of valuation-cost Or market value, and distinguishing between (1) Investments in Government or Trust Securities (2) Investments is Shares, Debentures or bonds (Giving details of classes of shares along with their paid up value) (5) Immovable Properties (4) Investments in Capital of Partnership firms. **Current Assets, Loans and Advances** (A) Current Assets (1) Interest Accrued on Investments (2) Stores and Spare parts* (3) Loose Tools (4) Stock in Trade* (5) Work-in Progress* * Mode of valuation and Amount in case of raw materials **Sundry Debtors** (a) Debts outstanding for a period exceeding six months (b) Other debts (Less Provision) In regard to sundry debtors, particulars to be given separately (i) Debts considered good and In respect of which company is fully secured (ii) Debts considered good	

Current Liabilities & Provisions

A. Current Liabilities

(i) Acceptances

(ii) Sundry Creditors

(iii) Subsidiary Companies

(iv) Advance payments and Unexpired discounts for the portion for which value has still to be give e.g. in the following classes of companies Newspaper, Fire-Insurance, Theaters, Clubs, Banking & Steamship Companies

(5) Unclaimed Dividends

(6) other Liabilities, if any

(7) Interest accrued but not due on loans

B. Provision

(8) Provision for taxation

(9) Proposed dividends

(10) For Contingencies

(11) For Provident Fund Scheme

(12) For Insurance, Pension and Similar Staff Benefit schemes

(13) Other provisions

for which company holds no security other than the debtor's personal security.

(iii) Debts considered doubtful doubtful or bad.

(iv) Debts due by directors or Other officers or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director or a member–to be separately stated.

(7a) Cash Balance at hand

(7b) Bank Balances

(i) With Scheduled banks &

(ii) With Others

(B) Loans and Advances

(8) (a) Advances loans to Subsidiaries.

(b) Advances and loans to Partnership firms in which company or any of it's subsidiaries is a partner.

(9) Bills of Exchange

(10) Advance receivable in cash or in kind or for value to be received e.g. rate, taxes Insurance etc.

(11) Balances on Current Accounts with managing Agents, secretaries and Treasures.

(12) Balances with customs Port trust (where payable on Demand)

Misc. Expenditure

(1) Preliminary Expenses

(2) Expenses including commission, or brokerage on underwriting or subscription of shares or debentures.

(3) Discount on issue of Shares or debentures

(4) Interest paid out of capital during construction period

(5) Development Expenditure not adjusted

(6) Other items (specifying nature)

Profit and Loss Account

(Debit balance of P&L A/c Carried forward after adjusting uncommitted (free) reserves, is any.)

xxx	xxx	xxx		xxx

Footnote: to be shown separately such as:

1) Claims against the Company not acknowledged as debts.
2) Uncalled liability on shares partly paid
3) Arrears of cumulative dividends
4) Estimated amount of contracts remaining to be executed on capital account and not provided for.
5) Other money for which company is contingently liable.

Preparation of Financial Statements–Conventional Format

Illustration 9

From the following Trial Balance of A Ltd., prepare a Profit and Loss Account of the company for the year ended 31st March 2003 and a Balance Sheet as on that date.

	Rs.	Rs.
5,00,000 Equity shares of Rs. 10 each fully called		50,00,000
9% Debentures (Rs. 100 each)		20,00,000
Freehold Building	40,50,000	
Plant and Machinery	28,00,000	
Profit and Loss Account		2,75,000
Stock (1.4.2002)	7,50,000	
S. Debtors and Creditors	9,50,000	4,25,000
Bills Payable		3,75,000
Purchases and Sales	19,75,000	45,25,000
Provision for Bad Debts		45,000
Bad Debts	25,000	
General Reserves		3,50,000
Calls in Arrears	75,000	
Goodwill	3,00,000	
Interim Dividend Paid (1.11.2002)	4,92,500	
Cash at Bank	1,60,000	
Wages and Salaries	6,95,500	
Office Expenses	77,000	
Salaries of office and marketing staff	5,15,000	
Interest on Debentures	90,000	
Discount on Issue of Debentures	40,000	
	1,29,95,000	1,29,95,000

Adjustments:

i) Stock on 31st March 2003 was Rs. 8,75,000

ii) Depreciate Plant & Machinery by 10% and write off 1/8th of the discount con issue of debentures

iii) Maintain 5% provision for doubtful debts on debtors.

iv) Interest on debentures has been paid only for the first half

v) Income tax @ 50% is to be provided. Corporate dividend tax is 12.5%

vi) There is a claim for Rs. 50,000 for workmen's compensation, which has been disputed by the company. The case is pending in the country of law.

Solution

Profit and Loss Account
For the year ended 31st March 2003

	Rs.		Rs.
To Stock (1.4.2002)	7,50,000	By Sales	45,25,000
To Purchases	19,75,000	By Closing Stock	8,75,000
To Wages and Salaries	6,95,500		
To Gross Profit c/d	19,79,500		
	54,00,000		54,00,000
To Salaries	5,15,000	By Gross Profit b/d	19,79,500
To Office Expenses	77,000		
To Bad Debts	25,000		
To Provisions for bad debts (Rs. 47,500 – Rs. 45,000)	2,500		
To Depreciation	2,80,000		
To Interest on Debentures Rs. 90,000 Add outstanding interest Rs. 90,000	1,80,000		
interest on Debentures			
To Discount on issue of Deb.	5,000		
To Provision for Tax	4,47,500		
To Net Profit c/d	4,47,500		
	19,79,500		19,79,500
To Interim Dividend	4,92,500	By Balance b/d	2,75,000
To Corporate Dividend Tax (Interim dividend Rs. 4,92,500 x 12.5%)	61,563	By Profits and Loss A/c (Net Profit)	4,47,500
To Balance c/d	1,68,437		
	72,22,500		7,22,500

Balance Sheet of A Ltd.
As on 31st March 2003

Liabilities		Rs.	Assets	Rs.
Called up & paid up Capital			Fixed Assets	
5,00,00 shares of Rs. 10 each			Goodwill	3,00,000
	Rs. 50,00,000		Freehold Building	40,50,000
Less Calls-in-Arrears	Rs. 75,000	49,25,000	Plant & Machinery	
Reserve & Surplus			(Rs. 28,00,000–Rs. 2,80,000)	25,20,000
General Reserve		3,50,000	Current Assets, Loans	
Profit and Loss Account		1,68,437	Advances	
Secured Loan			Current Assets	
9% Debentures	Rs. 20,00,000		Stock	8,75,000
Interest outstanding	Rs. 90,000	20,90,000	Debtors (Rs. 9,50,000–Rs. 47,500)	9,02,500
Current Liabilities and Provisions			Cash at Bank	1,60,000
Current Liabilities			Miscellaneous Expenditure	
Sundry Creditors		4,25,000	Discount on Issue	35,000
Bills Payable		3,75,000	of Debentures	
Provisions:			(Rs 40,000–written off Rs 5000)	
Provision for Tax		4,47,500		
Corporate Dividend Tax		61,563		
		88,42,500		88,42,500

Note: There is a contingent liability of Rs. 50,000 for workmen's compensation

1 No statutory transfer to general reserve is made, as the dividend paid does not exceed 10% of paid up capital.

For the sake of simplicity surcharge on corporate dividend tax not taken into account.

Illustration 10

Following in the Thial Balance of a limited Company as at 31st December, 2004.

Particulars *Credit*	*Debit*	
Share Capital		4,00,000
Cash in Hand	6,200	
Rent	5,300	
Prepaid Expenses	4,600	
Repairs & Maintenance	8,600	
Advances from Customers		50,000
General Reserve		3,00,000
Raw Materials at Cost	2,67,000	
Sundry Creditors	3,40,000	
Plant and Machinery	4,30,000	
Power	8,800	
Travelling and Conveyance	4,100	
Auditors' Fees	1,500	
Cash at Bank	8,000	
Land	30,000	
Provision for Taxation	2,10,000	
Furniture	12,200	
Staff advances	5,300	
Sundry Debtors	1,40,000	
Misc. Income	54,600	
Finished Goods at cost	3,10,000	
Income-tax Advances	3,00,000	
Misc. Expenses	61,400	
Raw Materials consumption	28,60,000	
Sales	42,30,000	
Development Rebate Reserve	1,00,000	
Building	74,100	
Salaries, Wages & Bonus	11,60,000	
Cash Credit from Bank	12,500	
Total	56,97,100	56,97,100

The following additional information is also available:

i) The authorised capital of the company is 80,000 equity shares of Rs. 10 each of which 50% has been issued and has been recommended by the directors.

ii) A dividend of 15% on the paid up capital has been recommended by the directors.

iii) The closing stock of finished goods at cost is Rs. 5,60,000.

iv) The development rebate reserve is no langer required.

v) Depreciation on plant and machinery amounting to Rs. 43,000 on furniture amounting to Rs. 1,300 and on building amounting to Rs. 3,800 has been debited to miscellaneous expenses.

vi) Surplus in profit and loss account after proposed dividends, is to be transferred to general reserve.

vii) Income-tax assessment for a prior year has been completed, fixing the income tax liability at Rs. 1,55,000 (against which a provision of Rs. 80,000 and advances of income tax of Rs. 70,000 exists in the books).

You are required to prepare:

i) profit and loss account for the year ended 31st December, 2004; and

ii) Balance sheet in the prescribed form as on that date.

Solution

A Company Limited
Profit and Loss Account
for the year ended 31st December, 2004

Particulars	*Rs*	*Particulars*	*Rs*
To Open. Stock of finished goods	3,10,000	By Sales	42,30,000
To Raw Materials consumed	28,60,000	By Clos. Stock of Finished	5,60,000
To Gross Profit c/d	16,20,000	Goods	
	47,90,000		47,90,000
To Salaries, Wages and Bonus	11,60,000	By Gross Profit b/d	16,20,000
To Power	8,800	By Miscellaneous Income	54,600
To Rent	5,300		
To Repairs and Maintenance	8,600		
To Aduditors' Fees	1,500		
To Travelling and Conveyance	4,100		
To Depreciation on:			
Plant and Machinery	43,000		
Furniture	1,3000		
Building	3,800		
To Miscellaneous Expenses	13,300		
To Provision for Taxation	169960		
To Net Profit for the year	254940		
	16,74,600		16,74,600
To Provision for Taxation		By Net Profit for the year	2,54,940
(for a prior year)	75,000	By Development Rebate Reserve	
To Statutory Reserve	12747	written Back	1,00,000
To Proposed Dividend	60,000		
To General Reserve (transfer)	2,07,193		
	354940		354940

Note: Provision for taxation for the year is assumed to be 40% of the profit.

A Limited Company
Balance Sheet
as on 31st December, 2004

Particulars		*Rs*	*Particulars*		*Rs*
Share Capital:			**Fixed Assets:**		
Authorised:			Land at cost	Rs.	30,000
80,000 Equity shares of Rs. 10 each		8,00,000	Building	77,900	
Issued: Subscribed and Paid up:			*Less:* Depreciation	3,800	74,100
40,000 Equity shares of Rs 10 each			Plant and Machinery	4,73,000	
fully paid up		4,00,000	*Less:* Depreciation	43,000	4,30,000
Reserves and Surplus:			Furniture	13,500	
General Reserve:	Rs.		Less: Depreciation	1300	12,200
Brought forward	3,00,000		Investments		–
Add: ransfer from			**Current Assets, Loans and**		

Profit and Loss A/c	207193	5,07,193	**Advances:**	
Satutory Reserve		12,747	*A.* Current Assets:	
Development			Raw Materials at cost	2,67,000
Rebate Reserve:	1,00,000		Finished Goods at cost	5,60,000
Less: Transferred to			Sundry Debtrors	1,40,000
Profit and Loss A/c	1,00,000	–	Cosh in Hand	6,200
Secured Loans:			Cash at Bank	8,000
Cash Credit from Bank		12,500	*B.* Loans and Advances:	
Unsecured Loans:		–	Staff Advances	5,300
Current Provisions:			Prepaid Expenses	4,600
A. Current Liabilities:			Income Tax Advance	2,30,000
Sundry Creditors		3,40,000		
Income Tax Payable		85,000		
Advances from Customers		50,000		
B. Provisions:				
Provisions for Taxation		2,99,960		
Proposed Dividend		60,000		
Total		17,67,400		17,67,400

Working Notes:

		Rs
(i)	Provision for Taxation:	
	As per Trial Balance	2,10,000
	Less: Adjustment for prior year provision	80,000
		1,30,000
	Add. Provision for current year taxation	169,960
	Provision taken to Balance Sheet	2,99,960
(ii)	Prior year tax Adjustments:	
	Income Tax Liability for Prior Year	1,55,000
	Less: Prior Provision	80,000
	Additional Provision to be made in current year	75,000
	Total Tax Liability	1,55,000
	Less: Advance Tax	70,000
	Tax Payable	85,000
(iii)	Advances Income Tax	3,00,000
	Less: Adjustment against prior year completed assessment	70,000
	Balance in Advance Income tax	2,30,000

(iv) A sum equal to 5% to the net profits is required to be transferred to statutory reserve as the rate of dividend is 15%.

Illustration 11

The Bangalore Manufacturing Co. Ltd., was registened with a nominal capital of Rs. 15,00,000 divided into equity shares of Rs. 100 each. On 31st March 2004 the follwing ledger balances were extracted from the company's books.

	Rs.		*Rs.*
Equity Share Capial Called		Preliminary Expenses	12,500
up and paid up	11,50,000	Freight and Duty	32,750
Calls-in-arrears	18,750	Goodwill	62,500
Plant and Machinery	9,00,000	Wages	2,12,000
Stock (1-4-2003)	1,87,500	Cash in hand	5,875
Fixtures	18,000	Cash at Bank	95,750
Sundery Debtors	2,17,500	Directors' Fees	14,350
Buildings	7,50,000	Bad Debts	5,275
Purchases	4,62,500	Commission paid	18,000
Interim Dividend Paid	18,750	Salaries	36,250
Rent	12,000	6% Debentures	7,50,500
General Expenses	12,250	Sales	10,37,500
Debenture Interest	12,250	4% Government Securities	1,50,500
Bills Payable	95,000	Provision for Doubtful Debts	8,750
General Reserve	62,500	Sundry Creditors	1,15,000
Profit and Loss A/c	36,250		
(Cr.) 1-4-2003			

The stock on 31st March, 2004 was estimated at Rs. 2,52,000

The following adjustments© were to be made:

1) Final Dividend at 5% to be provided.
2) Depreciation on Plant and Machinery at 10% and on Fixtures at 5%.
3) Preliminary expenses to be written off by 20%.
4) Rs. 25,000 were to be transferred to General Reserve.
5) The provision for bad debts to be maintained at 5% on sundry debtors.

You are required to prepare the Trading and Profit and Loss Account and Profit and Loss Appropriation Account for the year ended 31st March 2004 and the Balance Sheet as on that date.

Solution

Trading and Profit and Loss Account of the Bengal Manufacturing Co. Ltd.
for the year ending 31st March, 2004

		Rs.		*Rs.*
To Opening Stock (1-4-2004)		1,87,500	By Sales	10,37,500
” Purchases		4,62,500	” Closing Stock (31-3-2004)	2,52,000
” Freight and Duty		32,750		2,52,000
” Wages		2,12,000		
” Gross Profit c/d		3,94,750		
		12,89,500		12,89,500
To Salaries		36,250	By Gross Profit b/d	3,94,750
” Commission		18,000		
” Rent		12,000		
” General Expenses		12,250		
” Directors’ Fees	Rs.	14,350		
” Debenture Interest	12,500			
Add. Outstanding Interest	32,500			
To Bad Debts	5,275			
Add: Provision for Bad Debts Required @ 5% on Debtors Rs. 2,17,500	10,875			
	16,150			
Less: Old Provision for Doubtful Dets	8,750			
		7,400		
” Depreciation on: Plant & Machinery @ 10%	90,000			
Fixtures @ 5%	900			
		90,9000		
“ Preliminary Expenses (20%)		2,500		
” Provision for Taxation		62,500		
” Net Profit transferred to Profit and Loss Appropriation A/c		93,000		
		3,94,750		3,94,750

Calculation of Outstanding Interest

	Rs.
Interest on Rs. 7,50,000 debentures @ 6% for one year	45,000
Less: Debenture interest paid	12,500
Outstanding interest	32,500

Profit and Loss Appropriation Account
for the ending 31st March, 2004

	Rs.		Rs.
To Interim Dividend	18,750	By Balance b/d (1-4-2003)	36,250
” Proposed Final Dividend @ 5% on Rs. 11,31,250 (i.e. Rs. 11,50,000 called) up capital—Rs. 18,750 calls-in-arrears)	56,562	” Net Profit for the year	93,600
” General Reserve	25,000		
Balance c/d	29,538		
	1,29,850		1,29,850

Balance Sheet of the Bangalore Manufacturing Co. Ltd.
as at 31st March, 2004

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital: Rs.		**Fixed Assets:**	
Authorsed Capital: 15,000		Goodwill	62,500
equity shares of Rs. 100 each	15,00,000	Buildings Rs.	7,50,000
		Plant & Machinery 9,00,000	
Called up and Paid up Capital:		*Less:* Depreciation 90,000	
11,500 shares of Rs. 100 each			8,10,000
fully calld up 11,50,000		Fixtures 18,000	
Less: Calls-in-arrears 18,750		*Less:* Depreciation 900	
	11,31,250		17,100
Reserves and Surplus:		***Investments:***	
General Reserve 62,500		4% Government Securities	1,50,000
Add: Transferred during		***Current Assets, Loans and***	
the year 25,000		***Advances:***	
	87,500	A. ***Current Assets:***	
Profit and Loss Account	29,538	Stock	2,52,000
Secured Loans		Sundry Debtors 2,17,500	
6% Debentures	7,50,000	*Less:* Provision for	
Debenture Interest Outsanding	32,500	Bad Debts @ 5% 10,875	
Unsecured Loans	Nil		2,06,625
Current Liabilities & Provisions:		Cash in hand	5,875
A. ***Current Liabilities:***		Cash at Bank	95,750
Bills Payable	95,000	B. Loans and Advances	Nil
Sundry Creditors	1,15,000	***Miscellanceous Expenditure:***	
B. ***Provisions:***		(to the extent not written	
Provision for Taxation	62,500	off or adjusted)	
Proposed Dividends	56,562	Preliminary Expenses	10,000
	23,59,850		23,59,850

Illustration 12

Spik and Span Ltd. was registered with an authorised capial or Rs. 3 lakh divided into 30,000 equity shares of Rs. 10 each. The company offered 15,000 shares for public subscription of which Rs. 7.50 pen share was called up.

The following trral balance was drawn from the book of accounts as on March 31, 2004. You are required to prepare a Profit & Loss Appropriation Account for the year ending on March 31, 2004 and Balance Sheet as on that date.

	Debit Rs.	Credit Rs.
Land	23,800	
Buildings	52,900	
Calls in Arrear	5,000	
Brokerage on Shares	8000	
Stores and Spare parts	18,000	
Preliminary Expenses	7,600	
Unexpired Insurance	640	
Live Stock	900	
Plant & Machinery	1,03,600	
Loose Tools	24,000	
Stock in trade at cost	50,000	
Cash at Office	12,480	
Cash Bank	25,000	
Sundry Debtors	26,000	
Share Capital		1,12,500
Sundry Creditors		1,24,600
Capital Reserve		30,800
Wages Outstanding		1,820
Godown Rent due		700
General Reserve		16,800
Employee's Benefit Fund		3,000
Salaries Outstanding		1,000
Reserve for Doubtful Debts		1,300
Unpaid Dividends		700
Profit & Loss Accoaunt		57,500
Total	3,50,720	3,50,720

Out of the creditors of, Rs. 1,24,600 Rs. 84,600 were due to bank for a loan secured by mortage on buildings and machinery, and Rs. 22,000 were due on account of loan from subsidiary company.

The company earned a profit of Rs. 61,200 during the year. The balance of profit brought forward from the previous year was Rs. 38,600 out of which it was decided that Rs. 15,000 be paid as final dividend, Rs. 16,800 the carried to General Reserve, Rs. 3,000 to Employees Benefit Fund. It was further resolved that Rs. 7,500 be paid by way of interim dividend for the first half of the current year.

Solution

Spik and Span Ltd.
Profit and Loss Appropriation A/c for the year ended March 31, 2004

	Rs.		*Rs.*
To Interim Dividend	7,500	Balance as per P & L A/c for the	
To Balance of Profit	57,500	year ending March 31, 2003	38,600
To Dividend	15,000		
To General Reserve	16,800		
To Employee's Benefit Fund	3,00	Profit as per P & L A/c	61,200
	99,800		99,800

Spik & Span Ltd.
Balance Sheet as on March 31, 2004

Liabilities	*Rs.*	*Assets*		*Rs.*
Share Capital:		**Fixed Assets:**		
Authorised		(Net Block)	Rs.	
30,000 Equity Shares of		Land	23,800	
Rs. 10 each	3,00,000	Buildings	52,900	
Issued & Subscribed Capital:				
15,000 Equity Shares of		Plant &		
Rs. 10 each Rs. 750 per		Machinery	103,600	
Share called up Rs. 1,12,500		Live Stock	900	1,81,200
Less Calls in Arrear Rs. 5,000		**Current Assets:**		
	1,07,500	Stock in trade at cost		50,000
		Stores & Spares		18,000
Reserves and Surplus:				
Capital Reserve	30,800	Loose Tools		24,000
General Reserve	16,800	Sundry Debtors	26,000	
		Less Reserve		
Profit & Loss Account	57,500	for D'ful Debts	1,300	24,700
Empioyees Benefit Fund	3,000	Cash & Bank Balances		37,480
Secured Loans:		**Loans and Advances:**		
From Bank (Secured by		Unexpired Insurance		640
mortgage on buildings machinery)	84,600			
Unsecured Loans:		**Miscellanceous Expenditure**		
From Subsidiary	22,000	**& Losses:**		
Current Liabilities and		Preliminary Expenses		7,600
Provisions:		Brokerage on Shares		800
Sundry Creditors	18,000			
Unpaid Dividends	700			
Outstanding Wages	1,820			
Outstanding Salary	1,000			
Godown Rent due	700			
	3,44,420			3,44,420

Adjustment: (1) Stock on 31st March 2003 was valued at Rs. 3,42,000

(2) Depreciate:

Plant and Machinery	15%
Computers	10%
patents & Trade Marks	5%

(3) Provision for Bad & doubtful debts is required at Rs. 2,040

(4) Provide for–

Rent o/s	Rs.	3,200
Salaries o/s	Rs.	3,600
Proposed Dividend	15%	

Provision for Income Tax 50% & Corporate Dividend tax 12.5%

Ans: Net Profit after Tax Rs. 1,03,900
Corporate dividend Rs. 12,000
Balance Sheet Total Rs. 8,32,800

Corporate Tax = Rs. 6000 + Rs. 3600 = Rs. 9600
Rs. 96000 × 12.5% = Rs. 12000

2. The following balances appeared in the books of ABC Co. Ltd. as on December 31, 2004.

Particulars	*Rs.*	*Rs.*
Paid up Capital		6,00,000
60,000 Equity Shares of Rs. 10 each		2,50,000
General Reserve		6,526
Unclaimed Dividend		36,858
Trade Creditors		
Buildings at Cost	1,50,000	
Purchases	5,00,903	
Sales		10,83,947
Manufacturing Expenses	3,59,000	
Establishment Charges	26,814	
General Charges	31,078	
Machinery at Cost	2,00,000	
Motor Vehicle at Cost	30,000	
Furniture at Cost	5,000	
Opening stock	1,72,058	
Book Debts	2,23,380	
Investments	2,88,950	
Depreciation Reserve		71,000
Advance Payment of Income Tax	50,000	
Cash Balnce	72,240	
Directors Fees	1,800	
Investment's Interest		8,544
Profit and Loos Account		
(January 1,2004)		16,848
Staff Providend Fund		37,500
	21,11,223	21,11,223

From these balances and the following information prepare the Company's Balance Sheet as on December 31, December 31, 2004 and its Profit and Loss Accout for the year ended on that date.

a) The stock on December 31, 2004 was Rs. 1,48,680.

b) Provide Rs. 10,000 for depreciation on fixed assets, Rs. 6,500 for Managing Director's Commission and Rs. 1,500 for the Company's contribution to the Staff Providend Fund.

c) Interest accrued on Investment amounted to Rs. 2,750.

d) A Provision of Rs. 60,000 for taxes in respect of the profit for 2004 is considered necessary.

e) The directors propose a final dividend at 4% after transfering Rs. 50,000 to general Reserve.

f) A claim of Rs. 2,500 for workmen's compensation is being disputed by the company.

g) The Market value of investment as on 31.12 2004 amounts to Rs. 3,02,500.

(Ans: Net Profit after tax Rs. 74,268, P and L Appn. A/c Rs. 17,116, Balancer Sheet Rs. 10,90,000).

3) An inexperienced accountant has prepared the balance sheet of ABC Ltd. as follows:

Balance Sheet of A B C Limited

Liabilities	*Rs*	*Assets*		*Rs*
Trade Creditors	80,900	Stock:		
Advances from Customers	42,260	In hand		3,60,480
Share Capital	8,00,000	With Agents		24,300
Profit & Loss A/c	45,630	Cash in hand		23,540
Provision for Taxes	95,000	Investments		20,000
Proposed Dividend	59,000	Fixed Assets:		
Loan to Managing Director	5,000	Land		1,80,000
General Reserve	75,000	Plant & Machinery		
Dev. Rebate Reserve	30,000	(W.D.V.)		4,10,000
Provision for Contingencies	23,000	Debtors	2,15,450	
Share Premium A/c	22,000	Less: Provision		
Forfeited Shares	3,000	For B/D	9,300	
				2,06,150
		Bills Receiveable		5,000
		Amount due from Agents		51,320
	12,80,790			12,80,790

Redraft the above Balance Sheet in the form prescribed by Indian Companies Act, 1956 giving necessary details yourself.

4) The following balances have been extracted from AB Ltd. as on September 30, 2004:

	Rs.	*Rs.*
Share Capital (Authorised and issued):		
Equity (1,50,000 shares)		15,00,000
8% Redeemable Preference (400 shares)		40,000
Share Premiium		25,000
Preference share Redemption	48,000	
General Reserve		1,00,000
Land (Cost)	3,00,000	
Buildings (Cost less Depreciation)	7,00,000	
Furniture (Cost Less Depreciation)	20,000	
Motor Vehicle (Cost less Dep.)	35,000	
Trading Account–gross Profit		9,00,000
Establishment Charges	2,50,000	
Rates, Taxes and Insurance	12,000	
Commission	4,000	
Commission		5,000
Discount received		8,000
Directors' Fees	2,000	
Depreciation	60,000	
Sundry Office Expenses	60,000	
Payment to Auditors	4,000	
Sundry Debtors and Creditors	1,06,600	25,600

Profit and Loss Account (as on 30.9.2003)		10,000
Unpaid Dividend		2,000
Cash in hand	12,000	
Cash at Bank in Current Account	1,95,000	
Security Deposit	10,000	
Outstanding Expenses		6,000
Investment in G.P. Notes	2,00,000	
Stock-in-trade (at or below cost)	3,53,000	
Provision for taxation (y/e 30.9.03)		70,000
Income tax paid under dispute (y/e 30.9.03)	1,00,000	
Advanced payment of income-tax	2,20,000	
Total	26,91,600	26,91,600

The following further details are available:

1) The Preference shares were redeemed on 1st October, 2003 at a premium of 20% but no entries were passed for giving effect thereto, except payment standing to the debit of Preference Share Redemption A/c.

2) Depreciation provided up to 30th September, 2004 is as follows:

   a) Buildings 2,10,000
   b) Furniture 20,000
   c) Moter Vehicles 60,000

3) Establishment charges include Rs. 18,000 paid to Managing Director as minimum remuneration in terms of agreement which provides for a remuneration of 5% of annual net profits subject to the above minimum in the case of absence or inadequacy of profitsw in the year.

4) Payment to Auditors includes Rs. 1,000 for taxation work in addition to audit fees.

5) Market value of investments on 30th September 2004 Rs. 1,80,000

6) Sundry Debtors include Rs. 40,000 due for a period exceeding six months.

7) All receivables and deposits are considered good for realisation.

8) Income-tax demand for the year ended 30.9.2003 Rs. 1,00,000 has not been provided for against which an appeal is pending.

9) Income-tax to be provided@ 55%.

10) Directors decide to transfer Rs. 25,000 to the General Reserve and to recommend payment of dividend on equity shares at the rate of 5%.

11) Ignore previous year's figures.

You are required to prepare the Profit and Loss Account for the year ended 30th September, 2004 and the Balance Sheet as at that date.

(**Ans:** Net profit after tax and commission Rs. 2,30,422,

Balance of P/L Appn. A/c Rs. 1,40,422
Balance Sheet Total Rs. 22,51,600).

Hint: 5% Remeneration Rs. 26950

5) The following balances have ben extracted for the books of XYZ Company Ltd. as on March 31, 2004.

	Rs.		*Rs.*
Freehold Land	23,000	Income from Investments	1,200
Building	7,500	Provisions for doubtful debt	
Furniture	2,000	(1st April 2003)	200
Debtors	5,000	Creditors	2,000
Stock (31 March 2004)	4,000	Provision for Depreciation	
Cash at Bank	500	(1st April, 2003)	500
Cash in hand	100	Buildings	
Cost of Goods sold	30,000	Furniture	
Salaries and Wages	1,500	Suspense A/c	
Misc. Expenses	800	Equity Share Capital	36,750
Investment in Shares	18,000	6% Cumulative Pref.	
Interest	300	Share Capital	8,000
Bad Debts	100	Share Premium	1,000
Repairs and Maintenance	150	Bank Overdraft	5,000
Advance payment of		Sales	38,000
Income-tax	600	Profit and Loss A/c	
		(1st April, 2003)	250
	93,550		93,550

The following further particulars are available:

1) The land was revalued on 1st january, 2004 at Rs. 30,000 by an expert valuer but no effect has been given in the books although the Directors have decided to adjust the relavant amount.
2) Provision for doubtful debt is to be adjusted to 5% on the amount of debtors.
3) Equity Share Capital is composed of Rs. 10 Shares, 3640 shares were fully paid and 50 on which a call of Rs. 3 remains unpaid.
4) Suspense A/c represents money received from the new allottee for re-issue of 50 shares shares forfeited during the year for non-payment of the final call, but no entry for adjustment thereof has been passed.
5) Provision for taxation is to be made at 45%
6) Market value of investments was Rs. 18,500 on 31st March 2004
7) The company is managed by the Directors who are entitled to a remuneration of 3% on the annual net profits.
8) Depreciation is to be charged on written down value of:

   Building at 2%

   Furniture at 10%
9) The land and buildings of the company are mortgaged in favour of the bank as security for overdraft sanctioned up to a limit of Rs. 25,000.
10) Dividend on Cumulative preference shares were in arrears for 5 years upto March 31, 2004. The Directors have recommended payment of dividend for two years.

Prepare Profit and Loss Account for the year ended March 31, 2004 and Balance Sheet on that date.

(**Answer:** Profit Rs. 5,999, Balance Sheet total Rs. 60,491)

6) Ajax Co. Ltd. had an authorised capital of 5,000 equity shares of Rs. 100 each. As on December 31, 2003, 3000 shares were fully called up, and the following balances were extracted from the company's ledger accounts.

	Rs.		*Rs.*
Salary	4,85,000	Printing and Stationery	2,300
Purchases	3,20,000	Advertishing Expenses	7,300
Stock	75,000	Sundry Debtors	52,700
Manufacturing wages	70,000	Sundry Creditors	34,200
Insurance upto 31-3-2004	6,720	Plant & Machinery	83,500
Rent	6,000	General Reserve	60,700
Salaries	18,500	Furniture	27,100
Discount Allowed	1,050	Building	84,580
General Expenses	9,050	Cash at Bank	1,24,000
Calls in Arrear	4,800	Loans from Managing Director	3,700
Profit and Loss A/c (Cr.)	21600	Bad Debts	12,600

The following further information is given: (i) Depreciation to be charged on Machinery and Furniture at 15% and 10% respectively; (ii) Provision for Taxation to be made Rs. 19,000; (iii) Closing Stock Rs. 1,21,000; (iv) Outstanding liabilities: Wages, Rs. 7,000; Salaries Rs. 8,200; Rent, Rs. 1,600; (v) Dividend at 5% on paid-up capital to be provided; (vi) Rs. 10,000 to be transferred to General Reserve.

Prepare Profit and loss Account for the year ended December 31, 2003 and Balance Sheet (in proper form) as on that date.

(**Answer:** Profit for the year Rs. 28125, total of Balance Sheet Rs. 4,79,325).

7) The following balances are extracted from the books of ABC Ltd., as on 31 March, 2003.

Share Capital	40,00,000
Cash in hand	62,000
Repairs and Maintenance	86,000
Raw Materials at cost	26,70,000
Furniture	1,22,000
Sundry Creditors	34,00,000
Directors' Fees	4,000
Plant and Machinery	43,00,000
Miscellaneous Expenses	6.10,000
General Reserve	30,00,000
Land	3,00,000
Finished Goods at cost	31,00,000
Sales	4,33,00,000
Buildings	7,41,000
Cash at Bank	80,000
Provision for Taxation	21,00,000
Sundry Debtors	14,00,000
Raw Materials Consumption	2,86,00,000

Staff Advance	53,000
Advance from customers	5,00,000
Salaries, Wages and Bonus	1,16,00,000
Cash credit from Bank	1,25,000
Power	88,000
Prepaid expenses	46,000
Rent	53,000
Travelling and Conveyance	41,000
Auditors' Fees	15,000
Miscellaneous Income	5,46,000
Income Tax Advance	30,00,000

The following further information is also given:

1) The authorised share capital of the company is 80,000. Equity Shares of Rs. 100 each which has been issued and subscribed to the extent of 50%.
2) Tax provision @ 6% is to be made on current year's profits.
3) 15% dividend on the paid-up share capial is recommended by the Directors.
4) The closing stock of finished goods at cost is Rs. 56,00,000.
5) Depreciation on assets amounting to Rs. 4,30,000 on Furiture and Rs. 33,000 on Building has been debited to miscellanceous expenditure.
6) The surplus in profit and loss account is to be transferred to General Reserve Account.

Prepare Profit and Loss Account and Balance Sheet as on 31.3.2003.

(**Answer:** Net Profit before tax Rs. 25,79,000
Total of Balance Sheet Rs. 1,57,04,000)

8) An inexperienced accountant has prepared the balance sheet ABC Ltd. as follows:

Balance Sheet of A B C Limited

Liabilities	*Rs*	*Assets*		*Rs*
Trade Creditors	80,900	Stock:		
Adances from Customers	42,260	In hand		3,60,480
Share Capital	8,00,000	With Agents		24,300
Profit and Loss A/c	45,630	Cash in hand		23,540
Provision for Taxes	95,000	Investments		20,000
Proposed Dividend	59,000	Fixed Assets:		
Loan to Managing Director	5,000	Land		1,80,000
General Reserve	75,000	Plant and Machinery		
Dev. Rebate Reserve	30,000	(W.D.V.)		4,10,000
Provision for Contingencies	23,000	Debtors	2,15,450	
Share Premium A/c	22,000	Less: Provision		
Forfeited Shares	3,000	For B/D	9,300	
				2,06,150
		Bills Receiveable		5,000
		Amount Due from Agents		51,320
	12,80,790			12,80,790

3.11 LET US SUM UP

Financial statements are prepared by all forms of business organisations to ascertain the operating results of the business and to know the financial position on a particular date. Before preparing financial statements one must gain clarity about the nature of certain items and their treatment in the final accounts. It is obligatory on the part of companies to maintain and prepare financial statements by the end of each accounting period. Manufacturing account is prepared to know the cost of goods produced while Trading account is prepared to know the results of trading operations. Profit and loss account is prepared to ascertain the net profit earned or net loss incurred by the business concern during an accounting period. The operating and non-operating expenses are charged to profit and loss account. The distribution or appropriation of profit is shown under Profit and Loss Appropriation Account, which is also called 'Below the Line'.

Balance Sheet is a statement of assets and liabilities to ascertain the financial position of a concern at a particular date. The assets and liabilities are presented either on the basis of liquidity or performance. Under 'liquidity order' assets are shown on the basis of 'most liquid', 'liquid' and 'least liquid' assets. Liabilities are shown in the order of payment. Under 'order of performance' the assets are arranged on the basis of their useful life whereas liabilities are shown on the besis of long term, medium term, short term and current liabilities.

It is important to distinguish between capital and revenue to ascertain correct profit or loss amount and fair view of the affairs of the business. There are certain rules which guide us to determine whether a particular expenditure or receipt is of a capital nature or of a revenue nature.

Revenue recognition is concerned with the timing of recognition revenue in the statement of profit and loss. 'Realisation Concept' recognises the revenue at the point of sale or service rendered. Operating and non-operating revenues should be shown separately while preparing Profit and Loss Account. There are some established practices as per the Accounting Standards to recognise certain items as revenues. The Accounting Standards have some established practices to recognise revenue in cases of sale of goods, rendering services and financial services. But there are also certain exception to this general rule.

The financial statements of non-corporate entities may be presented either in conventional format or vertical format. Under vertical form various items of incomes and expenses, assets and liabilities arranged vertically to get some additional information about the operating efficiency and financial position of the business enterprise. The sole traders and partnership forms hardly adopt vertical form of financial statements. As regards preparation of Balance Sheet of a company, the nature of details shown with respect to the liabilities and assets and the order of arrangement of the items are prescribed in Schedule VI, Part I of the Companies Act. There are two alternate proformas given in Schedule VI for the preparation of Company Balance Sheets: (i) horizonal and (ii) vertical. Any of these forms may be adopted for the Balance Sheet of a Company. Both the prescribed forms may require that the figures of the previous year should be shown in a separate column along side the figures of the current year.

3.12 KEY WORDS

Capital Expenditure: An expenditure which results in the acquisition of fixed asset or addition to fixed asset, or an improvement in the earning capacity of the business.

Capital Receipt: Receipt in the form of additions to capital, liabilities or sale proceeds of a fixed asset.

Revenue Expenditure: An expenditure the benefit of which is limited to one year.

Revenue Receipt: Receipts on account of goods sold or services provided.

Deferred Revenue Expenditure: A revenue expenditure which involves a heavy amount and the benefit of which is likely to spread over the years.

Appropriation: Distribution of profits.

Balance Sheet: Statement of assets and liabilities depicting the financial position at the end of the financial year.

Below the line: Part of the Profit and Loss Account which shows the appropriation of profits.

Above the line: Profit and loss account which shows the profit or loss before appropriation of profits.

Contingent Liability: Liability which depends upon the happening of a certain event

Preliminary Exenses: Expenses incurred in connection with the formation and registration of a company.

Profit and Loss Account: Income statement disclosing the results of operation (profit or loss) for the financial year.

Dividend: Part of profits distributed to the equity shareholders.

Final Dividend: Dividend declared in the annual general meeting.

Provision for Taxation: The amount appropriated from profit for the liability arising on account of payment of taxes.

Financial Statements: Annual statements of assets and liabilities (Balance Sheet) and of income and expenditure (Profit and Loss Account).

3.13 TERMINAL QUESTIONS

1) Following is the Trial Balance of V.N. Ltd. as on 31st March 2003. Prepare Trading and Profit and Loss Account and Balance Sheet after taking into account the adjustments.

	Rs.	Rs.
Opening Stock	3,00,000	
Purchases/Sales	9,80,000	13,60,000
Bills Receivable/Bills Payable	20,000	28,000
Patents and Trade Marks	19,200	
General Reserve		62,000
Cash at Bank	1,84,800	
Plant and Machinery	1,16,000	
Debtors and Creditors	1,10,000	70,000
Share Capital		4,00,000
Dividend paid for 2001-2002	36,000	
Profit and Loss A/c (1.4.2002)		94200
Sundry Expenses	28,200	
Rent	16,000	
Salaries	30,000	
Computers	68,000	
Carriage–Inward	38,000	
Discount Received		12,000
Wages	1,20,000	
Return outwards		40,000
	20,66,200	20,66,200

UNIT 4 UNDERSTANDING FINANCIAL STATEMENTS

Structure

4.0 Objectives

4.1 Introduction

4.2 Vertical Format of Corporate Financial Statements

- 4.2.1 Vertical Format of Balance Sheet
- 4.2.2 Vertical Format of Profit and Loss Account

4.3 Revenues and Provisions

- 4.3.1 Reserves
- 4.3.2 Provisions
- 4.3.3 Distinction between Provision and Reserve

4.4 Concepts of Profits

- 4.4.1 Gross Profit
- 4.4.2 Operating Profit
- 4.4.3 PBIT, PBT, PAT
- 4.4.4 Cash Profit
- 4.4.5 Profit Available to Equity Shareholders (Residual Profit)

4.5 Concept of Capital

- 4.5.1 Capital Employed
- 4.5.2 Shareholders Funds
- 4.5.3 Shareholders Equity
- 4.5.4 Debt Fund
- 4.5.5 Net Working Capital Employed

4.6 Uses of Financial Statements

4.7 Limitations of Financial Statements

4.8 Let Us Sum Up

4.9 Key Words

4.10 Answers to Check Your Progress

4.11 Terminal Questions

4.12 Suggested Readings

4.0 OBJECTIVES

After studying this unit you should be able to:

- prepare company financial statements in vertical form;
- acquaint with the concepts of revenues and provisions, profit and capital; and
- appreciate the uses and limitations of financial statements.

4.1 INTRODUCTION

According to Section 210 of the Companies Act, a company is required to prepare a balance sheet at the end of each trading period. Section 211 requires the balance sheet is to be prepared in the prescribed form. Schedule VI Part I permits presentation of Balance Sheet either in horizontal or vertical forms. The present trend of the whole corporate world is to present their annual accounts in vertical form which has now

become a modern practice. The purpose of this unit is to provide knowledge of working model of annual financial statements prepared in accordance with Schedule VI of Companies Act 1956, Accounting Standards applicable to reporting enterprise and the basic concepts of reserves and provisions, profit and capital. It also deals with the uses and limitations of financial statements.

4.2 VERTICAL FORMAT OF CORPORATE FINANCIAL STATEMENTS

The Profit and Loss Account and Balance Sheet may also be presented in vertical form. In the vertical form, a summarised profit and loss account is prepared and details of the items are shown separately in the form of annexures. In the case of balance sheet, the liabilities are shown under the heading 'Sources of Funds' and the assets are shown under the heading 'Application of Funds'. Both the prescribed forms of profit and loss account and balance sheet require that figures of the previous year should be shown in separate column along with the figures of the current year with respect to each of the items. The current trend of the whole corporate world is to present their annual accounts in vertical form. Part I of Schedule VI permits preparation of financial statements in vertical form which has now become a modern practice.

4.2.1 Vertical format of Balance Sheet

Under vertical form, a Balance Sheet is prepared under single column divided in two sections. First section shows the "Sources of Funds" which includes Share Capital, Reserves and Surplus, Secured and Unsecured Loans. The second section is represented by "Application of Funds" in the form of Fixed Assets, Investments, Net Current Assets (Current Assets-Current Liabilities) and Miscellaneous Expenditure. A format is given below.

Balance sheet of ....
As on ......

		Schedule No.	Figures for the current year	Figures for the previous year
I	**Sources of Funds**			
	1. **Shareholders' Funds**			
	(a) Share Capital	1	....	....
	(b) Reserves and Surplus	2	....	....
	2. **Loan Funds**	3		
	(a) Secured Loans		....	....
	(b) Unsecured Loans		....	....
	Total		....	....
II	**Application of Funds:**			
	1. **Fixed Assets**	4		
	(a) Gross Block		....	....
	(b) Less Depreciation		....	....
	(c) Net Block		....	....
	(d) Capital Work-in-progress		....	....
	2. **Investments**	5	....	....
	3. **Current Assets, Loans and Advances**	6	....	....

(a) Inventories		
(b) Sundry Debtors		
(c) Cash and Bank Balances		
(d) Other Current Assets		
(e) Loans and Advances		
Less: Current Liabilities and Provisions	7	
(a) Liabilities		
(b) Loans and Advances		
Net Current Assets		
4. **(a) Miscellaneous Expenditure**		
(Amount not written off)		
(b) Profit and Loss Account		
(Less) Balance in General Reserve		
As per contra		
Total		
Significant Accounting Policies & notes on accounts	15	

Various schedules as mentioned above, will provide necessary details of items and information as required to be given as per schedule VI of Companies Act 1956. The figures in the amount column may be rounded off to the nearest thousand (000) as may be decided by the management. These schedules, significant accounting policies and explanatory notes form an integral part of the Balance schedules, significant accounting policies and explanatory notes form an integral part of the Balance Sheet as required by applicable Accounting regarding disclosure of accounting policies. Contingent liabilities are shown by means of footnote to the Balance Sheet.

4.2.2 Vertical Format of Profit and Loss Account

Almost all the companies prepare and present their Income Statement (Profit and Loss Account) in vertical form. In fact the information relating to activities (operating , investing, financing) of the companies are arranged in vertical order rather than conventional (horizontal 'T' form). A format of Profit and Loss in vertical form is given below:

Particulars	**Schedule No.**	**Figures at the end of current year**	**Figures at the end of previous year**
I Income			
Sales			
Services			
Dividend			
Interest			
Other Income	8		
TOTAL			
II Expenditure			
Cost of goods sold/raw material consumed	9		
Selling and other expenses	10		
Depreciation	11		
Financial Expenses	12		
TOTAL			

Profit before Taxation, Extraordinary and Prior Period Items
Provision of Taxation
Net Profit before Extraordinary and Prior Period Items 12

Extra Ordinary Items (Net of Tax) 13
Prior Period Items (Net of Tax) 14
Net Profit
Balance brought forward from
Previous year profits available for appropriation
Appropriation

Interim Dividend
Dividend on Preference Shares
Proposed Final dividend
Corporate Dividend Tax
Transfer to Debenture Redemption Reserve
Transfer to Capital Redemption Reserve
Transfer to General Reserve

Balance taken to Balance Sheet

Significant Accounting Policies and notes on accounts 15

(For details of schedules learners are advised to refer to Horizontal (conventional) form of Balance Sheet)

A list of significant accounting policies and notes is as follows:

1. Basis of Accounting
2. Revenue Recognition
3. Fixed Assets
4. Depreciation and Amortisation
5. Investments
6. Inventories
7. Foreign Currency Transactions
8. Retirement Benefits
9. Deferred Revenue Expenditure
10. Hire Purchase-Lease rental income
11. Product warranty expenses
12. Provision for contingencies
13. Research and Development
14. Taxation
15. Investment in debt and equity shares
16. Long term contracts and property development activity
17. Government grants
18. Amortisation of License fees
19. Changes in accounting policies
20. Amortisation of License fees
21. Provision for re-inventing the company
22. Employees stock option scheme.
23. Amalgamation

24. Changes in provisions of retirement benefits of employees.
25. Investment in sick units
26. Contingencies
27. Approval of managerial remuneration
28. Extraordinary items.

Illustration 1

The following is the trail balance of ABC Ltd. as on 31st March 2003 (Rs. In '000')

Debit Balances	Rs.	Credit Balances	Rs.
Freehold Building	2750	Equity Share Capital (Shares of Rs. 10 each)	3750
Plant and Machinery at Cost	9500	10% Debenture	2500
Debtors	1200	General Reserve	1625
Stock (31.03.2003)	1075	Profit and Loss Account	900
Bank	250	Securities premium	500
Adjusted Purchases	4000	Sales	8750
Factory Expenses	750	Creditors	650
Administration Expenses	375	Provision for Depreciation	2050
Selling Expenses	375	Other Income	25
Debenture Interest	250		
Interim Dividend	225		
	20750		**20750**

Additional Information:

i) The authorised share capital of the company is Rs. 75,00,000.

ii) Freehold premises have been valued at Rs. 45,00,000.

iii) Proposed final dividend is 10% & corporate dividend tax 12.5%.

iv) Depreciation on Plant & Machinery is to be provided at 10% on cost.

v) Provided for income tax @ 40%.

You are required to prepare Profit and loss account for the year ended 31st March 2003 and a Balance Sheet as on that date in vertical form as per the provisions of Schedule VI of the Companies Act 1956.

Solution **ABC Ltd.**

Profit and Loss Account for the year ended 31st March 2003

	Particulars	Schedule No.	Rs. (in '000')
Income:			
	Sales		8750
	Other Income		25
			8775
Expenditure:			
	Purchases (Adjusted)		4000
	Factory Expenses		750
	Administration Expenses		375
	Selling Expenses		375
	Depreciation		950
	Interest on debentures		250
			6700

	Profit before tax			**2075**
Less:	Provision for taxation @ 40% on Rs. 2075		830	
	Net Profit after tax			**1245**
Less:	Dividend: Interim		225	
	Final (Rs.3750 × 10%)		375	
	Dividend tax		75	675
	(225+375 = 700 × $12^1/_2$%)			**570**

Balance Sheet as on 31st March 2003

				Schedule No.	Rs. (in '000')
I	Sources of Funds				
	Shareholders Funds				
	(a) Share Capital			1	3750
	(b) Reserves and Surplus			2	5345
					9095
	Loan Funds: a) Secured				
	10% Debentures				2500
	Total				**11595**
II	Application of Funds				
	Fixed Assets			3	
	(a) Gross Block				1400
	(b) Depreciation				3000
	(c) Net Block				**11000**
	Current Assets, Loans and Advances				
	Current Assets:				
	(a) Stock	1075			
	(b) Debtors	1200			
	(c) Bank	250	2525		
Less:	Current Liabilities				
	Creditors	650			
	Provision for Taxation	830			
	Proposed Dividend	375			
	Corporate Dividend Tax	75	1930		
					595
	Net Current Assets				**11595**

Schedule 1:	**Share Capital:**	
	Authorised	
	75,000 shares of Rs. 10 each	**Rs. 75,00,000**
	Issued, Subscribed & paid up	
	37500 shares of Rs. 10 each	
	fully paid	Rs. 37,50,000
Schedule 2:	**Reserves and Surplus**	**Rs.**
	Securities Premium	5,00,000
	Revaluation Reserve	17,50,000
	General Reserve	16,25,000
	Profit & Loss Account*	
	(9,00,000 + 5,70,000)	14,70,000
* (Opening Bal. +Bal. of Current year's P&L A/c)		**53,45,000**

Schedule 3: Fixed Assets

	Opening Balance	Additions	Revaluation Reserve	Disposal	Provision for Dep.	Closing Balance
1 Freehold Premises	27,50,000	–	17,50,000 (4500000–2750000)	–	–	45,00,000
2 Plants & Machinery	95,00,000	–	–	–	30,00,000	65,00,000
	1,22,50,000		**17,50,000**		**30,00,000**	**1,10,00,000**

Illustration 2

From the following information, prepare a Balance Sheet in a vertical form as on 31st March 2003 as per the provisions of Schedule VI of Companies Act 1956.

Debit Balances	Rs. (000)	Credit Balances	Rs. (000)
Fixed Assets	14,300	Equity Share Capital	4,000
Finished Goods	1,500	10% Pref. Share Capital	1,600
Stores	800	Profits for the year	1,810
(Before interest & tax)			
Preliminary Expenses	206	12% Debenture	3,000
Advance Tax	400	P & L Account (1.04.2002)	100
Capital Work-in-progress	640	Security deposits from dealers	240
Interest on debentures (net)	324	Securities Premium	1,000
Interest on Loans (other)	160	Investment Allowances Reserves	300
Cas at Bank	550	Creditors	2,300
Loose Tools	100	Provision for doubtful debts	50
Short term investment at cost	450	Provision for Depreciation	3,000
(Market value Rs. 440)			
Advance to staff	120	Loan from Customers	400
Debtors	2,450	General Reserve	4,200
	22,000		**22,000**

Additional Information:

(i) Dividend is proposed on equity shares @ 0%.

(ii) Provide TDS:

Interest on debentures	@	10%
Corporate dividend tax	@	12.5%
Corporate Income tax	@	40%

Solution

Balance sheet of...

As on 31st March 2003

	Schedule No.	Rs. (in '000')
I Sources of Funds		
1 Shareholders funds		
a. Share Capital	1	5,600
b. Reserves & Surplus	2	5,738
		11,338
2 Loan Funds		
a. Secured Loans		3,000
b. Unsecured Loans	3	640
TOTAL		**14,978**

II	Application of Funds:			
1.	Fixed Assets		4	
	a. Gross Block			**14,300**
	b. Less Depreciation			(3000)
	c. Net Block			**11,300**
	d. Capital work-in-progress			640
				11,940
2.	Short term Investments (at realisable value)			440
3.	Current Assets, Loans and Advances			
	a. Inventories	2400	5	
	b. Debtors less provision	2400		
	c. Cash at Bank	550		
	d. Loan & Advances (Advance to staff)	120		
		5470		
	Less: Liabilities and Provision			
	a. Liabilities	(2336)	6	
	b. Provisions	(742)	7	
	Net Current Assets (Working Capital)			2,392
4.	Miscellaneous Expenditure (Prelim. Exp.)			206
	TOTAL			**14, 978**

Schedule 1

Share Capital	
Equity Share Capital	4000
10% Pref. Share Capital	1600
	5600

Schedule 2

Reserves and Surplus:	
Securities Premium	1000
Investment allowance Reserve	300
General Reserve	4200
Profit & Loss Account	238
	5738

Schedule 3

Unsecured Loans:	
Security deposits from Dealers	240
Loans from Customers	400
	640

Schedule 4

Fixed Assets	14300
Less Depreciation	3000
	11300
Capital work-in-progress	640
	11940

Schedule 5

Current Assets, Loans and Advances	
a. Inventories	
Loose tools	100
Stores	800
Finished Goods	1500
	2400

Schedule 6

Current Liabilities	Rs.
Creditors	2300
TDS on interest on debentures	36
	2336

Schedule 7

Provisions:		Rs.
Provision for Income Tax	512	
Less Advance Tax	400	112
proposed Dividend:		
Equity		400
Preference		160
Corporate Dividend Tax		70
		742

Working:

Profit and Loss Appropriation Account

	Rs.		Rs.
To Interest on debentures	360	By Profit	1810
To Interest on Loan	160		
To Loss on Investment	10		
To Provision for Income Tax	512		
{1810 – (360+160+10) x 40/100}			
To Balance c/d	768		
	1810		1810
To Proposed Dividend:		By Balance b/d	768
Equiity	400		
Preference	160	By profit	100
To Corporate Tax	70	(1.4.02)	
To Balance (Carried to Balance Sheet)	238		
	868		868

Check Your Progress A

1) Under what headings will you classify the following items:
   a) Securities Premium
   b) Preliminary Expenses
   c) Live-Stock
   d) Unclaimed Dividend

e) Interim dividend declared but not paid

f) Arrears of fixed cumulative preference dividend

g) Share forfeited account

h) Loose tools

i) Advance income tax paid

j) Sinking fund

2. State briefly the items that are included under the following heads:

   a) Contingent Liabilities (b) Unsecured Loans (c) Secured Loans

   d) Reserve & Surplus (e) Current Liabilities & Provisions

   f) Current Assets, Loans & Advances

l *Students are advised to see the annual reports of various companies to develop a better understanding of financial statements through notes attached thereto.*

4.3 RESERVES AND PROVISIONS

The reliability, and accuracy of income statement (profit & loss account) and financial position statement (balance sheet) depends to a greater extent, upon the estimates, which govern the amount of various provisions to be made. And similarly transfers to various reserves including statutory transfer, determine the financial soundness, creditworthiness and depict strong fundamentals which send clear signal to stock market and other interested parties. Hence, the concepts of 'reserves' and 'provisions' are of utmost importance while preparing, analysing and understanding the financial statements.

4.3.1 Reserves

The portion of earning, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by management for a general or specific purpose is known as reserve. These reserves are primarily of two types: Revenue and Capital reserves which may be classified and treated as follows:

1) **Revenue Reserves:** are also know as free reserves. These are created to meet a **contingent** liability not specifically mentioned. These contingencies reserves indicate management's belief that funds may be required for an **usual purpose** or to meet a possible obligation that does not yet have the status of a liability such as settlement of a pending law suit or to meet any trading loss. These reserves are also created for any other **general** purposes such as for expansion or modernisation. For accounting purposes the transfer of amount to such 'general reserve' or 'contingency reserve' is treated as appropriation and not a charge.

2) **Specific Reserve:** When a reserve is created for a specific purpose it is known as 'specific reserve'. It may be created to maintain a stable rate of dividend or to meet redemption of debentures after a stipulated period of time. Such reserves may take form of "Dividend Equalisation Reserve", "Debenture Redemption Reserve" etc. None of these reserves represent maney or anything tangible. From accounting point of view it is simply a transfer of divisible profit to other head.

   However, when these Revenue Reserves (General/Specific) are not retained within the business but invested outside business are termed as "reserve Funds".

3) **Capital Reserve:** A reserve which is created not out of divisible profits is called capital reserves. Such reserve is not available for distribution among shareholders as dividend. It is generally created out of capital profits such as profits prior to incorporation, securities premium, profit on re-issue of forfeited shares, profit

on redemption of debentures, profit on sale of fixed assets, profit on revaluation of fixed assets and capital redemption reserve crated as per the provisions of Companies Act on redemption of preference shares.

As stated above, such profits are not available for distribution as dividend. However, some of the capital profits (profit on sale of fixed assets) can be distributed as dividend if the same are realised in cash. But the companies act expressly prohibits the following to be used for payment of dividend:

Premium on issue of shares.
Profit on re-issue of forfeited shares and
Capital redemption reserve
Revaluation reserve

According to section 7 of Companies Act 1956, Securities Premium can be utilized only for the following purposes:

1) Issue of fully paid bonus shares.
2) Writing off the preliminary expenses, discount on issue of shares or debentures or other fictitious assets.
3) Providing for the premium payable on redemption of debentures or preference shares.

U/s80, Capital Redemption Reserve can be utilised only for the purpose of issuing fully paid bonus shares.

4) **Secret Reserve:** A reserve which is not disclosed in the Balance Sheet is known as secret reserve. The companies Act 1956 prohibits creation of secret reserve because it conceals the actual financial position. However, the financial position of the company is definitely better what it appears from the balance sheet. Such reserve is created in any of the following manner by:

1) Writing of excessive depreciation
2) Understating the value of assets.
3) Overstating liabilities.
4) Treating capital expenditure as revenue.
5) Creating excessive provision for bad debts.
6) Creating provisions which are not required.
7) Treating contingent liability as an actual liability
8) Treating revenue receipt as capital

Secret reserve may arise on account of a permanent appreciation in the value of assets or a permanent diminution in the value of a liability. Such changes usually are not accounted for in the books of accounts.

The policy of secret reserve is adopted by the management to achieve the following objectives:

- To meet the exceptional losses
- To bring down the market value of shares within the trading range.
- To enhance the availability of working capital
- To maintain dividend rate
- To elude competition by concealing large profits
- To minimize tax liability
- To keep strong financial position
- To lessen the dependence on external finances

All these reserves are shown on the liabilities side of the balance sheet.

4.3.2 Provisions

The companies Act 1956 states that, "Provision means amount written off or retained by way of providing depreciation, renewals of diminution in the value of assets or retained by way of providing for any known liability the amount of which can not be determined with substantial accuracy".

Thus the above definition clearly mentions that a provision may be created either for depreciation or for a known liability, the amount which cannot be ascertained with substantial accuracy such as:

– Provision for bad & doubtful debts
– Provision for Repairs and renewals.
– Provision for discount on debtors
– Provision for fluctuation in investments

Therefore, it can be summed up that a provision is created either against the loss (fall) in the value of assets in the normal course of business operation or against a known liability the amount of which cannot be determined accurately but in estimated only.

4.3.3 Distinction between Provision and Reserve

1) A provision is a charge against the profits which reserve is simply an appropriation of profits.
2) A provision is created to meet a known liability whose amount is uncertain while reserve is created to strengthen the financial position and the meet contingency, if any.
3) A provision is shown as a deduction out of the assets concerned whereas reserve is shown separately on the liabilities side.
4) The sum so set aside as provision is never invested outside business whereas reserves may be invested outside business.
5) Provision is part of divisible profits but the same cannot be made available for the purpose of distributing dividend while reserves (revenue) are always available to be distributed as dividends.
6) Provisions have to be created whether there is profit or loss while reserve is created only when there is profit.

Check Your Progress B

I.

1. .... is created to meet a known liability. (Provision)
2. .... is built to meet a contingency. (Revenue reserves)
3. .... is treated as a charge against profits. (Provision)
4. Transfer to .... is an appropriation. (General reserve)
5. .... is not affected by profit or loss of the enterprise. (Secret reserve)
6. .... is made only when there are profits. (Reserve)

II. Write a short note on usage of "Securities Premium", U/s 78

III. Prepare a list of possible capital profits.

IV.. What are managerial objectives for creating secret reserves, and how is it created?

V. Distinguish between: Reserve and Reserve Fund
General Reserve Vs Specific Reserve.

4.4 CONCEPTS OF PROFITS

The main objective of this topic is to make students familiar with the various concepts of profits which are used by the management as the basis for taking appropriate decisions. A clear line of demakation between these terms will help to understand their application for decision-making purposes.

4.4.1 Gross Profit

It is also known as gross margin. As per the provisions of Companies Act 1956, Gross profit is 'the excess of the proceeds of goods sold and services rendered during a period over their cost, before taking into account administration, selling and distribution and financing expenses".

So the difference between the revenue (Sales) and cost of goods sold is the gross profit. Normally, the profit and loss account is prepared in two parts– (1) Trading Account and (2) Profit and Loss Account. Trading Account shows the "result" of trading operation under normal conditions which represents "Gross Profit" or "Gross Loss". Revenue means the inflow from main business activity in which the enterprise deals in whereas the cost of goods sold, in case of trading concerns, comprises purchases (of goods in which concern deals in) and direct expenses incurred (such as freight, octroi, duty etc) on or before purchases. However, in case of a manufacturing concern, the cost of goods sold will include cost of materials consumed, wages and other manufacturing expenses.

Modern practice of the whole corporate world is to present the information in a summarized statement (called abridged profit and loss account) giving the details in various schedules forming part of income statement.

Illustration 3

From the following details of ABC manufacturing company find the gross profit:

	Rs.
Raw Material Purchased	12,00,000
Stock of raw material in the beginning	2,50,000
Productive wages	3,50,000
Carriage Inward	20,000
Freight and Octroi	60,000
Other manufacturing expenses	1,20,000
Stock of raw material at the end	2,40,000
Sales	18,75,000

Solution

ABC Company
Profit and Loss Account
For the year ended ....

Particulars	**Schedule No.**	**Rs. (in '000')**
Income:		
Sales	1	1875
Other Income* (not related business)		–
		1875
Expenditure		
Cost of goods sold	2	1760
Gross Profit	115	

* Not to be considered for gross profit purposes.

Schedule 1: Provides the details of sales: product-wise, segment-wise (Business segment/Geographical segments) etc in India and outside India less returns inwards & sales or trade discount.

Schedule 2:

		Rs.
	Cost of goods sold:	
	Opening stock of raw material	2,50,000
Add:	Purchases	12,00,000
		14,50,000
	Less: Closing Stock	2,40,000
	Raw Material Consumed	12,10,000
Add:	Direct expenses	
	Carriage Inward	20,000
	Freight & Octroi	60,000
	Productive wages	3,50,000
	Other manufacturing expenses	1,20,000
	Cost of goods produced (sold)	17,60,000

- Because there is no closing balance
- When there is opening and closing work in progress (semi-finished goods), then along with the opening and closing stock of raw material, the work-in-progress (semi-finished goods) will also be added and subtracted accordingly.
- However, if there is opening and closing stock of finished goods, this will also form the part of inventory.

Illustration 4

In the above illustration, if the following balances also appear, findout the cost of goods sold:

	Rs.
Opening balance of work-in-progress	35,000
Opening balance of finished goods	1,25,000
Closing balance of work-in-progress	55,000
Closing balance of Finished goods	1,75,000

Solution

The following changes will be made in the Schedule 2:

Schedule 2: Cost of goods sold will be as follows

Inventory on 1st April..........			
	Raw Material	2,50,000	
	Semi-finished goods	35,000	
	Finished goods	1,25,000	4,10,000
Add:	Purchases		12,00,000
	Direct Expenses		5,50,000
			21,60,000
Less:	Inventory on 31st March		
	Raw Material	2,40,000	
	Semi-finished goods	55,000	
	Finished goods	1,75,000	4,70,000
Cost of Goods Sold			16,90,000

4.4.2 Operating Profit

It refers to net profit arising from the main revenue producing activities of an enterprise after accounting for operating expenses but before taking into account expenses of financial nature and non-operating income. Operating expenses include over and above the cost goods sold, such as:

- Factory overheads
- Administration Overheads (Office Over-Heads) and
- Selling and Distribution over-heads

In other words, when above mentioned operating expenses are subtracted from the gross profit, the resultant figure is "operating profit" and if total operating expenses exceed gross profit, the difference is treated as operating loss. Operating profit is the measure of operating efficiency of the enterprise and it is referred as OPBIT (Operating Profit before and Tax). When non-operating items are also considered, the resultant figure is Profit Before Tax (PBT). Let us consider the following illustration:

Illustration 5

From the following information, calculate gross profit and OPBIT

	Rs. (in '000')
Sales (Gross)	2,075
Return Inwards	15
Return Inwards	60
Rent Received	25
Interest & Dividend on investments	35
Direct Expenses (Manufacturing)	375
Selling and Distribution expenses	75
Office and Administration Expenses	150
Purchases Less returns	850
Inventories (1.4.2002)	145
Inventories (31.03.2003)	165

Solution

Profit and Loss Account
For the year ended 31st March 2003

Particulars	Schedule No.	Rs. (in '000')
Sales	1	2,060
Less Cost of goods sold	2	1,205
Gross Profit		855
Operating Expenses:		
Office and Administration expenses	150	
Selling and Distribution expenses	75	
		225
Operating Profit (OPBIT)		630

Schedule 1:	**Rs. (000)**
Gross Sales	2,075
Less Returns	15
	2,060

Schedule 2:

Inventories (1.4.2002)	145
Add: Purchases Less Returns	850
	995
Add: Direct Expenses	375
	1,370
Less: Inventories (31.03.2203)	165
Cost of goods sold	1,205

4.4.3 PBIT (Profit Before Interest and Tax)

It refers to net profit before deducting any amount of financing expenses and income tax. other words when interest expense and tax liability are not accounted for while calculating profit or loss of an enterprise, it is treated as PBIT. Interest expense includes:

Interest on debentures
Interest paid or public deposits accepted by a trading or manufacturing organisation
Interest on Loan from public
Interest on Loan from Banks, financial institution or from Government.
Cas packaging or credit from Banks.

PBIT = Operating Profit + Other Income

*** PBT (Profit Before Tax)**

PBT = PBIT – Interest

When interest expense is subtracted from 'Profit Before Interest & Tax' (PBIT) (or total net earnings) before providing for any income tax thereon, it is called 'Profit before Tax'. This shows overall performance of an enterprise resulting from operating, investing and financing activities. This is also termed as EBT (Earnings before tax). Thus,

PBT = PBIT – Interest.

*** Pat (Profit After Tax)**

This refers to net profit after taxes, but before making nay appropriation during the year. The net profit before tax (PBT) is adjusted for tax liability calculated at the current rate of taxation. For various sources of incomes there are different rates. Such as income from business is taxed at a flat rate of 35%, income from long-term capital gains @ 20%. The tax so calculated will be enhanced by a surcharge of 5% for assessment year 2003-2004 and 2.5% for 2004-2005 However, for foreign companies the tax rate is 40%.

PAT = PBT – Provision for Taxation

It should be noted that income tax purposes the profits are recomputed for determining tax liability by income tax authorities. The actual tax liability is determined only after the assessment is completed. That's why in the profit and loss account the amount of tax so determined on the basis of net profit as disclosed by Profit and Loss Account is transferred to 'Provision for Taxation'. This provision is adjusted against the actual tax liability. You might have already learnt more about provision for taxation under Unit 3.

Illustration 6

From the above Illustration 5, calculate Gross Profit, Operation Profit, PBIT, PBT and PAT

Solution

Particulars	**Schedule No.**	**Rs. (in '000)**
Sales	1	2,060
Less cost of goods sold	2	1,205
Gross Profit		855
Operating Expenses:		
Office and Administation expenses		150
Selling Distribution expenses		75
		225
Operating Profit (OPBIT)		630
Add: Non Operating Incomes		60
Net profit before interest and tax (PBIT)		690
Less: Financial expenses (Non-operating)		60
Net profit before tax (PBT)		630
Less: Provision for Taxation		220.5
(630000 × 35%)		220.5
Profit After Tax (PAT)		
		409.5

Schedule 1:

	Rs. (000)
Gross Sales	2,075
Less: Returns	15
	2,060

Schedule 2:

Inventories (1.4.2002)	145
Add: Purchases Less Returns	850
	995
Add: Direct Expenses	375
	1,370
Less: Inventories (31.3.2003)	165
Cost of goods sold	1,205

Schedule 3:

Other Income (Non-operating):	
Rent Received	
Interest and Dividend	25
	35
	60

4.4.4 Cash Profit

When all the non-cash charges which have been debited to Profit and Loss Account are added back to net profit, the amount so arrived at is termed as **cash profit**. Non-cash charges are those expenses in respect of which no payment is to be made to outside parties. It includes

- Depreciation
- Discount on issue of shares & debentures written off
- Preliminary Expenses written off, etc.

It should be noted that 'outstanding expenses' are not treated as non-cash charges because in respect of such expenses, the payment has to be made in the next accounting year. Whereas cash does not flow-out in respect of depreciation and discount on issue of shares or debentures. Preliminary expenses are the formation expenses which have already been incurred in yester years, hence question of making payment of such expenses does not arise. That's why while calculating cash profit such non-cas charges are added back to net profit. Suppose net profit of an enterprise amounts to Rs. 15,30,000 after changing depreciation of Rs. 3,70,000 and writing off of Rs. 15,000 preliminary expenses. The cash profit will be taken at Rs. 19,15,000. (Rs. 15,30,000 + 3,70,000 + 15,000).

The concepts of Gross Profit, Operating Profit before interest and Tax, Operating Profit before Tax and Operating Profit after Tax can be found out with the help of the following format:

Operating Income Statement for the period ....

Gross Sales	xxx	
Less: Returns	xxx	
Net Sales		xxx
Less: Cost of sales:		
Material consumed	xxx	
Direct wages	xxx	
Manufacturing expenses	xxx	
Finished goods, etc.	xxx	xxx
Less: Closing stock		xxx
Gross Profit		xxx
Less: Operating expenses:		
Office & Administrative expenses	xxx	
Selling ad Distribution expenses	xxx	xxx
Net Operating Profit (Opit)		xxx
Add: Non-operating Incomes		
Interest Received	xxx	
Dividend Received	xxx	
Rent Received, etc.	xxx	
Less: Non-operating expenses:	xxx	
Discousnt Allowed	xxx	
Interest on Debentures	xxx	
Interest on Borrowings, etc.	xxx	xxx
Net Profit Before Tax (PBT)		xxx
Less: Provision for Income Tax		xxx
Net Propfit After Tax (PAT)		xxx

4.4.5 Profits Available to Equity Shareholders (Residual Profit)

Residual profit is that portion of profit which is available for equity share holders. It means the profit which the directors consider, should be distributed among equity shareholders after making necessary adjustments as per the provisions of companies Act. In normal course, profits are distributed as dividend only after meeting all expenses, losses, depreciation (current & unabsorbed), fall in the amount of current assets, taxation, past losses, preference dividend and transfer to sinking fund, debenture redemption fund and to general reserve U/s 205 (2A). However, profit arising out of revaluation of fixed assets and other profits of extra ordinary nature (capital profits) are not included in the profits available for equity shareholders ads dividend. It should be noted that the depreciation must be calculated as per the provisions of the section 205 of the Companies Act 1956.

Illustration 7

You are given the following information:

	Rs. (000)
PBIT	5,782
Depreciation charged as per Books	182
Depreciation as per Section 205	360
10% Preference Share Capital	1,500
Past Accumulated Losses	1,500
Transfer to Debenture Redemption Fund	1,200
Unabsorbed Depreciation as per section 205	560
Interest on Loans & Advances	252
Transfer to General Reserves	600

Calculate profit available for equity shareholders, presuming tax rate of 40%.

Solution

		Rs. (000)
PBIT (as given)		5782
Less Interest		252
		5530
Less provision for transfer @ 40%		2212
		3318
Add Depreciation as per books		182
		3500
Less Depreciation as per section 205		360
		3140
Less Unabsorbed Depreciation		560
		2580
Less Accumulated Past Losses		1200
		1380
Less Transfers-Debenture Redemption Fund150	150	
General Reserve	600	750
		630
Less Preference Dividend		150
Profits available to equity shareholders		**480**

Check Your Progress C

1. Gross Profit is the result of two variables
   (i) Turnover & (ii) ....
2. Turnover is the total of:
   (i) Gross Profit & (ii) ....

3. Operating profit is equal to
   (i) .... (ii) Operating expenses
5. Operating expenses include:
   (i) ....
   (ii) ....
   (iii) ....
6. Financial expenses are treated as ....
7. When non-cash charges are added back to net profit the resultant is ....
8. Non-cash charges include:
   (i) ....
   (ii) ....
   (iii) ....

4.5 CONCEPTS OF CAPITAL

There are certain key terms which are used in the process of analysis of financial statements, to draw certain conclusions after judging the company's networth, liquidity, solvency and credit worthiness etc.

4.5.1 Capital Employed

The term capital employed has been defined as the finances deployed by an enterprise in it's fixed assets, investments and working capital. However, if the investments are non-business or non-trading, the same may be excluded from the capital employed.

The capital employed can be worked out by two methods:

First Method: Capital Employed = Fixed assets (Less Depreciation)

+ Net working capital (Current Assets – Current Liabilities)

Since spare funds are used to buy government, semi-govt, or commercial securities the same are treated as non-trading assets. Hence, such funds are not used for business purposes. However, if such assets have to be acquired, these should be treated as trade investments and should form part of capital employed.

Second Method: Capital employed can also be worked out and expressed as the total sum of share capital (Preference & Equity both), reserves (accumulated till date) and long-term liabilities (loans & debentures) as reduced by fictitious assets such as Debit balance of profit and loss account, preliminary expenses, discount on issue of shares and debentures and non-business assets.

It should be noted that certain intangible assets which have been generated over the years and no payment has been made to acquire them, are not considered for the purpose of determining capital employed. These intangible assets include goodwill, patents, copyrights, trade marks etc.

Thus capital employed = Paid-up share capital (Preference & Equity) + Reserves + Accumulated profits + Revaluation – Revaluation Loss- Fictitious assets–intangibles (generated.)

Average Capital Employed

It is calculated by adding the capital employed in the beginning and at the end divided by two. Alternatively, half of the current year's profits may be added to the capital employed in the beginning or subtracted from the capital employed at the end to arrive at the figure of average capital employed which fairly represents capital employed throughout the year.

$$\text{Average capital employed} = \frac{\text{Capital Employed at the beginning} + \text{Capital Employed at the end}}{2}$$

It should be remembered that when capital employed is calculated for the purpose of determining the rate of net profit on capital employed then, debentures and loans are excluded for the purpose of computing the capital employed because net profit does not include interest on loans and debentures.

Illustration 8

From the following Balance Sheet, calculate capital employed under both the methods:

Liabilities	Rs.	Assets	Rs.
9% 2500 preference shares of Rs. 100 each	2,50,000	Goodwill	50,000
50,000 equity shares of Rs. 10 each	5,00,000	Fixed Assets	9,00,000
Reserve Fund	4,50,000	Investment in Govt. Securities	1,00,000
10% Debentures	2,50,000	Current Assets	5,00,000
Provision for Taxation	50,000	Preliminary Expenses	50,000
Creditors	1,25,000	Discount on issue of debentures	25,000
	16,25,000		16,25,000

Fixed assets are valued at Rs. 9,25,000.

Solution

Computation of capital employed: (First Method)

			Rs.
Fixed Assets (after revaluation)			9,25000
Current Assets			5,00,000
			14,25,000
Less:	Creditors	50,000	
	Provision for taxation	1,25,000	1,75,000
			12,50,000

Alternatively: (Second Method)

			Rs.
9% Preference Share Capital			2,50,000
Equity Share Capital			5,00,000
Reserve Fund			4,50,000
10% Debentures			2,50,000
			14,50,000
Add:	Revaluation Profit		25,000
			14,75,000
Less:	Goodwill	50,000	
	Investment	1,00,000	
	Preliminary Expense	50,000	
	Discount on issue of shares & debentures	25,000	2,25,000
Capital Employed			**12,50,000**

4.5.2 Shareholders Funds

Shareholders funds are also referred as networth which is equal to the excess of total assets (excluding fictitious) over the liabilities. This represents the amount belonging to shareholders i.e. what amount the shareholders will be paid, had there been liquidation of the company.

Hence, shareholders funds = All assets (excluding fictitious) less liabilities (short-term and long-term both)

or

Shareholders funds = Preference share capital + Equity share capital + Reserves + Accumulated Profits (Capital/Revenue)–Fictitious assets– Assets which are worth less + revaluation profit - Revaluation loss.

Illustration 9

From the following information compute shareholders' funds

11% Preference Share Capital	3,00,000	Goodwill	2,50,000
Equity Share Capital	7,00,000	Fixed Assets	10,00,000
Reserves (Revenue)	1,50,000	Investments	2,50,000
Capital Reserves	75,000	Current Assets	3,75,000
Securities Premium	1,25,000	Preliminary Expenses	80,000
9% Debentures	5,00,000	Discount on debentures	45,000
Current Liabilities	1,50,000		
	20,00,000		20,00,000

Fixed assets include Rs. 40000 for patents which are considered useless and freehold premises which is valued Rs. 75000 more than its bookvalue. Goodwill is to be valued at Rs. 2,20,000.

Solution

Computation of Shareholders' Funds

First Method

				Rs.
Goodwill				2,50,000
Fixed Assets				10,00,000
Investments				2,50,000
Current Assets				3,75,000
				18,75,000
Less:	9% Debentures		5,00,000	
	Current Liabilities		1,50,000	
	Revaluation Loss:			
		Patents	40,000	
		Goodwill	30,000	7,20,000
				11,55,000
Add:	Revaluation Profit (Freehold premises)			75,000
	Shareholders' Funds			12,30,000

Second Method: Shareholders' Funds may also be computed as follows:

			Rs.
Pref. Share Capital			3,00,000
Equity Share Capital			7,00,000
Revenue Reserve			1,50,000
Capital Reserve			75,000
Securities Premium			1,25,000
			13,50,000
Less:	Preliminary Expenses	80,000	
	Disc. On debentures	45,000	
	Revaluation Loss (Patent Rs. 40,000 + Goodwill Rs. 30,000)	70,000	1,95,000
			11,55,000
Add:	Revaluation Profit (Freehold premises)		75,000
Shareholders' Funds			12,30,000

4.5.3 Shareholders

It is the interest of equity shareholders in the net assets of the company. However, in case of liquidation it is represented by the residual assets meeting prior claims. If the claims of the preference shareholders are subtracted from the shareholders' funds the remaining balance is termed as equity shareholders' equity.

Shareholders' Equity = Shareholders' Funds – Preference Shareholders claim

In the above example, equity shareholders' equity will be Rs. 9,30,000 (Rs. 12,30,000-3,00,000). That is shareholders funds less preferences share capital, if the preference shares are participating i.e. they are entitled to share surplus assets after meting the claims, then such share of preference shareholders will also be subtracted from the shareholders' funds.

It is to be noted that "Shareholders' Equity" includes preference share capital also as against the "Equity Shareholders' equity" which expressly excludes preference share capital and other claim thereof.

4.5.4 Debt Funds

Debt Funds are represented by outside liabilities. It is also known as "external equities". It consists of short-term as well as long-term liabilities. Debt funds are in the form of debentures, loans and borrowings, and current liabilities such as creditors, bills payable, bank overdraft and short term bank credit. By and large these current liabilities are always available year after year on a permanent basis, thus become a part of debt funds.

However, there is no unanimity or consensus on this point. Some authors do not treat current liabilities as a part of debt funds, especially for the purpose of calculating debt-equity ratio because of the following reasons:

i) Currnet liabilities are of a short-term nature and the liquidity ratios are calculated to judge the ability of the firm to honour current obligations.

ii) Current liabilities vary from time to time within a year and interest thereon has no relationship with the book value of current liabilities.

The reasons for taking both short-term and long-term debts are as follows:

i) When a firm has an obligation, no matter whether it is of short-term or long-term nature, it should be taken into account to evaluate the risk of the firm.

ii) Just as long-term loans have a cost, short-term loans do also have a cost.

iii) As a matter of fact, the pressure from the short-term creditors is often greater than that of long-term loans.

4.5.5 Net-working Capital Employed

Net working capital implies to the "funds available for conducting day-to-day operations of an enterprise". It can also be referred as excess of current assets over current liabilities. Hence working capital is the results of two variables viz current assets and current liabilities. A change in the amount of either of two variables brings about a change in the amount of working capital employed.

Net working capital employed = current assets–current liabilities.

Current assets refer to "cash and other assets which are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business. This includes stock, debtors, bill receivable, short-term trade investment or marketable securities & pre-paid expenses etc.

Current Liabilities are those liabilities which have to be paid within a normal course of business (within a year). It includes creditors, bills payable, Bank-overdraft, short-term loans, outstanding expenses of other liabilities which fall due for payment in a relatively short period, not more than twelve months.

An enterprise should employ enough working capital so that it can meet its current obligations to keep the enterprise on the margin of safety. However, tis margin of safety should not be big enough that the most of the funds remain idle. Otherwise the company cannot make optimum use of the funds employed. The ideal amount of net working capital to be employed, according to traditional belief, should be equal to current liabilities i.e. current assets should be double of the amount of current liabilities so that company enjoys better liquidity position and does not become technical insolvent.

4.6 USES OF FINANCIAL STATEMENTS

The financial statements are useful in many ways in the process of decision making. They are the basis of decision making for its users, namely management, investors, creditors, government authorities, etc. Let us now discuss the usefulness of financial statements.

1) **Economic Decision-making**

Sound economic decisions (of external users) require assessment of impact of current business activities and development on the earning power of the company. Information about economic resources and obligations of a business enterprise is needed to form judgement about the ability of the enterprise to survive, to adopt, to grow, to prosper amid changing economic conditions. In this process, the financial statements provide information that is important in evaluating the strength and weaknesses of the enterprise and its ability to meet it's commitments.

2) **Investors Decisions**

Adequate disclosure in the financial statements in expected to have favourable effect on security process of the company. An informed investor is always in a position to take appropriate and timely decision on investment or disinvestment. Financial statements and annual reports provide necessary information regarding profitability, dividend policy, net worth, intrinsic value of shares. Earnings per share (EPS) to assess future prospects to substantiate their investment decisions. The group is not only interested in present health of the enterprise but the future fitness as well. Bankers & financial institutions and foreign institutional investors are always worried about the future solvency of the invested firms.

3). **Employees' Decisions**

Employees' decisions are usually based on perceptions of a company's economic status acquired through financial statements. Employees and their trade unions use the financial statements to assess risk and growth potential of a company, which helps settle industrial disputes, avert lockout & strike or likewise situation arise form demand for wage hike, bonus, higher compensation, more fringe benefits, better working conditions and so on. Labour unions and individual employees use financial statements as the basis for collective bargaining and settlement. Tis develops sense of belongingness among the workers for they know that their interest is not being jeopardised.

4) **Creditors and Financiers**

Short-term creditors make use of the financial statements mainly to ascertain the ability of the firm to pay its current liabilities one time and the value of stock and other asset which can be accepted as security against credits granted. Long-term creditors and financiers are more concerned about the firm's ability to repay the principal amount as and when due. From the financial data provided by the periodic statements, it is possible to make projections about the generation of funds and cash flows, which may assure the safety of investment in debentures and loans.

5) **Customers' Public and Competitiors' Decisions**

Customers and the public in general may use financial statements to predict and forecast future prospect of the company. This information may be important in estimating the value of warranty or in predicting the availability of supporting services or continuing supplies of goods over an extended period of time. Likewise, competitors may analyse financial statements (from competition point of view) to judge the ability of competitor to withstand competition and it's absorbing capacity.

6) **Managerial Decisions**

Published account and reports forming part of financial statements may have economic effects through it's impact on the behaviour of the managers of corporate enterprises. Financial statements provide necessary information base for taking all managerial decisions. In the absence of accounting information neither the objectives of the enterprise can be laid down nor measurement and evaluation of performance is possible nor corrective measures can be taken. Managerial tools such as production budget, sales budget, cash budget, capital budget, and master budget etc. are all the offspring of financial statements. Similarly, wage policy, price policy, credit policy, recruitment policy and other policy matters are decided after careful analysis of financial statements.

7) **Government and it's Agencies**

Government Agencies include taxation authorities and regulatory bodies such as Ministry of Trade & Commerce, Company Law Board, Registrar of Joint Stock Companies, Securities Exchange Board of India (SEBI). These agencies require information for policy decisions purposes. It may be a fiscal policy of Central Board of Direct Taxes (CBDT) or a regulatory policy of company law board and so on, they all require financial statements for policy formulation purposes.

8) **Others**

The financial statements are also useful to stock exchange, brokers, underwriters, press and the public in general. Though Their interest and goals being altogether different in nature, yet they require accounting information in the form of financial statements to serve their own ends. For example researchers may provide some startling facts and findings which may be used by Government to set its economic policy, by regulatory agencies to take regulatory measures and by management to review its own policies and by the public (NGO's) for social reporting purposes. Social reporting aims at measuring adverse and beneficial effects of an enterprise activities both on the company and those affected by the firm; it measures social costs and the related benefits thereof.

4.7 LIMITATION OF FINANCIAL STATEMENTS

Despite the fact that financial statements are the back-bones of the decision-making process for different levels of executives in an organisation, financial analysts and advisors and other interested persons, these suffer from certain limitations because the facts and figures which are reported may not be precise, exact and final. Again some aspects which may be crucial for decision-making purposes may go unreported.

1) **Periodic nature of statements:** The profit or loss arrived at in the Profit and Loss Account is for a specified period. It does not give any idea about the earning capacity over time. Similarly, the financial position as at the date of Balance Seet is true of that point of time. The likely change in position on a future date is not depicted. Liabilities which were dependent on future events (contingent liabilities) are estimated and shown in the Balance Sheet. They are not accurate figures. Similarly, revenue expenditure is sometimes partly charged to Profit and Loss Account and partly deferred or carried forward. The proportion which is deferred and shown on the asset side of Balance Sheet is based on convenience and depends on the level of earnings relatively to the expenditure. In all these respects the annual statements do not reveal the exact earning capacity or financial state of affairs.

2) **The statements are not realistic:** Financial statements are prepared on the basis of certain accounting concepts and conventions. As a result, the financial position depicted in the statements cannot be considered realistic. For example, fixed assets are required to be shown on the basis of their value to the business as represented by their acquisition price less depreciation, not as per the estimated resale price. Also, the Profit and Loss Account invariably includes probable losses but does not include probable income. This is according to the accounting convention of conservation.

3) **Lack of objectivity due to personal judgement:** Values assigned to many items are determined on the basis of the personal judgement of accountants. Hence, relevant amounts shown in the financial statements have no objectivity and they are not varifiable. For instance, estimates of the life of fixed assets and the method of depreciation to be used are based on the personal judgement of accountants. So is the case with valuation of inventories (stock) of materials, work in progress, stores and spare parts, etc. The method of valuation to be adopted depends on the poilicy at the discretion of management based on their judgement.

4) **Only financial matters are reported:** The financial statements present information in terms of monetary units. There is no information relating to the non-monetary aspects of business operations. Facts which cannot be depicted in money terms are excluded from the statements. Thus, information relating to the development of skill and efficiency of employees, the reputation of management, public image of the firm, and such matters do not find a place in the financial statements. Yet these are very relevant for investors to consider while forming any opinion about the future prospects of the firm.

5) **No Suggestive Approach:** Financial Statements disclose information about the past (historical) i.e. what has happened? But it does not disclose why and how it happened. If a company makes profits or incurs losses, the financial statements will show only the amount of profits or losses made but fails to divulge any details as to why there is an increase or decrease in profits or losses.

6) **Subjective Approach of the Management:** Financial performance (profitability) cannot be taken as the only indicator of managerial performance. The profit figures, to a greater extent, are affected by managerial policy of charging depreciation, writing off fictitious assets, amortisation of intangible assets, allocation of advertisement cost,

valuation of stock etc. Likewise, objectivity factor is lost while preparing financial statements to depict the financial position of the concern. Further application of certain concepts and conventions does not allow to show the assets at the true current values (cost concept). The assets shown in the Balance Sheet reflect unexpired cost (W.D.V.) However, liabilities are shown at the same figures thereby distrorting the solvency position of the enterprise. Likewise, the accounting year may be chosen after due thought so that financial statements can send the desired signals to outside interested parties.

7) **Conflicting Principles:** According to Principle of conservatism stock may be valued at cost or market price whichever is less. This implies that current assets are shown at cost in one year and at marker price the other year. It shows clear violation of principle of consistency. Similarly the change of method of charging depreciation from straight line method to written down value method and vice versa highlights contradiction in application of accounting principles. Again, because of flexibility of accounting principles, certain liabilities are not provided for, such as no provision for gratuity payment is made. This is bound to give distorted picture of the financial statements.

8) **Figures are not-self explanatory:** How far the financial statements are useful depends upon the ability of the users to analyse and interpret accounting data for their decision making purposes. Truly accounting is the language of the business but financial statements do not speak themselves, you need certain expertise and tools to make them speak. Every user is not competent to draw conclusions from these statements. Even audited financial statements do not provide a complete and total guarantee of accuracy.

Check Your Progress D

1. Fill in the blanks:
   (a) Final accounts of a company are prepared according to .... Companies Act ....
   (b) Excess of current assets over current liabilities is called ....
   (c) Shareholders' funds comprise of .... and ....
   (d) Liquidity is the ability of the company to meet ....
   (e) Net worth of the company is equal to ....
   (f) .... are show by means of footnote under the Balance Sheet.

4.8 LET US SUM UP

The financial statements are presented either in horizontal or vertical form. The present practice of the corporate enterprises is to present their annual accounts in vertical form which has now become a modern practice. Under vertical form, in case of Balance Sheet, the liabilities are shown under the heading "Sources of Funds" and the assets are shown under the heading "Application of Funds". A summarised profit and loss account is prepared to know the profit or loss and the details of the items are shown separately in the form of annexures.

The concepts of "Reserves" and "Provisions" have its own significance in the preparation of financial statements. The portion of earning whether capital or revenue appropriated by management for a general or specific purpose is known as reserve. A reserve may be a revenue reserve or capital reserve. A revenue reserve may be either a general reserve or specific reserve. General reserve is created to meet a contingent

liability. A specific reserve is created for a specific purpose. It may be created to maintain a stable rate of dividend or to meet redumption of debentures, etc. A reserve which is not created out of 'divisible profits' is called 'capital reserve' and is generally created out of capital profits. Capital profits are not available for distribution as dividends. A reserve which is not disclosed in the Balance Sheet is called as 'secret reserve'. Secret reserves may arise on account of permanent appreciation in the value of assets or permanent diminution in the value of a liability which is not accounted for in the books of accounts. A provision may be created either against the loss (fall) in the value of assets in the normal course of business operation or against a known liability the amount of which cannot be determined accurately but is estimated only.

Gross profit is the difference between the revenue (sales) and cost of goods sold. If we deduct operating expenses from the gross profit, the resultant figure is 'operating profit'. When interest expense and tax liability are not accounted for while calculating profit or loss, of an enterprise, it is treated as 'Profit before Interest and Tax' (PBIT). When interest expense is subtracted from PBIT before providing any income tax, the resultant figure refers to PBT. PAT refers to net profit after taxes. When all non-cash charges which have been debited to Profit and Loss account are added back to net profit, the amount so arrived at is termed as 'cash profit. There are certain key concepts which are used in the process of analysing financial statements. These concepts are: capital employed, shareholders' funds, equity shareholders' equity, debt fund and net working capital.

The financial decisions are useful in many ways in the process of decision-making. These statements are the basis for decision making for its users, e.g. management, investors, creditors, government authorities, etc. They help us in evaluating the strength and weaknesses of the enterprise and investment decisions. Inpsite of its uses, these statements are subject to certain limitations because the facts and figures which are reported may not be precise, exact and final. Further, some aspects which are crucial for decision making may go unreported.

4.9 KEY WORDS

Vertical form of Balance Sheet: A statement prepared under single column divided in two sections, viz. 'Sources of Funds' and 'Application of Funds'.

Vertical form of Profit and Loss Account: A summarised profit and loss account prepared in vertical form and details of the items are shown separately in the form of annexures.

Residual Profit: Net profit available for equity shareholders.

Secret Reserve: A reserve which is not disclosed in the Balance Sheet which may arise on account of a permanent appreciation in the value of assets or a permanent diminuation in the value of a liability.

Gross Profit: The difference between net sales and cost of goods sold.

Operating Profit: Gross profit minus operating expenses.

Cash Profit: The amount which is arrived at by adding back to net profits those non-cash charges which have been debited to the profit and loss account.

Capital Employed: Long-term funds including owners' capital and borrowed capital.

Net Working Capital: Excess of current assets over current liabilities.

4.10 ANSWERS TO CHECK YOUR PROGRESS

A. 1 (a) Reserves and surplus, (b) Miscellaneous expenditure, (c) Fixed assets, (d) Current liabilities and provisions, (e) Current liabilities and provisions, (f) Contingent liability, (g) Reserves and surplus, (h) Current assets, (i) Loans and advances or a deduction from liability for tax, (j) Reserves and surplus.

B. 1. Provision, 2. Revenue reserves, 3. Provision, 4. General reserve, 5. Secret reserve, 6. Reserve.

C. 1. Cost of goods sold, 2. Cost of goods sold.
4. Gross profit, 5(i) Factory overheads, (ii) Office and administrative overheads, (iii) Selling and distribution overheads, 6. Non-operating expenses, 7. Cash profit, 8(i) Depreciation, (ii) Discount on issue of shares and debentures written off, (iii) Preliminary expenses written off.

D. 1 (a) Schedule VI, 1956, (b) Net working capital, (c) Share capital, reserves and surplus, (d) Debts, (e) Excess of total assets over the liabilities, (f) Contingent liabilities.

4.11 TERMINAL QUESTIONS

1) Write notes on:
   a) Horizontal presentation of Balance Sheet, and
   b) Vertical presentation of Balance Sheet.
2) "Balance Sheet is a statement of assets and liabilities or sources and uses of capital or both". Comment.
3) What are the financial statements? How far are they useful for decision-making purposes?
4) Write a note on nature and limitations of financial statements.
5) Z Ltd. made a loss of Rs. 50,000 after providing depreciation of Rs. 1,00,000 in 2002. In 2003 the company earned a profit of Rs. 3,00,000 before charging depreciation of Rs. 75,000.
   b) Also find out cash profit for the year 2002 and 2003.

(Ans: (a) Rs. 1,25,000 (b) Rs. 50,000 and Rs. 3,00,000)

6) From the following calculate Gross Profit, operating profit, Profit before tax (PBT) and Profit after Tax (PAT). The balance of profit standing to the credit of Profit and Loss Account after making following adjustments Rs. 61,000.

	Rs.
Depreciation	85000
Proposed Dividend	1,50,000
General Reserves	45,000
Dividend Received	10,000
Loss on sale of fixed assets	23,000
Indirect Business Expenses	3,05,000

However, Income tax @ 50% has not been provided for.

(Ans: Gross Profit : Rs. 6,53,000
Net Profit : Rs. 2,50,000 (PBT) & Rs. 1,25,000 (PAT)
Operating Profit : Rs. 2,40,000)

7) Explain the purpose and procedure of calculating the following:

   1) Gross Profit

   ii) Operating Profit

   iii) PBIT

   iv) PAT

8) An inexperienced accountant has prepared the balance sheet of ABC Ltd. as follows:

Balance Sheet of ABC Limited

Liabilities	Rs.	Assets		Rs.
Trade Creditors	80900	Stock:		
Advances from Customers	42,260	In hand		3,60,480
Share Capital	8,00,000	With Agents		24,300
Profit & Loss A/c	45,630	Cash in hand		23,540
Provision for Taxes	95,000	Investments		20,000
Proposed Dividend	59,000	Fixed Assets:		
Loan to Managing Director	5,000	Land		1,80,000
General Reserve	75,000	Plant and Machinery		
Development Rebate Reserve	30,000	(W.D.V.)		4,10,000
Provision for Contingencies	23,000	Debtors	2,15,450	
Share Premium A/c	22,000	Less: Provision		
Forfeited Shares	3,000	for B/D	9,300	
				2,06,150
		Bills Receivable		5,000
		Amount due from Agents		51,320
	12,80,790			12,80,790

Redraft the above Balance Sheet in the vertical form prescribed by Indian Companies Act, 1956 giving necessary details yourself.

9) From the following prepare a Balance Sheet in vertical form as on 31st March 2003

Sundry Debtors	612500
Profit & Loss A/c (Dr.) Current year	150000
Miscellaneous Expenses	29000
Investments	112600
Loose Tools	25000
Securities Premium	237500
Securities Premium	85000
Advances to staff	27500
Cash & Bank Balances	137500
Advances	186000
S. Creditors	572500
Term Loan	500000
Capital work-in-progress	100000
General Reserve	1025000
Finished Goods	375000

Gross Block (NDR)	2575000
Stores	200000
Provision for doubtful debts	10100
Loans from Customers	100000
Share Capital: Equity Shares	150000
10% Preference Shares	500000

Additional Information:

(1) Terms Loans are secured (2) Depreciation on fixed assets Rs. 2,50,000

10) From the following particulars prepare profit and loss account for the year ended 31st March 2003 and a Balance Sheet as on that data in vertical form. The company has a authorised capital of Rs. 50,00,000 divided in to 2,50,000 equity of Rs. 10 each and 2,50,000 10% preference shares of Rs. 10 each.

Debit Balances	**Rs. (000)**	**Credit Balances**	**Rs. (000)**
Materials Purchased	1233	4% debentures	500
Furniture & Fittings	150	Equity Share Capital	1500
Stock (1.4.2002)	665	10% Preference Share Capital	500
Discounts & Rebates	30	Bank overdraft	757
Patents	375	S. Creditors	240
Carriage Inwards	57	Sales	3617
Rent, Rates & Insurance	55	Transfer Fees	7
Wages	1305	Rent Received	30
Coal & Coke	63	Profit & Loss A/c (1.4.02)	67
Bank Balance	20		
Cash in Hand	8		
Debenture Interest (for 6 month)	10		
Bank Interest	91		
Preliminary Expenses	10		
Calls-in-Arrears	10		
Freehold Premises	1250		
Plant & Machinery	750		
Tools & Equipment	150		
Goodwill	375		
S. Debtors	266		
Bills Receivable	134		
Advertisement	15		
Commission & Brokerage	68		
Business Expenses	56		
Repairs	47		
Bad Debts	25		
	7218		**7218**

Additional Information:

The closing stock was valued at Rs. 712000. Outstanding liabilities for wages Rs. 25,000 and for business expenses Rs. 25,000 Charge depreciation on:

Plant and Machinery	@	5%
Tools and Equipments	@	20%
Patents	@	10%
Furniture & Fixtures	@	10%

Provide 2% on debtors for doubtful debts after writing off Rs. 16,000 as bed debts. Write off preliminary expenses Rs. 5000. Transfer Rs. 50,000 to debenture Redemption Fund. A dividend of 10% was declared. Corporate Income tax @ 5-% is to be provided. Ignore dividend tax.

Hints

1. Provision for Bad debts (Debtors-Additional Bad debts) 2% on (Rs. 2,66,000-16000) = 5000
2. Dividend @ 10 % on paid up capital:

Preference	:	50000
& on Equity Capital @ 10%	:	
(Rs. 150000-1000)		149000
		199000

3. Add amount of Outstanding expenses to their respective heads
4. Balance of profit and loss account after appropriation: Rs. 38,000
5. Outstanding debenture interest for six months: Rs. 10,000

(Ans: Net Profit Rs. 2,20,000 (after tax))

4.12 SUGGESTED READINGS

1. Report of the study group on the *"Objectives of Financial Statements"* AICPA, 1973
2. *'Accounting for Financial Statements Presentation'* by Smith & Keith.
3. *Financial Accounting* "A Simplified Approach" by Dr. Naseem Ahmed–Atlantic Publishers & Distributors 2002, Darya Ganj, New Delhi.