

MODULE - I

1

ACCOUNTING: AN INTRODUCTION

Unit Structure

- 1.1 Accounting: the language of business
- 1.2 Accounting: an information system.
 - 1.2.1 Definitions
 - 1.2.2 Objectives of accounting
 - 1.2.3 Function of accounting
- 1.3 Users of accounting information:
- 1.4 Branches of accounting
- 1.5 Book-keeping
 - 1.5.1 Accounting cycle
 - 1.5.2 Basic accounting terms

1.1 ACCOUNTING: THE LANGUAGE OF BUSINESS

Accounting is a business language. We can use this language to communicate financial transactions and their results. Accounting is a comprehensive system to collect, analyze, and communicate financial information.

The origin of accounting is as old as money. In early days, the number of transactions was very small, so every concerned person could keep the record of transactions during a specific period of time. Twenty-three centuries ago, an Indian scholar named *Kautilya* alias *Chanakya* introduced the accounting concepts in his book *Arthashastra*. In his book, he described the art of proper account keeping and methods of checking accounts. Gradually, the field of accounting has undergone remarkable changes in compliance with the changes happening in the business scenario of the world.

Business is an economic activity undertaken with the motive of earning profits and to maximize the wealth for the owners. Business cannot run in isolation. Largely, the business activity is carried out by people coming together with a purpose to serve a common cause. This team is often referred to as an organization, which could be in different forms such as sole proprietorship, partnership, body corporate etc. The rules of business are based on general principles of trade, social values, and statutory framework encompassing national or international

boundaries. While these variables could be different for different businesses, different countries etc., the basic purpose is to add value to a product or service to satisfy customer demand.

A bookkeeper may record financial transactions according to certain accounting principles and standards and as prescribed by an accountant depending upon the size, nature, volume, and other constraints of a particular organization.

With the help of accounting process, we can determine the profit or loss of the business on a specific date. It also helps us analyze the past performance and plan the future courses of action. As the basic purpose of business is to make profit, one must keep an ongoing track of the activities undertaken in course of business.

1.2 ACCOUNTING: AN INFORMATION SYSTEM

Accounting as an information system collects data and communicates economic information, regarding the enterprise, to different internal users and external users, whose decisions are depended upon the enterprises performance.

Identification of transactions, is the starting point of accounting process and the preparation of financial statements is the end of accounting process.

Each and every step, in the accounting process, generates information which is communicated to the various users.

Such information helps the users to take right decisions, at the right time.

Accounting is the business language, which acts as a means of communication.

Accounting is used to communicate business information to different interested parties i.e. the internal users and external users of accounting information.

The external users are investors, creditors, consumers, government, non-profit organization members and research scholars.

The internal users are owners, management and employees.

Accounting as an information system, converts inputs into outputs through processes.

The figure given below shows the accounting information system

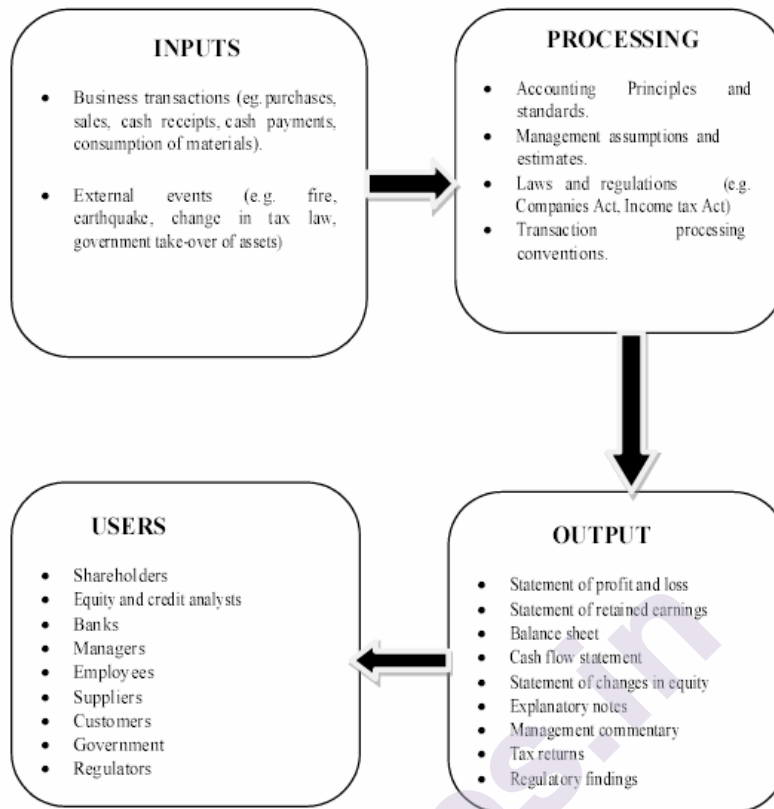


Fig. Accounting Information System

Source: Financial Accounting A managerial Perspective R. Narayanaswamy Sixth Edition PHI Pg. 23

1.2.1 DEFINITIONS

Definition of Accounting

Definition by the American Institute of Certified Public Accountants (Year 1961):

"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 result thereof".

Definition by the American Accounting Association (Year 1966):

"The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounting".

1.2.2 OBJECTIVES OF ACCOUNTING

To Providing Information

The primary objective of accounting is to provide useful information for decision-making to stakeholders such as owners, management, creditors, investors, etc. Various outcomes of business activities such as costs, prices, sales volume, value under ownership, return of investment, etc. are measured in the accounting process.

To keep systematic records:

Accounting is done to keep systematic record of financial transactions. The primary objective of accounting is to help us collect financial data and to record it systematically to derive correct and useful results of financial statements.

Ascertainment of Results

'Profit/loss' is a core accounting measurement. It is measured by preparing profit and loss account for a particular period. Various other accounting measurements such as different types of revenue expenses and revenue incomes are considered for preparing this profit and loss account. Difference between these revenue incomes and revenue expenses is known as result of business transactions identified as profit/loss.

To ascertain the financial position of the business: A balance sheet or a statement of affairs indicates the financial position of a company as on a particular date. A properly drawn balance sheet gives us an indication of the class and value of assets, the nature and value of liability, and also the capital position of the firm. With the help of that, we can easily ascertain the soundness of any business entity.

To assist in decision-making: To take decisions for the future, one requires accurate financial statements. One of the main objectives of accounting is to take right decisions at right time. Thus, accounting gives you the platform to plan for the future with the help of past records.

To fulfill compliance of Law: Business entities such as companies, trusts, and societies are being run and governed according to different legislative acts. Similarly, different taxation laws (direct indirect tax) are also applicable to every business house. Everyone has to keep and maintain different types of accounts and records as prescribed by corresponding laws of the land. Accounting helps in running a business in compliance with the law.

To Know the Solvency Position : Balance sheet and profit and loss account prepared as above give useful information to stockholders regarding concerns potential to meet its obligations in the short run as well as in the long run.

1.2.3 FUNCTION OF ACCOUNTING

The main functions of accounting are as follows:

Measurement: Accounting measures past performance of the business entity and depicts its current financial position.

Forecasting: Accounting helps in forecasting future performance and financial position of the enterprise using past data.

Decision-making: Accounting provides relevant information to the users of accounts to aid rational decision-making.

Comparison & Evaluation: Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and contingent liabilities which play an important role in predicting, comparing and evaluating the financial results.

Control: Accounting also identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.

Government Regulation and Taxation: Accounting provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues.

1.3 USERS OF ACCOUNTING INFORMATION:

Generally users of accounts are classified into two categories:

- a) Internal User
- b) External User

Following are the various users of accounting information:

- i) **Investor:** They provide capital to business. They need information to assess whether to buy, hold or sell their investment. Also they are interested to know the ability of the business to survive, prosper and to pay dividend.
- ii) **Employees:** Growth of employees is directly related to the growth of the organisation and therefore, they are interested to know the stability, continuity and growth of the enterprise and its ability to provide remuneration, retirement and other benefits and to enhance employment opportunities.
- iii) **Lenders:** They are interested to know whether their loan-principal and interest will be paid when due.
- iv) **Supplier and Creditors:** They are also interested to know the ability of the enterprise to pay their dues that helps them to decide the credit policy for the relevant concern, rates to be charged and so on. Sometime, they also become interested in long term continuation of

the enterprise if their existence becomes dependent on the survival of the business. Suppose, small ancillary units supply their products to a big enterprise, if the big enterprise collapses, the fate of the small units also becomes sealed.

- v) **Customers:** Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent on the supply of goods, suppose, a company produces some chemicals used by pharmaceutical companies and supplies chemicals on three months credit. If all a sudden it faces some trouble and is unable to supply the chemical, the customers will also be in trouble.
- vi) **Government and their agencies:** They regulate the functioning of business enterprise for public good, allocated scarce resources among competing enterprise, control price, change excise duties and taxes, and so they have continued interest in the business enterprise.
- vii) **Public:** The public at large is interested in the functioning of the enterprise because it may make a substantial contribution to the local economy in many ways including the number of people employed and their patronage to local suppliers.
- viii) **Management:** On the basis of Accounts, management determine the effects of their various decisions on the functioning of the organisation. This helps them to make further managerial decisions.

External users of accounting information	External users include Investors Creditors Customers Suppliers Employees Government organizations
Internal users of accounting information	Internal users include Management Managers of operations

1.4 BRANCHES OF ACCOUNTING

Following are various branches of Accounting.

1.4.1 Financial Accounting

It is commonly termed as Accounting. The American Institute of Certified Public Accountants defines Accounting as "an art of recoding, 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."

1.4.2 Cost Accounting

According to the Chartered Institute of Management Accountants (CIMA), Cost Accountancy is defined as "application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability as well as the presentation of information for the purpose of managerial decision-making."

1.4.3 Management Accounting

Management Accounting is concerned with the use of Financial and Cost Accounting information to managers within organizations, to provide them with the basis in making informed business decisions that would allow them to be better equipped in their management and control functions.

1.4.4 Social responsibility Accounting

Social responsibility accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created.

1.4.5 Human Resource Accounting

Human resource accounting is an attempt to identify, quantify and report investment made in human resource of an organisation that are not presently accounted for under conventional accounting practice.

1.4.6 Difference between Management Accounting and Financial Accounting

Management Accounting	Financial Accounting
1. Management Accounting is primarily based on the data available from Financial Accounting.	1. Financial Accounting is based on the monetary transactions of the enterprise.
2. It provides necessary information to the management to assist them in the process of planning, controlling, performance evaluation and decision making.	2. Its main focus is on recording and classifying monetary transactions in the books of accounts and preparation of financial statements at the end of every accounting period.
3. Reports prepared in Management Accounting are meant for management and as per management requirement.	3. Reports as per Financial Accounting are meant for the management as well as for shareholders and creditors of the concern.
4. Reports may contain both subjective and objective figures.	4. Reports should always be supported by relevant figures and it emphasizes on the objectivity of data.

5. Reports are not subject to statutory audit.	5. Reports are always subject to statutory audit.
6. It evaluates the sectional as well as the entire performance of the business.	6. It ascertains, evaluates and exhibits the financial strength of the whole business.

1.5 BOOK-KEEPING

As defined by Carter, 'Book-keeping is a science and art of correctly recording in books-of accounts all those business transactions that result in transfer of money or money's worth'.

Book-keeping is an activity concerned with recording and classifying financial data related to business operation in order of its occurrence.

Book-keeping is a mechanical task which involves:

- Collection of basic financial information.
- Identification of events and transactions with financial character i.e., economic transactions.
- Measurement of economic transactions in terms of money.
- Recording financial effects of economic transactions in order of its occurrence.
- Classifying effects of economic transactions.
- Preparing organized statement known as trial balance.

The distinction between book-keeping and accounting is given below:

Book-Keeping	Accounting
Output of book-keeping is an input for accounting.	Output of accounting permit informed judgments and decisions by the user of accounting information.
Purpose of book-keeping is to keep systematic record of transactions and events of financial character in order of its occurrence.	Purpose of accounting is to find results of operating activity of business and to report financial strength of business.
Book-keeping is a foundation of accounting.	Accounting is considered as a language of business.
Book-keeping is carried out by junior staff.	Accounting is done by senior staff with skill of analysis and interpretation.
Objects of book-keeping is to summarize the cumulative effect of	Object of accounting is not only bookkeeping but also analyzing and

all economic transactions of business for a given period by maintaining permanent record of each business transaction with its evidence and financial effects on accounting variable.	interpreting reported financial information for informed decisions.
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1.5.1 ACCOUNTING CYCLE

When complete sequence of accounting procedure is done which happens frequently and repeated in same directions during an accounting period, the same is called an accounting cycle.

Steps/Phases of Accounting Cycle

The steps or phases of accounting cycle can be developed as under:

Recording of Transaction: As soon as a transaction happens it is at first recorded in subsidiary book.

Journal: The transactions are recorded in Journal chronologically.

Ledger: All journals are posted into ledger chronologically and in a classified manner.

Trial Balance: After taking all the ledger account closing balances, a Trial Balance is prepared at the end of the period for the preparations of financial statements.

Adjustment Entries: All the adjustments entries are to be recorded properly and adjusted accordingly before preparing financial statements.

Adjusted Trial Balance: An adjusted Trail Balance may also be prepared.

Closing Entries: All the nominal accounts are to be closed by the transferring to Trading Account and Profit and Loss Account.

Financial Statements: Financial statement can now be easily prepared which will exhibit the true financial position and operating results.

1.5.2 BASIC ACCOUNTING TERMS

In order to understand the subject matter clearly, one must grasp the following common expressions always used in business accounting.

Transaction: It means an event or a business activity which involves exchange of money or money's worth between parties.

Goods/Services: These are tangible article or commodity in which a business deals. These articles or commodities are either bought and sold or produced and sold.

Profit: The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.

Loss: The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.

Asset: Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be tangible and intangible. Tangible Assets are the Capital assets which have some physical existence. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as intangible Assets. They cannot be seen or felt although they help to generate revenue in future.

Liability: It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties.

Contingent Liability: It represents a potential obligation that could be created depending on the outcome of an event.

Capital: It is amount invested in the business by its owners. It may be in the form of cash, goods, or any other asset which the proprietor or partners of business invest in the business activity. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer of the business. Hence, it is not classified as a normal liability.

Drawings: It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use

Debtor : The sum total or aggregate of the amounts which the customer owe to the business for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Payable, or Book-Debts or Debtors.

Creditor: A creditor is a person to whom the business owes money or money's worth. E.g. money payable to supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.

Trade Discount: It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price.

Cash Discount: This is allowed to encourage prompt payment by the debtor. This has to be recorded in the books of accounts. This is calculated after deducting the trade discount.

1.6 MEANING AND TYPES OF FINANCIAL STATEMENTS

Meaning:

Financial statements are plain statements based on historical records, facts and figures. They are uncompromising in their objectives, nature and truthfulness. They reflect a judicious combination of recorded facts, accounting principles, concepts and conventions, personal judgements and sometimes estimates.

Financial statements consist of 'Revenue Account' and 'Balance Sheet'.

1. Revenue Account / Income Statement:

Revenue Account refers to 'Profit and Loss Account' or 'Income and Expenditure Account' or simply 'Income Statement'. Revenue Account may be split up or divided into 'Manufacturing Account', 'Trading Account', 'Profit and Loss Account' and 'Profit and Loss Appropriation Account'. Revenue Account is prepared for a period, covering one year. This statement shows the expenses incurred on production and distribution of the product and sales and other business incomes. The final result of this statement may be profit or loss for a particular period.

2. Balance Sheet:

Balance sheet shows the financial position of a business as on a particular date. It represents the assets owned by the business and the claims of the owners and creditors against the assets in the form of liabilities as on the date of the statement.

3. Funds Flow Statement –

It describes the sources from which the additional funds were derived and the use of these funds. Funds flow statement helps to understand the changes in the distribution of resources between two balance sheet periods. The statement reveals the sources of funds and their application for different purposes.

4. Cash flow Statement:

A cash flow statement shows the changes in cash position from one period to another. It shows the inflow and outflow of cash and helps the management in making plans for immediate future. An estimated cash flow statement enables the management to ascertain the availability of cash to meet business obligations. This statement is useful for short term planning by the management.

5. Schedules:

Schedule explains the items given in income statement and balance sheet. Schedules are a part of financial statements which give detailed information about the financial position of a business organization.

1.7 OBJECTIVES OF FINANCIAL STATEMENTS

The main object of financial statements is to provide information about the financial position, performance and changes taken place in an enterprise. Financial statements are prepared to meet the common needs of most users. The important objectives of financial statements are given below:

1. Providing information for taking Economic decisions:

The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines the capacity of an enterprise to pay its employees and suppliers meet interest payments, repay loans and make distributions to its owners.

2. Providing information about financial position:

The financial position of an enterprise is effected by the economic resources it controls, its financial structures its liquidity and solvency and its capacity to adapt to changes in the environment in which it operates.

Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise. This information is useful in predicting how successful the enterprise is likely to be in raising further finance. Information about liquidity and solvency is useful to predicting the ability of the enterprise to meet the financial commitments as fall due.

3. Providing information about performance(working results) of an enterprise:

Another important objective of the financial statements is that it provides information about the performance and in particular its profitability, which requires in order assessing potential changes in the economic resources that are likely to control in future. Information about performance is useful in predicting the capacity of the enterprise to generate cash inflows from its existing resource base as well in forming judgment about the effectiveness with which the enterprises might employ additional resources.

4. Providing Information about changes in financial position:

The financial statements provide information concerning changes in the financial position of an enterprise, which is useful in order to assess its investing, financing and operating activities during the reporting periods. This information is useful in providing the user with a basis to assess the ability of the enterprise to generate cash and cash equipments and the needs of the enterprise to utilize those cash flows.

1.8 AN OVERVIEW OF FINANCIAL STATEMENTS

Each business firm has to prepare two main financial statements viz. Income Statement and Balance sheet. The income statement reveals the profit of loss during a particular period generated from the activities of a business. Balance sheet shows the financial position of a business on a particular date.

- **Income statement**

Income statement summaries the incomes /gains and expenses /losses of a Business for a particular financial period. The format of Income statement explains in detail the items to be included in the statement. It is presented in the traditional T Format and also in the vertically statement form.

1. Horizontal Form T form Manufacturing Trading and Profit and Loss Account For the year ending

Dr.

Cr.

Particulars	Rs.	Particulars	Rs.
To Opening stock		By Closing stock	
Raw materials		Raw Material	
Work in progress		Work in progress	
To Purchase of raw materials		By Cost of finished goods c/d	
To Manufacturing wages		By Sales	
To Carriage/ Freight inwards		By Closing stock of Finished Goods	
To Custom duty		By Gross Loss c/d	
To Other factory		By Gross profit b/d	
To Opening stock		By Business incomes and Gains	
Finished Goods		By Net Loss c/d	
To Cost of finished		By Balance b/d from Previous year	
Goods b/d		By Net Profit b/d	
To Gross profit c/d			
To Gross loss b/d			
To Office and administration Expenses			
To Interest and financial Expenses			
To Provision for Income tax			
To Net Profit c/d			
To Net loss b/d			

To Transfer to General reserve			
To Dividend			
To Balance c/f			

Particulars	Rs.	Rs.
Gross Sales		xxx
Less : Sales returns	xxx	
Sales tax / Excise duty		
Net Sales		xxx
Less : Cost of goods sold		
(Materials consumed + Direct Labour+ Manufacturing Expenses)	xxx xxx xxx	
Add / Less : Adjustment for change in stock	xxx	xxx
Gross Profit		xxx
Less : Operating expenses	xxx	
a. Office and administration Expenses	xxx	
b. Selling and distribution Expenses	xxx	xxx
Add : Operating Income		xxx
Operating Profit	xxx	
Add : Non Operating Income		xxx
Less : Non Operating expenses (including interest)		xxx
Profit before interest and tax		xxx
Less : Interest		xxx
Profit before tax		xxx
Less : Appropriations:	xxx	xxx
a. Transfer to reserves	xxx	xxx
b. Dividends declared / paid		xxx
Surplus carried to Balance Sheet		xxx

- **Balance sheet:**

It is one of the major financial statements which presents a company's financial position at the end of a specified date. Balance sheet has been described as a "snapshot" of the company's financial position at a moment

for e.g. the amounts reported on a balance sheet dated March 31st, 2016 reflects that all the transactions throughout December 31st have been recorded. The balance sheet provides information related to the assets, liabilities and the shareholders' equity of the company as on a specific date.

Total Assets = Total Liabilities + Share holders' equity

The companies Act, 1956 stipulates that the balance sheet of a joint stock company should be prepared as per Part I of Schedule VI of the Act. However, the statement form has been emphasized upon by accountants for the purpose of analysis and interpretation.



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MODULE - II

2

ACCOUNTING PRINCIPLES

Unit Structure

- 2.1 Introduction
- 2.2 Accounting Concepts
- 2.3 Accounting Principles
- 2.4 Accounting Conventions
- 2.5 Widely Accepted Accounting Concepts

2.1 INTRODUCTION

Accounting is the language of the business. Accounting Principles are the rules or guidelines which are developed to maintain a uniformity and consistency in accounting records. This **generally accepted accounting principles** (GAAP's) provides unity of understanding and unity of approach in the practice of accounting and also in better preparation of financial statements.

Let us imagine a situation where you give copies of your books of accounts to three different accountants and you ask them to prepare financial statements and to compute the income from business for the financial year on the basis of books of accounts given to them. All three accountants are ready with the financial statements and all three accountants have computed different figure of income i.e. profit from the business and that too with very wide variations among them. Guess in such a situation what impact would it leave on you about accounting profession. To avoid this, a generally accepted set of accounting principles/rules have been developed.

Financial statements prepared by the accountants to communicate financial information to the various users of financial statements for decision making purpose. Therefore, it is important that financial statements prepared by different business entities should be prepared on uniform basis. Also there should be consistency over a period of time in the preparation of these financial statements. If every accountant starts following his own methods and concepts for accounting different items then there will be confusion.

To avoid confusion and to achieve uniformity, accounting process is applied within the conceptual framework of 'Generally Accepted Accounting Principles' (GAAPs).

The term GAAPs is used to describe rules developed for the preparation of the financial statements and are called

- 1. Accounting Concepts;**
- 2. Accounting Conventions;**
- 3. Accounting Postulates ;**
- 4. Accounting Principles**

2.2 ACCOUNTING CONCEPTS

Accounting Concepts are certain rules that accountant should follow while recording business transactions and preparing accounts.

E.g. in India there is a basic rule to be followed by everyone that one should walk or drive on his/her left hand side of the road. It helps in the smooth flow of traffic. Similarly, there are certain rules that an accountant should follow while recording business transactions and preparing accounts.

Accounting concepts lay the foundation on the basis of which the accounting principles are followed. Concepts constitute the very basis of accounting. There are various concepts of accounting and all have been developed over the period of time from experience and thus, they are university accepted rules.

2.3 ACCOUNTING PRINCIPLES

Meaning of Principles:

A general law or rule followed or adopted as a guide to action is known as a principle.

Definitions of Accounting Principles:

1. According to **American Institute of Certified Public Accountants (AICPA)** : "The accounting principles are general law or rule adopted or preferred as a guide to action, a settled ground or basis of conduct or practice."
2. According to **R.N Antony**: "The rules and conventions of accounting are commonly referred to as Principles."

Accounting principles must satisfy following conditions:

1. They should be based on real assumptions;
2. They must be simple, understandable & self explanatory;

3. They must be followed consistently;
4. They should be able to reflect future predictions;
5. They should be informational for the users.

2.4 ACCOUNTING CONVENTIONS

An accounting convention refers to common practices which are universally followed in recording and presenting accounting statements of the business entity. Accounting conventions are followed like customs, traditions, etc. in a society. They make accounting information more clear and useful. They have evolved through the regular and consistent practice over the years. They facilitate uniform recording in the books of accounts.

2.5 WIDELY ACCEPTED ACCOUNTING CONCEPTS

1. Business Entity Concept
2. Money Measurement Concept
3. Accounting Period(Periodicity) Concept
4. Cost Concept
5. Realization Concept or Revenue recognition Concept
6. Matching Concept
7. Accrual Concept
8. Dual Aspect Concept
9. Materiality Concept
10. Conservatism or Prudence Concept

- 1) **Business Entity Concept:** Entity Concept states that Business Enterprise is separate entity from its owner. As per this concept business transactions to be recorded in business books and owner's transactions to be recorded in his personal books.

Entity concept means that enterprise owes to the owner for capital provided by the owner.

Example: Mr. A Commenced business by investing Rs. 12,00,000/- with which he purchased Equipments & other Fixed assets required in business for Rs. 10,00,000/- & kept balance in hand. i.e. Rs. 2,00,000/- The financial position(Balance sheet) of business is as follows:

Balance Sheet

Liabilities	Amount(Rs.)	Assets	Amount(Rs.)
Capital	1200000	Equipment & Fixed Assets	1000000
		Cash in Hand	200000
	<u>1200000</u>		<u>1200000</u>

This means that Business Enterprise owes to Mr. A Rs.12,00,000/- now if Mr. A Spends/ uses Rs. 50,000/- for Household Expenses from business capital Fund then as per business entity concept it should not be classified/recorded as business expenses but should be charged to capital account i.e. Capital will get reduced by Rs. 50,000/- & revised Balance sheet will show following position

Balance Sheet

Liabilities		Amount(Rs.)	Assets	Amount(Rs.)
Capital	12,00,000		Equipment & Fixed Assets	10,00,000
Less: Drawings(Personal Expenses.)	(50,000)	11,50,000	Cash in Hand	1,50,000
		<u>11,50,000</u>		<u>11,50,000</u>

- 2) **Money Measurement Concept:** This Concept states that only monetary transactions i.e. which can be measured in terms of money are to be recorded. In accounting, a record is made only of those facts or transactions that can be expressed in monetary terms. It provides a common unit for measurement, i.e., money for measuring, recording and summarizing the transaction. Events, which cannot be expressed in money terms, do not find a place in account books. *Example, salary paid to manager is recorded in account books but his competence is has no place in account books.*
- 3) **Accounting Period / Periodicity Concept:** All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as periodicity or accounting period concept. Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. This is necessary for different purposes

like, calculation of profit, ascertaining financial position, tax computation etc. Usually one year is taken as one accounting period which may be a calendar year or a financial year.

Thus, the periodicity concept facilitates in:

- (a) Comparing of financial statements of different periods
- (b) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business
- (c) Matching periodic revenue with expenses for getting correct results of the business operations.

- 4) **Cost Concept:** As per cost concept value of asset recorded at its acquisition/purchase cost, in other words, at its historical cost.

For example, if a plot of land is purchased for Rs. 1,50,000 then as per this concept, the asset will be recorded in the books at Rs. 1,50,000, even if its market value at that time is Rs. 2,00,000.

- 5) **Realization Concept or Revenue recognition Concept:** This Concept deals with the problem, when the revenue should be recognized? According to this concept, the sale should be recognised at the point, when the property in goods passes to the buyer and he becomes legally liable to pay and other income is recognised, when they accrue.

Example: Mr. A places an order with Mr. B for supply of certain goods, which are yet to be manufactured. On receipt of order, Mr. B purchases raw materials employs workers, produces the goods and delivers finished goods to Mr.A. Mr. A makes payment on receipt of goods. In this case, the sale will be presumed to have been made not at the time of receipt of the order for the goods, but at the time, when goods are delivered to Mr. A.

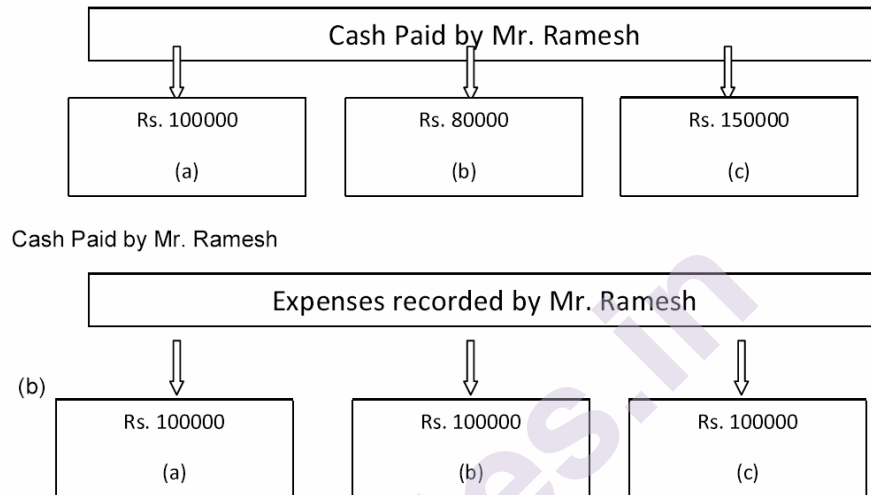
- 6) **Matching Concept:** In this concept, all expenses matched with revenue of that period should only be taken into consideration. The objective of running business is to earn profit in order to ascertain the profit made by the business during a period. It is necessary that the revenues of the period should be matched with the cost (Expenses) of the period. The term matching means appropriate association of related revenues and expenses.

Example: ABC Ltd. purchases a large appliance from wholesalers for Rs.5,000 and resells it to a local restaurant for Rs.8,000. At the end of the period, ABC Ltd. should match the Rs.5,000 cost with the Rs.8,000 revenue.

- 7) **Accrual Concept:** Under Accrual concept/ Accrual basis of accounting, income must be recorded in the accounting period in which it is earned. Therefore, accrued income must be recognized in the accounting period in which it arises rather than in the subsequent

period in which it will be received. Conversely, prepaid income must be not be shown as income in the accounting period in which it is received but instead it must be presented as such in the subsequent accounting periods in which the services or obligations in respect of the prepaid income have been performed.

Example: Suppose Mr. Ramesh rents a house from Suresh at Rs.100,000 per year. Now consider the following three cases in which Ramesh pays cash to Suresh and records rent expense.



In above example, even though cash paid is different in all the three cases but the rent expense recorded is Rs.1,00,000 in each case. Justification behind that is the accrual concept of accounting in which expenses must be recorded in the accounting period in which they are incurred not in the period in which they are paid.

Notice that in case “b” Mr. Ramesh has paid Rs.80,000 cash but has recorded Rs.100,000 expense during the period because the annual rent is Rs.100,000 not Rs.80,000. The remaining Rs.20,000 will be paid subsequently. Also notice that in case “c” Mr. Ramesh has paid Rs.1,50,000 but has recorded Rs.100,000 expense, the balance of Rs.50,000 will be adjusted against the rent of subsequent period.

8) Dual Aspect Concept: This is a basic concept of accounting. According to this concept, every business transactions has dual effect-

- | 1 st Aspects | | 2 nd Aspects |
|--------------------------------|-----|------------------------------------|
| (i) It increases on Asset | and | decreases other Asset, |
| <i>[Purchase of Machinery]</i> | | <i>[Payment of Cash]</i> |
| (ii) It increases an Asset | and | simultaneously increase liability, |
| <i>[Purchase of Machinery]</i> | | <i>[Payment at future date</i> |
| | | <i>(on credit basis)]</i> |

(iii) It decreases one Asset, and decreases one Liability

[Payment of Cash]

[Settlement of Liability]

(iv) It increase liability, and decreases simultaneously liability

[Bank Loan Obtained]

[Payment to Creditors]

(Using Loan Amount)]

For example, suppose Mr. Rahul purchases Assets of Rs. 100000 in cash. In this business transaction, Mr. Rahul receives the assets of Rs. 100000, but on the other hand, Cash balance will decrease by Rs. 100000 So, Assets Account and Cash Account shall be affected by this transaction.

Thus in every business transaction, one aspect represents the assets or expenses other represents the claim or income and these two aspects are always equal. This approach generates the concept of accounting equation, which can be summarized as below:

Liabilities	=	Assets
External Liabilities + Capital	=	Assets

For example, if A starts a business with a capital of Rs. 1,00,000. There are no aspects of this transaction. On the one hand, the business has asset (in the form of cash) of Rs. 1,00,000, while on the other hand the business has to pay to the proprietor a sum of Rs. 1,00,000, which is known as proprietor's capital. This expression can be shown in the form of accounting equation as follows:

Capital (Liability)	=	Cash (Assets)
1,00,000	=	1,00,000

In the example given above, if the Machinery worth Rs. 50,000 is purchased, the situation will be as follows:

Capital (Rs. 1,00,000) = Cash (Rs. 50,000) + Machinery (Rs. 50,000)

Thus, this concept develops a relationship between liabilities and assets. The Accounting Equation can be technically started as "for every debit, there is an equivalent credit". As a matter of fact, the entire Double Entry System of Book-Keeping is based on this concept.

9) Materiality Concept: As per the concept of materiality, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements and any insignificant item which will only increase the work of accountant but will not be relevant to the users need should not be disclosed in the financial statements.

The term materiality depends not only upon the amount of the item but also upon the size of the business, nature & level of information, level of the person making decision etc. Moreover an item material to one person may be immaterial to another person. What is important is that omission of any information should not impair the decision-making of various users.

10) Conservatism or Prudence Concept: Conservatism states that the accountant should not anticipate income and should provide for all possible losses. When there are many alternative values of an asset, an accountant should choose the method which leads to the lesser value. Later on we should see that the golden rule of current asset valuation – ‘cost or market price ‘whichever is lower originated from this concept.



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BASICS OF ACCOUNTING STANDARDS

Unit Structure

3.1 Meaning & Introduction

3.2 Accounting Standards in Brief

3.1 MEANING & INTRODUCTION

Accounting standards are the *written policy documents* issued by the regulatory authority, experts accounting body or by the government covering various aspects of recognition, treatment, measurement, presentation & disclosure of accounting transactions and events in the financial statements. The accountant has to adhere to various accounting standards while preparing financial statements of the entities.

Accounting standard provide framework and standard accounting policies so that the financial statement of different enterprises become comparable.

The accounting standards deals with the issues of –

- i. Recognition of events and transactions in the financial statements;
- ii. Measurement of these transactions and events;
- iii. Presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader; and
- iv. The disclosure requirements which should be there to enable public at large and the stakeholders and the potential investors in particular, to get insight into what these financial statement are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

3.2 ACCOUNTING STANDARDS IN BRIEF

AS-1-Disclosure of Accounting Policies: Accounting Policies refer to *specific accounting principles and the method of applying those principles* adopted by the enterprises in preparation and presentation of the financial statements.

AS-2-Valuation of Inventories: The objective of this standard is to formulate the method of computation of cost of inventories / stock, determine the value of closing stock / inventory at which the inventory is to be shown in balance sheet till it is not sold and recognized as revenue.

AS 3-Cash Flow Statements: Cash flow statement is additional information to user of financial statement. This statement exhibits the flow of incoming and outgoing cash. This statement assesses the ability of the enterprise to generate cash and to utilize the cash. This statement is one of the tools for assessing the liquidity and solvency of the enterprise.

AS 4-Contingencies and Events occurring after the balance sheet date: In preparing financial statement of a particular enterprise, accounting is done by following accrual basis of accounting and prudent accounting policies to calculate the profit or loss for the year and to recognize assets and liabilities in balance sheet. While following the prudent accounting policies, the provision is made for all known liabilities and losses even for those liabilities / events, which are probable. Professional judgment is required to classify the likelihood of the future events occurring and, therefore, the question of contingencies and their accounting arises. Objective of this standard is to prescribe the accounting of contingencies and the events, which take place after the balance sheet date but before approval of balance sheet by Board of Directors. The Accounting Standard deals with Contingencies and Events occurring after the balance sheet date.

AS 5-Net Profit or Loss for the Period, Prior Period Items and change in Accounting Policies: The objective of this accounting standard is to prescribe the criteria for certain items in the profit and loss account so that comparability of the financial statement can be enhanced. Profit and loss account being a period statement covers the items of the income and expenditure of the particular period. This accounting standard also deals with change in accounting policy, accounting estimates and extraordinary items.

AS 6-Depreciation Accounting: It is a measure of wearing out, consumption or other loss of value of a depreciable asset arising from use, passage of time. Depreciation is nothing but distribution of total cost of asset over its useful life.

AS 7-Construction Contracts: Accounting for long term construction contracts involves question as to when revenue should be recognized and how to measure the revenue in the books of contractor. As the period of construction contract is long, work of construction starts in one year and is completed in another year or after 4-5 years or so. Therefore question arises how the profit or loss of construction contract by contractor should be determined. There may be following two ways to determine profit or loss: On year-to-year basis based on percentage of completion or on completion of the contract.

AS 8-Accounting for Research & Development: Accounting for research & development, is withdrawn from the date of AS 26, Intangible assets, becoming mandatory for respective enterprises.

AS 9-Revenue Recognition: The standard explains as to when the revenue should be recognized in profit and loss account and also states the circumstances in which revenue recognition can be postponed. Revenue means gross inflow of cash, receivable or other consideration arising in the course of ordinary activities of an enterprise such as the sale of goods, rendering of services, and use of enterprises resources by other yielding interest, dividend and royalties. In other words, revenue is a charge made to customers / clients for goods supplied and services rendered.

AS 10-Accounting for Fixed Assets: AS 10 prescribes accounting for fixed assets used by entity in the business. AS defines term fixed asset. It is an asset, which is held with intention of being used for the purpose of producing or providing goods and services not held for sale in the normal course of business and expected to be used for more than one accounting period.

AS 11-The Effects of changes in Foreign Exchange Rates : Effect of Changes in Foreign Exchange Rate shall be applicable in Respect of Accounting Period commencing on or after 01-04-2004 and is mandatory in nature. This accounting Standard applicable to accounting for transaction in foreign currencies in translating in the financial statement of foreign operations. Effect of changes in foreign exchange rate, an enterprises should disclose following aspects:

- a) Amount Exchange Difference included in Net profit or Loss;
- b) Amount accumulated in foreign exchange translation reserve;
- c) Reconciliation of opening and closing balance of Foreign Exchange translation reserve;

AS 12-Accounting for Government Grants: Accounting standard 12 deals with accounting for government grants both capital and revenue from government. Government Grants are assistance by the Govt. in the form of cash or kind to an enterprise in return for past or future compliance with certain conditions. Government assistance, which cannot be valued reasonably, is excluded from Govt. grants,. Those transactions with Government, which cannot be distinguished from the normal trading transactions of the enterprise, are not considered as Government grants.

AS 13-Accounting for Investments: AS 13 provides accounting principles for investments in the financial statement and related disclosure requirements. As per AS 13 Investment means the assets held for earning income by way of dividend, interest and rentals, for capital appreciation or for other benefits.

AS 14-Accounting for Amalgamation: This standard prescribes accounting for amalgamation. This accounting standard deals with accounting to be made in books of Transferee Company in case of amalgamation. The standard is applicable when acquired company is dissolved and separate entity ceased exist and purchasing company continues with the business of acquired company

AS 15-Employee Benefits: Accounting Standard 15 prescribes the accounting and disclosure for employee benefits. This Standard covers all forms of employee benefits i.e. Short term employee benefits (Salaries, Leave, bonus, housing, mediclaim etc.), Post employment benefits (gratuity, pension, post employment medical care etc.) and other long term employee benefits and termination benefits.

AS 16-Borrowing Costs : Enterprises are borrowing the funds to acquire, build and install the fixed assets and other assets, these assets take time to make them useable or saleable, therefore the enterprises incur the interest (cost on borrowing) to acquire and build these assets. The objective of the Accounting Standard is to prescribe the treatment of borrowing cost (interest + other cost) in accounting, whether the cost of borrowing should be included in the cost of assets or not.

AS 17-Segment Reporting: An enterprise needs in multiple products/services and operates in different geographical areas. Multiple products / services and their operations in different geographical areas are exposed to different risks and returns. Information about multiple products / services and their operation in different geographical areas are called segment information. Such information is used to assess the risk and return of multiple products/services and their operation in different geographical areas. Disclosure of such information is called segment reporting.

AS 18-Related Party Disclosure: Sometimes business transactions between related parties lose the feature and character of the arms length transactions. Related party relationship affects the volume and decision of business of one enterprise for the benefit of the other enterprise. Hence disclosure of related party transaction is essential for proper understanding of financial performance and financial position of enterprise.

AS 19-Accounting for leases: Lease is an arrangement by which the lesser gives the right to use an asset for given period of time to the lessee on rent. It involves two parties, a lessor and a lessee and an asset which is to be leased. The lessor who owns the asset agrees to allow the lessee to use it for a specified period of time in return of periodic rent payments.

AS 20-Earning Per Share: Earning per share (EPS) is a financial ratio that gives the information regarding earning available to each equity share. It is very important financial ratio for assessing the state of market price of share. This accounting standard gives computational methodology for the determination and presentation of earning per share, which will

improve the comparison of EPS. The statement is applicable to the enterprise whose equity shares or potential equity shares are listed in stock exchange.

AS 21-Consolidated Financial Statements: The objective of this statement is to present financial statements of a parent and its subsidiary (ies) as a single economic entity. In other words the holding company and its subsidiary (ies) are treated as one entity for the preparation of these consolidated financial statements. Consolidated profit/loss account and consolidated balance sheet are prepared for disclosing the total profit/loss of the group and total assets and liabilities of the group. As per this accounting standard, the consolidated balance sheet if prepared should be prepared in the manner prescribed by this statement.

AS 22-Accounting for Taxes on Income: This accounting standard prescribes the accounting treatment for taxes on income. Traditionally, amount of tax payable is determined on the profit/loss computed as per income tax laws.

AS 23-Accounting for Investments in Associates in consolidated financial statements: The accounting standard was formulated with the objective to set out the principles and procedures for recognizing the investment in associates in the consolidated financial statements of the investor, so that the effect of investment in associates on the financial position of the group is indicated.

AS 24-Discontinuing Operations: The objective of this standard is to establish principles for reporting information about discontinuing operations. The focus of the disclosure of the Information is about the operations which the enterprise plans to discontinue rather than disclosing on the operations which are already discontinued. However, the disclosure about discontinued operation is also covered by this standard.

AS 25-Interim Financial Reporting (IFR): Interim financial reporting is the reporting for periods of less than a year generally for a period of 3 months.

AS 26-Intangible Assets : An Intangible Asset is an Identifiable non-monetary Asset without physical substance held for use in the production or supplying of goods or services for rentals to others or for administrative purpose

AS 27-Financial Reporting of Interest in joint ventures: Joint Venture is defined as a contractual arrangement whereby two or more parties carry on an economic activity under 'joint control'. Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefit from it. 'Joint control' is the contractually agreed sharing of control over economic activity.

AS 28 Impairment of Assets: The dictionary meaning of 'impairment of asset' is weakening in value of asset. In other words when the value of asset decreases, it may be called impairment of an asset. As per AS-28 asset is said to be impaired when *carrying amount* of asset is more than its *recoverable amount*.

Carrying Amount means book value of Asset

Recoverable Amount means Market value of Asset

AS 29-Provisions, Contingent Liabilities And Contingent Assets: Objective of this standard is to prescribe the accounting for Provisions, Contingent Liabilities, Contingent Assets, Provision for restructuring cost

Provision: It is a liability, which can be measured only by using a substantial degree of estimation

Liability: A liability is present obligation of the enterprise arising from past events the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.



INTRODUCTION TO IFRS

Unit Structure

4.1 Introduction

4.2 Purpose

4.3 Scope

4.4 International Financial Reporting Standards

4.1 INTRODUCTION

IFRS stands for **International Financial Reporting Standards**. IFRS are developed by International Accounting standards boards (IASB). IFRS is set of standards used in many parts of the world, including the European Union, Hong Kong, Australia, Malaysia, Russia, South Africa, Singapore etc. for preparation of financial statements. Different Countries uses different set of accounting standards while preparation of financial statements for e.g. India uses its own set of Accounting standards issued by the ICAI, United states have their US GAAP, Canada has its Canadian GAAP and United Kingdom has its UK GAAP.

Conceptual Framework

Introduction: Financial statements are prepared and presented for external users by many many entities around the world. Although such financial statements may appear similar from country to country, there are differences which have probably been caused by a variety of social, economic and legal circumstances and by different countries having in mind the needs of different users of financial statements when setting national requirements.

The International Accounting Standards Board is committed to narrowing these differences by seeking to harmonize regulations, accounting standards and procedures relating to the Preparation and presentation of financial statements. It believes that further harmonization can best be pursued by focusing on financial statements that are prepared for the purpose of providing information that is useful in making economic decisions.

The Board believes that financial statements prepared for the purpose of making economic decisions meet the common needs of most users. This is because nearly all users are making economic decisions, for example:

- (a) to decide when to buy, hold or sell an equity investment.
- (b) to assess the stewardship or accountability of management.

- (c) to assess the ability of the entity to pay and provide other benefits to its employees.
- (d) to assess the security for amounts lent to the entity.
- (e) to determine taxation policies.
- (f) to determine distributable profits and dividends.
- (g) to prepare and use national income statistics.
- (h) to regulate the activities of entities.

The Board recognises, however, that governments, in particular, may specify different or additional requirements for their own purposes. These requirements should not, however, affect financial statements published for the benefit of other users unless they also meet the needs of those other users.

4.2 PURPOSE

This Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Conceptual Framework is:

- (a) To assist the Board in the development of future IFRSs and in its review of existing IFRSs;
- (b) To assist the Board in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs;
- (c) To assist national standard-setting bodies in developing national standards;
- (d) To assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS;
- (e) To assist auditors in forming an opinion on whether financial statements comply with IFRSs;
- (f) To assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs; and
- (g) To provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

4.3 SCOPE

The Conceptual Framework deals with:

- (a) the objective of financial reporting;
- (b) the qualitative characteristics of useful financial information;
- (c) the definition, recognition and measurement of the elements from which financial statements are constructed; and
- (d) concepts of capital and capital maintenance.

4.4 INTERNATIONAL FINANCIAL REPORTING STANDARDS

International Financial Reporting Standards in a broad sense comprise:

- ❖ ***Conceptual Framework for Financial Reporting***—stating basic principles and grounds of IFRS
- ❖ ***IAS***—standards issued before 2001
- ❖ ***IFRS***—standards issued after 2001
- ❖ ***SIC***—interpretations of accounting standards, giving specific guidance on unclear issues
- ❖ ***IFRIC***—newer interpretations, issued after 2001

IFRSs

IFRS 1: First time Adoption of International Financial Reporting Standards

IFRS 2: Share-based Payment

IFRS 3: Business Combinations

IFRS 4: Insurance Contracts

IFRS 5: Non-current Assets Held for Sale and Discontinued Operations

IFRS 6: Exploration for and Evaluation of Mineral Resources

IFRS 7: Financial Instruments: Disclosures

IFRS 8: Operating Segments

IFRS 9: Financial Instruments

IFRS 10: Consolidated Financial Statements

IFRS 11: Joint Arrangements

IFRS 12: Disclosure of Interests in Other Entities

IFRS 13: Fair Value Measurement

IFRS 14: Regulatory Deferral Accounts

IFRS 15: Revenue from Contracts with Customers

IASs

IAS 1: Presentation of Financial Statements

IAS 2: Inventories

IAS 7: Statement of Cash Flows

IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors

IAS 10: Events after the Reporting Period

IAS 11: Construction Contracts*

IAS 12: Income Taxes

IAS 16: Property, Plant and Equipment

IAS 17: Leases

IAS 18: Revenue*

IAS 19: Employee Benefits

IAS 20: Accounting for Government Grants and Disclosure of Government Assistance

IAS 21: The Effects of Changes in Foreign Exchange Rates

Note: IAS 3, 4, 5, 6, 9, 13, 14, 15, 22, 25, 30, 31 and 35 have been superseded SICs

SIC 7: Introduction of the Euro

SIC 10: Government Assistance – No Specific Relation to Operating Activities

SIC 15: Operating Leases – Incentives

SIC 25: Income Taxes – Changes in the Tax Status of an Entity or its Shareholders

SIC 27: Evaluating the Substance of Transactions Involving the Legal Form of a Lease

SIC 29: Service Concession Arrangements: Disclosures

SIC 31: Revenue – Barter Transactions Involving Advertising Services

SIC 32: Intangible Assets – Web Site Costs

Note: SIC 1, 2, 3, 4, 5, 6, 8, 9, 11, 12, 13, 14, 16, 17, 18, 19, 20, 21, 22, 23, 24, 26, 28, 30, 33 have been superseded

*Will be superseded by IFRS 15 as of 1 January 2017

IFRICs

IFRIC 1: Changes in Existing Decommissioning, Restoration and Similar Liabilities

IFRIC 2: Members' Shares in Co-operative Entities and Similar Instruments

IFRIC 4: Determining whether an Arrangement contains a Lease

IFRIC 5: Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

IFRIC 6: Liabilities Arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment

IFRIC 7: Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies

IFRIC 10: Interim Financial Reporting and Impairment

IFRIC 12: Service Concession Arrangements

IFRIC 13: Customer Loyalty Programmes*

IFRIC 14: IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction

IFRIC 15: Agreements for the Construction of Real Estate*

IFRIC 16: Hedges of a Net Investment in a Foreign Operation

IFRIC 17: Distributions of Non-cash Assets to Owners

IFRIC 18: Transfers of Assets from Customers*

IFRIC 19: Extinguishing Financial Liabilities with Equity Instruments

IFRIC 20: Stripping Costs in the Production Phase of a Surface Mine

IFRIC 21: Levies

Note: IFRIC 3, 8, 9 & 11 have been withdrawn



BASICS OF BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

Unit structure:

5.1 Objectives

5.2 Introduction

5.3 Meaning and Types of Financial Statements

5.4 Parties Interested In Financial Statements

5.5 Basics of Income Statement and Balance Sheet

5.6 Limitation of financial statement

5.7 Exercise

5.1 OBJECTIVE

After studying the unit, the students will be able to -

- Understand the meaning and types of financial statement.
- Know the parties interested in Financial statements
- Understand the objectives of Financial statements
- Explain the basics of Financial statements

5.2 INTRODUCTION

Government legislations require certain organizations to maintain proper accounts and draw financial statement. Public can understand from the financial statement the extent to which a company is discharging its social responsibilities. While issuing shares, bonds, financial statement become necessary as prospective investors can judge the financial position of the organization and able to take a proper decision. Workers union may study the financial statement and ascertain whether they can enforce their demand. Tax legislature makes it obligatory for the business entities to draw fair and objective financial statement. The financial statement serves as instruments to regulate equity and debentures issued by companies.

5.3 MEANING AND TYPES OF FINANCIAL STATEMENTS

Meaning:

Financial statements are plain statements based on historical records, facts and figures. They are uncompromising in their objectives, nature and truthfulness. They reflect a judicious combination of recorded facts, accounting principles, concepts and conventions, personal judgements and sometimes estimates.

Financial statements consist of 'Revenue Account' and 'Balance Sheet'.

1. Revenue Account / Income Statement:

Revenue Account refers to 'Profit and Loss Account' or 'Income and Expenditure Account' or simply 'Income Statement'. Revenue Account may be split up or divided into 'Manufacturing Account', 'Trading Account', 'Profit and Loss Account' and 'Profit and Loss Appropriation Account'. Revenue Account is prepared for a period, covering one year. This statement shows the expenses incurred on production and distribution of the product and sales and other business incomes. The final result of this statement may be profit or loss for a particular period.

2. Balance Sheet:

Balance sheet shows the financial position of a business as on a particular date. It represents the assets owned by the business and the claims of the owners and creditors against the assets in the form of liabilities as on the date of the statement.

3. Funds Flow Statement –

It describes the sources from which the additional funds were derived and the use of these funds. Funds flow statement helps to understand the changes in the distribution of resources between two balance sheet periods. The statement reveals the sources of funds and their application for different purposes.

4. Cash flow Statement:

A cash flow statement shows the changes in cash position from one period to another. It shows the inflow and outflow of cash and helps the management in making plans for immediate future. An estimated cash flow statement enables the management to ascertain the availability of cash to meet business obligations. This statement is useful for short term planning by the management.

5. Schedules:

Schedule explains the items given in income statement and balance sheet. Schedules are a part of financial statements which give detailed information about the financial position of a business organization.

5.4 PARTIES INTERESTED IN FINANCIAL STATEMENTS

In recent years, the ownership of capital of many public companies has become truly broad based due to dispersal of shareholding. Therefore, one may say that the public in general has become interested in financial statements. However, in addition to the share holders, there are other persons and bodies who are also interested in the financial results disclosed by the annual reports of companies. Such persons and bodies include:

1. Creditors, potential suppliers or others doing business with the company;
2. Debenture-holders;
3. Credit institutions like banks;
4. Potential Investors;
5. Employees and trade unions;
6. Important customers who wish to make a long standing contract with the company;
7. Economists and investment analyst;
8. Members of Parliament, the Public Accounts Committee and the Estimates Committee in respect of Government Companies;
9. Taxation authorities;
10. Other departments dealing with the industry in which the company is engaged; and
11. The Company Law Board

Financial Statement analysis, therefore, has become of general interest.

5.5 OBJECTIVES OF FINANCIAL STATEMENTS

The main object of financial statements is to provide information about the financial position, performance and changes taken place in an enterprise. Financial statements are prepared to meet the common needs of most users. The important objectives of financial statements are given below:

1. Providing information for taking Economic decisions:

The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines the capacity of an enterprise to pay its employees and suppliers meet interest payments, repay loans and make distributions to its owners.

2. Providing information about financial position:

The financial position of an enterprise is effected by the economic resources it controls, its financial structures its liquidity and solvency and its capacity to adapt to changes in the environment in which it operates.

Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise. This information is useful in predicting how successful the enterprise is likely to be in raising further finance. Information about liquidity and solvency is useful to predicting the ability of the enterprise to meet the financial commitments as fall due.

3. Providing information about performance(working results) of an enterprise:

Another important objective of the financial statements is that it provides information about the performance and in particular its profitability, which requires in order assessing potential changes in the economic resources that are likely to control in future. Information about performance is useful in predicting the capacity of the enterprise to generate cash inflows from its existing resource base as well in forming judgment about the effectiveness with which the enterprises might employ additional resources.

4. Providing Information about changes in financial position:

The financial statements provide information concerning changes in the financial position of an enterprise, which is useful in order to assess its investing, financing and operating activities during the reporting periods. This information is useful in providing the user with a basis to assess the ability of the enterprise to generate cash and cash equipments and the needs of the enterprise to utilize those cash flows.

5.6 BASICS OF INCOME STATEMENT AND BALANCE SHEET

Each business firm has to prepare two main financial statements viz. Income Statement and Balance sheet. The income statement reveals the profit of loss during a particular period generated from the activities of a business. Balance sheet shows the financial position of a business on a particular date.

- **Income statement**

Income statement summaries the incomes /gains and expenses /losses of a Business for a particular financial period. The format of Income statement explains in detail the items to be included in the statement. It is presented in the traditional T Format and also in the vertically statement form.

1. Horizontal Form T form Manufacturing Trading and Profit and Loss Account For the year ending

Dr.

Cr.

Particulars	Rs.	Particulars	Rs.
To Opening stock		By Closing stock	
Raw materials		Raw Material	
Work in progress		Work in progress	
To Purchase of raw materials		By Cost of finished goods c/d	
To Manufacturing wages		By Sales	
To Carriage/ Freight inwards		By Closing stock of Finished Goods	
To Custom duty		By Gross Loss c/d	
To Other factory		By Gross profit b/d	
To Opening stock		By Business incomes and Gains	
Finished Goods		By Net Loss c/d	
To Cost of finished		By Balance b/d from Previous year	
Goods b/d		By Net Profit b/d	
To Gross profit c/d			
To Gross loss b/d			
To Office and administration Expenses			
To Interest and financial Expenses			
To Provision for Income tax			
To Net Profit c/d			
To Net loss b/d			
To Transfer to General reserve			
To Dividend			
To Balance c/f			

Particulars	Rs.	Rs.
Gross Sales		xxx
Less : Sales returns	xxx	
Sales tax / Excise duty		
Net Sales		xxx
Less : Cost of goods sold		
(Materials consumed + Direct Labour+Manufacturing Expenses)	xxx xxx xxx	
Add / Less : Adjustment for change in stock	xxx	xxx
Gross Profit		xxx
Less : Operating expenses	xxx	
a. Office and administration Expenses	xxx	
b. Selling and distribution Expenses	xxx	xxx
Add : Operating Income		xxx
Operating Profit	xxx	
Add : Non Operating Income		xxx
Less : Non Operating expenses (including interest)		xxx
Profit before interest and tax		xxx
Less : Interest		xxx
Profit before tax		xxx
Less : Appropriations:	xxx	xxx
a. Transfer to reserves	xxx	xxx
b. Dividends declared / paid		xxx
Surplus carried to Balance Sheet		xxx

- **Balance sheet:**

It is one of the major financial statements which presents a company's financial position at the end of a specified date. Balance sheet has been described as a "snapshot" of the company's financial position at a moment for e.g. the amounts reported on a balance sheet dated March 31st, 2016 reflects that all the transactions throughout December 31st have been recorded. The balance sheet provides information related to the assets, liabilities and the shareholders' equity of the company as on a specific date.

Total Assets = Total Liabilities + Share holders' equity

The companies Act, 1956 stipulates that the balance sheet of a joint stock company should be prepared as per Part I of Schedule VI of the Act. However, the statement form has been emphasized upon by accountants for the purpose of analysis and interpretation.

Understanding Corporate Balance Sheet: A. Assets side:

1. Fixed Assets:

Fixed Assets are called long-term assets. These assets are used over several periods. They are major sources of revenue to the business. They are intended for long term use in the business. They are called “bundle of future services” or “Sunk Costs”. The group of fixed assets is explained in the proforma. Generally the Fixed assets are classifies as:

- a) Tangible movable assets;
 - b) Tangible immovable assets; and
 - c) Intangible assets.
- a) **Tangible movable assets** are the assets which can be seen, touched and moved from one place to another place. Plant and Machinery, furniture and fixtures, transportation equipments etc. are tangible movable assets.
 - b) **Tangible immovable assets** are the assets which can be seen and touched but cannot be moved from one place to another place. Such assets include land, buildings, mines, oil wells, etc.
 - c) **Intangible assets** are the assets which cannot be seen and touched. However, their existence can only be imagined such as patents, trademarks, copyrights, goodwill, etc.

The Fixed Assets are presented as:

Gross Block - Provision for Depreciation = Net Blocks

2. Investments:

Investments may be short-term or long term. Short-term investments are marketable securities and they represent temporary investments of idle funds. These investments can be disposed off by the company at any time. Investments are shown at cost. Cost includes brokerage, fees and all other expenses incurred on acquisition of investments. However, the market value is shown by way of a note.

Long-term investments are held for a long time. They are required to be held by the business by the very nature and conditions of the business. For example, a company engaged in generating electricity may be required to hold the bonds of the Electricity Board. These bonds are retained by the company so long as the company uses electric power.

As per Schedule VI of the Indian Companies Act 1956, investments are shown separately, showing the nature of investments and the mode of valuation of various classes of securities.

Long term Investments are grouped under fixed assets and short term investments under current assets.

3. Current Assets, Loans and Advances:

The item, “Current Assets, Loans and Advances” is divided into two parts:

- a. Current Assets, and
- b. Loans and Advances.

a. Current Assets and Quick assets:

“Current Assets include cash and the other assets that are likely to be converted into cash and the cash thus generated is available to pay current liabilities. Current assets are not intended for long-term use in business. Current assets represent employment of money by the company on a short-term basis. They circulate within the group. **For example**, cash becomes raw material when material is purchased, material becomes finished goods, finished goods become cash or debtors when sold and so on.

Current Assets = Stock + Debtors + Cash & Bank + Loans & Advances + Marketable Securities + Other Current Assets

In fact, total current assets are known as “Gross Working Capital”. Current assets less current liabilities are known as ‘net working capital’.

Quick Assets are known as ‘near cash’ assets. In other words, quick assets are those which can be converted into cash quickly. Therefore, they are also known as liquid assets. Cash and bank balances are the most liquid assets. Debtors and cash advances can be converted into cash at a short notice. Therefore, they are also regarded as quick assets. Marketable investments can be converted into cash, fall into the category of quick assets. Inventory does not fall in this category of quick assets, since it cannot be converted into cash quickly, as material is to be converted into finished goods and then they should be sold. Expenses paid in advance do not satisfy the criteria of quick assets. They cannot be converted into cash. They can be received in the form of services.

Therefore Quick Assets = Current Assets – Inventory – Prepayments

b. Loans and Advances:

Loans and advances given are current assets. It includes different types of advances such as advances against salary, advances

against machinery, advances to subsidiary, prepaid expenses on account of rent, taxes, insurance, etc.

4. Miscellaneous Expenditures and losses:

This heading covers Fictitious Assets and other expenses which are made for future on a mass basis. These expenses are really not assets but the whole balance on the account of these items is not charged to current year's Profit and Loss A/c therefore the amount to the extent not written off or adjusted is shown on the Assets side as Miscellaneous expenditures.

The **examples** of fictitious assets are:

- a. Preliminary expenses.
- b. Brokerage on issue of shares and debentures.
- c. Discount on issue of shares and debentures.
- d. Share or debenture issue expenses.
- e. Heavy Advertisement and Publicity expenditure.
- f. Profit and Loss A/c debit balance.

Liquidity means easy convertibility into cash. Though ultimately all assets are converted into cash, the term liquidity refers not only to the nature of assets but also to the purposes of holding the assets. Assets are normally arranged in order of permanency i.e., from least liquid to most liquid.

B. Liabilities Side

The term 'liability' when used in accounting, means a debt. A debt is something that a person or an organization owes to another person or organization. In other words, Liabilities are the claims of outsiders against the business. Technically speaking, all liabilities shown in a balance sheet are claims against all assets shown in it. But, there may be certain cases where a liability has a claim against a specific asset. Even under such circumstances, the liabilities are shown separately, not as a deduction from the specific assets.

Classification of Liabilities:

The liabilities of an enterprise may be classified into three categories

1. Permanent Funds or Proprietors' Funds.
2. Semi-permanent Funds or Long-term Borrowings.
3. Current liabilities and Provisions.

1. Proprietor's Funds:

These are the funds provided by the proprietors (owners) or the shareholders. Proprietors' fund represents the interest of the proprietors in the business. This is the amount belonging to the proprietors. Proprietors' fund is also called as

‘Proprietors’ Equity’, ‘Owners’ Funds’, or ‘Shareholders’ Funds’. This is also known as the ‘Net Worth’ of the business. Owners’ Equity refers to the claim of the owners it includes:

Owners’ Equity = Capital (May be Equity Share Capital only or Equity and Preference Share Capital) + Reserves + Profit and Loss A/c credit balance – Accumulated losses and Fictitious assets.

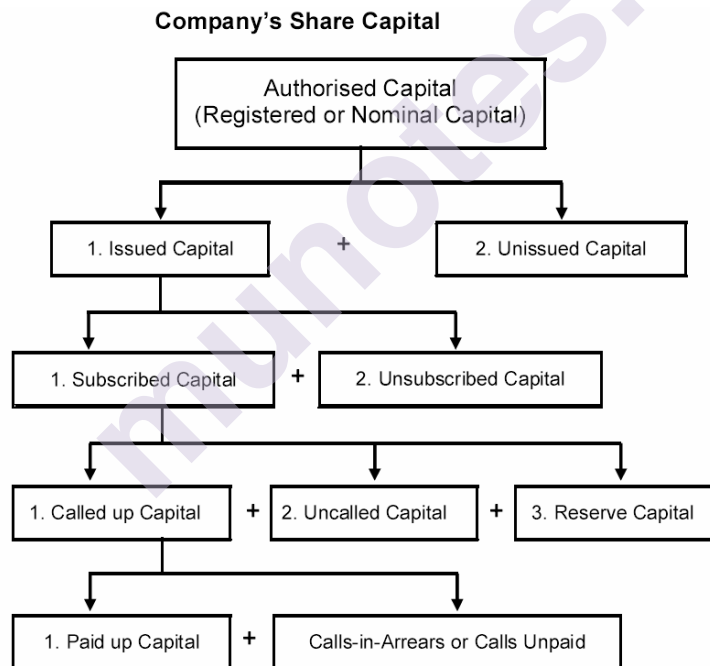
Owners’ equity increase either through fresh investments by the owners or by way of increasing the earnings retained i.e., profits not distributed. (Retained earnings are that part of the total earnings which have been retained for use in the business)

a. SHARE CAPITAL:

Share capital is the amount that is raised by a company from the public at large, through the issue of shares. There are different concepts of share capital from the legal and accounting points of view.

The following chart details the different concepts of capital :

Company’s Share Capital



i. **Authorised Capital** : Authorised Capital is the maximum capital a company can raise as mentioned in the Memorandum of Association under its Capital Clause.

ii. **Issued Capital** : A company usually does not need the entire registered capital. Issued capital is that part of the Authorised capital; which is actually offered to the prospective investors for subscription. The balance of the Authorised capital which is not issued is called the ‘unissued capital.’

iii. Subscribed Capital : Subscribed capital is that part of the issued capital which has been subscribed or taken up by the public. Therefore, the subscribed capital may be equal to or less than the issued capital.

Called up Capital Uncalled Capital: The company, therefore, may collect the capital in several instalments as per its need. The called-up capital is that portion of the subscribed capital which has been called or demanded by the company to be paid. The capital that is not demanded from the shareholders is called uncalled capital.

iv. Paid up Capital: Paid up capital is that part of the called up capital which has been actually paid by the members. The paid-up capital is the called-up amount less calls not paid. (Calls unpaid or calls-in-arrears).

v. Reserve Capital : It is that part of the uncalled capital which may only be demanded on winding up or liquidation, but not when the company is a going on. A company may determine this amount by a Special Resolution.

b. RESERVES AND SURPLUS:

A business may have to meet certain compulsory or voluntary, foreseen or unforeseen, recurring or non-recurring obligations in future. It is advantageous to for the organization to make provision in advance to meet them. If not sudden payment may adversely affect the financial health of the company. In order to avoid such situations some part of profit are retained in each year which is termed as 'Retained Earnings' or 'Plough Back of profits'. It means the reserves represent amounts set aside out of divisible profits. They are appropriations of profits. Indian Companies Act requires every company to transfer a specific percentage (upto 10%) of the profits to "Reserve" accounts.

Reserve created for a specific purpose is called as a "Specific Reserve" and a reserve created for a general purpose is called as a "General Reserve." General reserves are free and can be utilized for Payment of Dividends, Development and expansion purpose or for any other purpose the company thinks proper.

According to Companies Act "Reserve shall not include any amount written off by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability."

It is compulsory for the business organization to disclose each individual head of the reserves in the balance sheet with its opening balance as per last balance sheet, additions thereto and deductions there from in the current yare.

2. LONG-TERM LIABILITIES:

A company raises finance either from owners or through external borrowings. External borrowings of a company which constitute its "owed funds" are important sources of long-term finance. These

borrowings are termed as 'fixed liabilities' or 'term liabilities' or 'long term-loans'. They may take various forms such as debentures, public deposits, bank loans, deferred payments, etc. They may be fully secured or partly secured or unsecured.

3. CURRENT LIABILITIES AND PROVISIONS:

a. Current Liabilities:

Current liabilities are those short-term obligations of an enterprise which mature within one year or within the operating cycle. They constitute short-term sources of finance. It includes Sundry Creditors, Bills Payable, Interest accrued but not due, outstanding expenses, Unclaimed dividends and Bank Overdraft.

These liabilities are not normally secured and no interest is payable on them with the exception of bank overdrafts. These liabilities, are generally paid off by utilizing current assets or by creating a current liability.

Actually all current liabilities are payable within a short period of time. However, Bank Overdraft is the current liability which is not paid immediately or in a very short-time, in practice. Therefore, **Bank Overdraft is not considered as a quick liability**. It is a permanent arrangement with the banker. Hence

$$\text{Quick Liabilities} = \text{Current Liabilities} - \text{Bank Overdraft}$$

b. Provisions:

'Provision' means any amount retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. Provisions have to be made for maintaining the integrity of assets or for known liabilities. Although the amount of liability is not certain organization has to made provision on best estimates. The examples of provisions are Provision for depreciation on assets, Provision for doubtful debts, Provision for proposed dividends, Provision for taxation.

4. CONTINGENT LIABILITIES:

According to ICAI, Contingent liability refers to an obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events. These liabilities may or may not be converted into actual liabilities at some future date. It is a liability which may or may not occur. But on the date of the Balance Sheet, it is not known definitely whether the liability would arise or not. But as a matter of caution, it is indicated in the balance sheet for the sake of information and disclosure, under the head "Contingent Liabilities. Some of the examples of Contingent Liabilities are Discounted Bills of Exchange, Disputed liability on account of income-tax, etc., about which appeal has been filed, Uncalled amount on partly paid-up shares and debentures held by the company as investments, Cumulative preference dividend in arrears, Matters referred

to arbitration, Claims not acknowledged as debts, Estimated amount of contracts remaining to be executed on capital account and not provided for, Guarantees given by the company, Bonds executed. and debentures held by the company as investments, Cumulative preference dividend in arrears, Matters referred to arbitration, Claims not acknowledged as debts, Estimated amount of contracts remaining to be executed on capital account and not provided for, Guarantees given by the company, Bonds executed.

Following are the proforma of the Balance sheet

1) Horizontal Form:

Liabilities	Rs	Assets	Rs
Share Capital (with all particulars of authorized, issued, subscribed and Called up capital) Less: Calls in arrears Add: Forfeited shares		Fixed Assets 1. Goodwill 2. Land and Building 3. Lease hold Property 4. Plant and Machinery 5. Furniture and fixture 6. Patents and trade marks 7. Vehicles	
Reserve and Surplus 1. Capital Reserve 2. Capital Redemption Reserve 3. Share premium 4. Other Reserves Less: P&L a/c Debit balance 5. Profit and Loss appropriation A/c 6. Sinking fund A/c		Investments Current assets, Loans and Advances a. Current assets 1. Interest accrued on Investment 2. Loose tools 3. Stock in Trade 4. Sundry debtors Less Provision for Bad debts 5. Cash in Hand 6. Cash at Bank	

Long term loans a. Secured loan Debentures Add: Outstanding Interest Loan from Banks b. Unsecured loans Fixed deposits Short term loans and advances Current liabilities and Provisions a. Current liabilities 1. Bills payables 2. Sundry creditors 3. Bank overdraft 4. Income received in advance 5. Unclaimed Dividends 6. Other liabilities b. Provisions 1. Provision for taxation 2. Proposed dividends 3. Provident fund and Pension fund Contingent Liabilities		b. Loans and Advances 1. Advances to subsidiaries 2. Bills receivables 3. Prepaid expenses Miscellaneous expenditure 1. Preliminary expenses 2. Discount on issue of shares and Debentures 3. Underwriting commission 4. Profit and Loss a/c (debit balance)	
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2. Vertical Form

Income Statement of for the year ending

Previous	Particulars	Schedule	Current Year
	I. Sources of Funds 1. Shareholders' Funds a. Capital b. Reserves and surplus 2. Loan funds a. Secured loan b. Unsecured loans TOTAL II. Application of Funds 1. Fixed Assets a. Gross Block Less Depreciation		

	b. Net Block 2. Investments 3. Current Assets, Loans and Advances Less Current Liabilities and Provisions Net Current Assets 4. Miscellaneous expenditure to the extent not written off or adjusted Profit and Loss a/c debit balance <div style="text-align: right;">TOTAL</div>		

- **Statement of Retained Earnings:**

The Statement of Retained Earnings is prepared to show how the balance in Profit and Loss accounts is appropriated for various purposes like provision for dividend, transfer to reserves etc. The balance on this account is finally shown on the Balance sheet Under the heading Reserve and Surplus.

5.6 LIMITATION OF FINANCIAL STATEMENT

Following are the limitations of financial statements:

1. The information being of historical nature does not reflect the future.
2. It is the outcome of accounting concept, convention combined with personal judgement.
3. The statement portrays the position in monetary term. The profit or loss position excludes from their purview things which cannot be expressed or recorded in term of money.

To overcome from the limitations it becomes necessary to analyse the financial statements.



MODULE - IV

6

ACCOUNTING RECORDS

Unit Structure

6.1 Introduction

6.2 Process of Transaction and Its Record Generation

6.3 What is an Account?

6.4 Final Accounts

6.5 Horizontal or 'T' Format of Trading & P&L A/C

6.6 Vertical Format of Balance Sheet

6.1 INTRODUCTION

Accounting involves a series of processes like measuring economic value of a transaction, recording it and reporting it to various stake holders. Accounting information is used by a variety of users, like investors, creditors, workers, management, and government.

Accounting can be divided into financial accounting, management accounting, auditing, and tax accounting. Financial accounting focuses on the reporting of an organization's financial information, including the preparation of financial statements, to external users of the information, such as investors, regulators and suppliers and management accounting focuses on the measurement, analysis and reporting of information for internal use by management. The recording of financial transactions, so that summaries of the financials may be presented in financial reports, is known as bookkeeping, of which double-entry bookkeeping is the most common system.

Accounting records means internal or external documentary evidence maintained within the organisation to record the economic transaction which has taken place. These are important sources of information and evidences that are used to prepare the financial statements.

In book keeping and accountancy we will be recording only monetary transactions.

Accounting records can take on many forms and include:

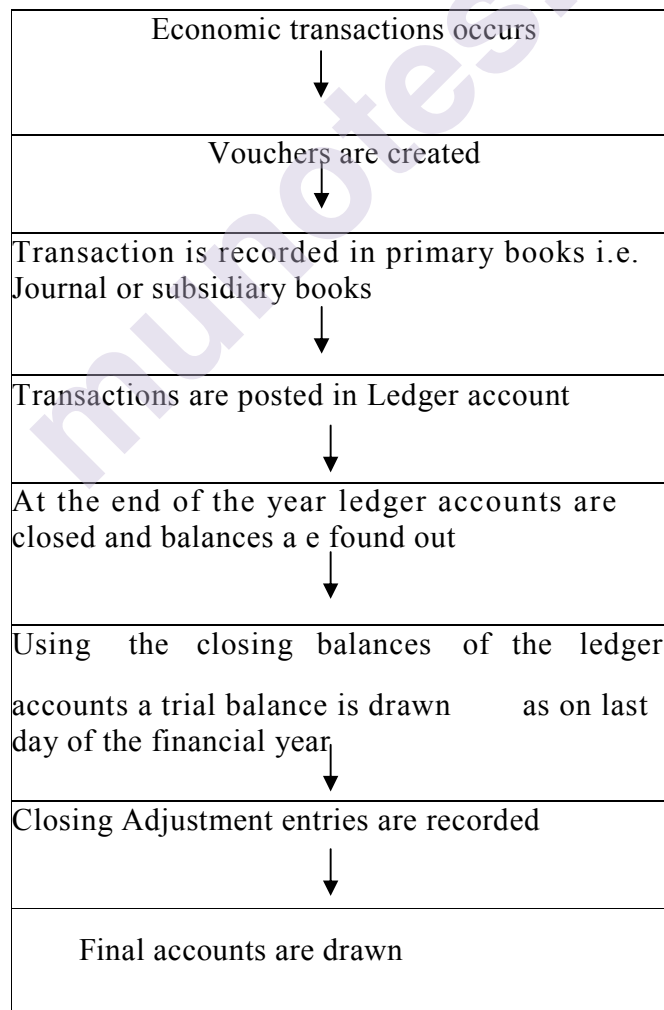
- Invoices
- Vouchers
- Ledgers

- Journals
- Bank statements
- Contracts and agreements
- Verification statements
- Transportation receipts etc.

Vouchers are most important document in accounting records. Vouchers form basis for recording any transaction. Account voucher is an accounting document representing an internal intent to make a payment to an external entity, such as a vendor or service provider. A voucher is produced usually after receiving a vendor invoice, after the invoice is successfully matched to a purchase order. A voucher will contain detailed information regarding the payee, the monetary amount of the payment, a description of the transaction, and more.

6.2 PROCESS OF TRANSACTION AND ITS RECORD GENERATION

Let us see the entire process of accounting with the help of a chart



Now let us discuss the entire procedure in the order of flow chart

1. Economic transactions occurs: In accounts we record only those transaction which has some monetary value. Accountancy is more of a historical record as it records whatever happens in money terms. One should not get confused with non cash and non-monetary transactions. A non cash transaction can be a monetary transaction e.g providing depreciation on fixed assets, is a non cash transaction but it is a monetary transaction as we know the amount of depreciation in money terms.

2. Vouchers are created: Whenever any transaction takes place a voucher is created depending upon the nature of transaction. Vouchers may be of following types

1. Receipt voucher
2. Payment vouchers
3. Journal vouchers
4. Cash memo
5. Contra entry vouchers
6. Purchase and returns invoice vouchers 7. Sales and returns vouchers

A voucher complete in all respects forms basis for recording the transaction. To be called a complete document it should be properly dated, amounted, authorised and signed by the party.

Any documentary evidence supporting the entries recorded in the books of accounts, establishing the arithmetic accuracy of the transaction, may also be referred to as a voucher for example, a bill, invoice, receipt, salary and wages sheet, memorandum of association, counterfoil of paying-in slip, counterfoil of cheque book, or trust deed.

Normally the following types of vouchers are used:

- (i) Receipt Voucher
- (ii) Payment Voucher
- (iii) Journal Voucher
- (iv) Supporting Voucher

Let us discuss each of these:

(i) Receipt Voucher:

A Receipt voucher is used to record cash or bank receipt. Receipt vouchers are of two types which are as follows:

(a) Cash receipt voucher – These vouchers are created whenever any cash generation transaction occurs. E.g. sale of scrap for cash.

(b) Bank receipt voucher – it indicates receipt of a cheque or demand draft i.e. money is not received in the form of cash in hand, instead, the money will be credited to the bank account of the assessee.

Contents of Receipt/Credit Voucher:

The following information are usually available from a receipt/credit voucher:

- (a) Names and address of the parties;
- (b) Date of preparing the voucher;
- (c) Voucher Number;
- (d) Amount of the transaction;
- (e) Heads of account;
- (f) Signature of the person who is preparing the voucher;
- (g) Authorized Signatory;
- (h) Narrations, i.e., short description of the transaction, and
- (i) Number of Supporting Voucher.

<u>CREDIT VOUCHER</u>										
Oriental Company G.S Road, Bhangagarh, Guwahati – 781005										
Voucher No. _____	Date _____									
CREDIT _____ A/C Being _____ _____	<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th colspan="2" style="text-align: center; padding: 2px;">Amount</th> </tr> <tr> <th style="width: 80%; text-align: center; padding: 2px;">Rs.</th> <th style="width: 20%; text-align: center; padding: 2px;">P</th> </tr> </thead> <tbody> <tr> <td style="height: 40px;"></td> <td></td> </tr> <tr> <td style="height: 20px;"></td> <td></td> </tr> </tbody> </table>		Amount		Rs.	P				
Amount										
Rs.	P									
(Rupees Only)	Total:									
Accountant	Manager	Proprietor								

ii). Payment/debit Voucher:

A payment voucher is just the opposite of a receipt voucher. In the above, cash/ bank was debited, while in this case, cash or bank will be credited. In the above case, there was an inflow of funds, while in this case, there is an outflow of funds. A Payment voucher is used to record a payment of cash or cheque. Payment vouchers are also of two types which are:

- (a) Cash Payment voucher – it denotes payment of cash
- (b) Bank Payment voucher – it indicates payment by cheque or demand draft i.e. money is not paid in the form of cash in hand, instead, the money will be debited from the bank account of the assessee

Contents of payment/debit Vouchers:

The following information are normally available from a debit voucher:

(a) Names and Addresses of the Party (b) Date of voucher; (c) Voucher Sr. Number; (d) Amount or value of the transaction; (e) Heads of Account; (f) Signature of the person who is preparing the voucher; (g) Authorized signatory; (h) Narration i.e., short description of the transaction and (i) Number of supporting Vouchers.

The format of a Debit Voucher is presented:

Payment Voucher		
Ref No: _____		
Amount:	Date:	
Method of Payment		
Cash:	Check#:	
To:		
The Sum of:		
Being:		Payee:
Approved By:	Paid By:	Signature

(If the amount of transaction exceeds Rs. 500 a revenue stamp valued Re 1. should be affixed.)

iii) Journal Voucher:

These vouchers are used for non-cash transactions, they are basically used as a documentary evidence. e.g., Goods sold on credit. In such cases, the cash or the bank account of the assessee is unaffected. In the case of Goods sold on credit, the Voucher would debit the Debtor to whom the goods are sold on credit, while sales on credit account would be credited further.


<u>JOURNAL VOUCHER</u>	
Voucher No.	Dated.....
DEBIT A/C	Amount (Rs)
.....	xxxxxxxx
Total Rs.	xxxxxxxx
CREDIT A/C	.....
.....	xxxxxxxx
(Rupees) only Total Rs.	xxxxxxx
Accountant	Manager Partner/Proprietor

These vouchers are the documentary evidence of transactions that have happened. For example, you can attach the bill of an expense along with the original voucher just to further support the primary voucher. Petrol Bills attached with the conveyance vouchers are a good example of Supporting Vouchers. Supporting Vouchers are the documentary evidence of business transactions which have happened.

(i) External Supporting Vouchers; and

These vouchers are prepared by the third parties who are associated with the firm.

(a) Debit Note Received; (b) Credit Note Received; (c) Cash Memo Received from the Sellers, etc.



COMPANY NAME
Company Name and Address

INVOICE

DATE: December 14, 2011
INVOICE: 100

Street Address
City, ST ZIP Code
Phone: (123) 456 78 33 **Fax:** (123) 456 78 33

Bill To:

Name:
Company Name:
Street Address:
City, ST ZIP Code:
Phone:

Ship To:

Name:
Company Name:
Street Address:
City, ST ZIP Code:
Phone:

SALESADDRESS	SHIP VIA	SHIP	TERMS	DATE DATE
ID	DESCRIPTION	QUANTITY	UNIT PRICE, \$	LINE TOTAL
1	Item 1 Description	10	99.99 \$	1,000.00
2	Item 1 Description	1	12.99 \$	12.99
3	Item 1 Description	2	99.99 \$	199.98
4	Item 1 Description	15	9.99 \$	149.85
			\$	-
			\$	-
			\$	-
Subtotal				1,362.82
TAX RATE				5.90%
SALES TAX				80.44
SHIPPING AND HANDLING				-
TOTAL				1,443.26

Have all these please to Your Company Name.
 If you have any questions concerning this invoice, contact Name,
 Phone Number, Email

THANK YOU FOR YOUR BUSINESS!

These vouchers are prepared by the internal staff on behalf of ‘the firm which are accepted by the third parties for the transaction so happened.

For example:

- (a) Counterfoil-of Challan for payment of income tax to a bank;
- (b) Counterfoil of pay-in-slip when money is deposited into bank, etc.

3. Transaction is recorded in primary books i.e. Journal books:

There are two sets of books maintained in any organisation viz. primary set of books and secondary set of books. Primary set of books is the one where initial transaction is recorded. It is the first instance of the recording of any economic transaction it includes journal and subsidiary books.

In order to record journal entries, one needs to have knowledge about following basics of accounting

6.3 WHAT IS AN ACCOUNT?

ACCOUNT: An account is a record of all transaction under one room relating to a particular person, income, expense, property etc.

Types of accounts:

There are three type of accounts in accounting:

A] **Personal account:** Ashok, Anil, Dena Bank, Abcd ltd, prepaid or outstanding incomes or expenses. Personal accounts consist of all those accounts which are related to a person, business, firm etc. There are also subtypes of personal account:

I] Natural Personal Any person like Peter Account, Ram account etc.

II] Artificial Personal: Any company or group of people like Microsoft account, Hindustan Petroleum account etc.

III] Representative Personal this type of Personal a/c represents owner like. Capital a/c, drawings a/c etc.

B] **Real account:** Real accounts consist of all those accounts which are related to assets. For example: Plant and Machinery account, Stock account, Furniture & Fixture, cash etc.

C] **Nominal account:** Nominal accounts consist of all those accounts which are related to expenses, losses, Income and Gains. For example: Rent account, wages account, printing & stationary etc.

Golden rules of accounting

There are three golden rules in accounting to record journal entries. Each of these rules is associated with separate account.

Personal accounts

"Debit the Receiver, Credit the Giver"

Real accounts

"Debit what Comes In, Credit what Goes out"

Nominal accounts

"Debit all Expenses and Losses, Credit all Income and Gains"

How to record a journal entry

First understand the format of a journal

A journal has five vertical columns

JOURNAL				
DATE	PARTICULARS	L. F.	DEBIT Rs.	CREDIT Rs.
1.4.2-16	Account to be debited A/c Dr To Account to be credited (Being..narrate the transaction)		xxx	xxx

Date column records date of the transaction

Particulars column records the two effects of a given transaction, by using at least two ledger accounts, one of which will be debited and other one credited.

Below these two accounts we write brief description of transaction in brackets prefixing the word 'Being', called as narration.

L.F. column records ledger folio or page number where that account is opened in a ledger book.

Debit (Amount) and Credit (Amount) columns records amount against each ledger account.

Steps to record a journal entry

1. Identify which accounts are involved
2. Identify types of accounts
3. Apply golden rules according to the type of account to determine which account will be Debited and which account will be Credited.

Example: You are writing in the books of Ganesh

Transaction : Cash received from Jagdish Rs5,000, for this transaction we will pass journal entry by using above mentioned

1 Identify which accounts are involved : a) Cash b) Jagdish

2 Identify types of accounts:

- a) Cash : real account
- b) Jagdish: personal account

3 Apply golden rules according to the type of account to determine which account will be Debited and which account will be Credited.

a) Cash : real account so: Debit what comes in

b) Jagdish: personal account: credit the giver

Therefore Cash A/c will be debited and Jagdish A/c will be credited The entry will be as follows

Cash a/c-----Dr5,000

To Jagdish a/c----- Cr 5,000

(Being cash received from Jagdish)

Example: Journalise the following transactions:

2016		Rs.
April. 1	Started business with cash	50,000
April. 3	Deposited cash into Bank	40,000
April. 5	Sold goods to Ganesh	22,000
April. 9	Goods returned by Ganesh	2,000
April. 11	Goods purchased from Kishore	30,500
April. 15	Goods returned to Kishore	1,500
April. 18	Bought Furniture & Fixture for office use by cheque	9,000
April. 22	Purchased goods for cash	1,000
April. 22	Paid carriage	50
April. 30	Paid interest on loan	500

Solution: Journal

Date	Particulars	L.F	Dr.(Rs.)	Cr. (Rs.)
2012				
April. 1	Cash A/c ...Dr. To Capital A/c (Being the business started with cash)		50,000	50,000
April 3	Bank A/c ...Dr. To Cash A/c (Being the amount deposited into the bank)		40,000	40,000
April 5	Ganesh To sales A/c (Being the goods sold to Ganesh)		22,000	22,000
April 9	Sales Returns A/c To Ganesh (Being the goods returned by Ganesh)		2,000	2,000
April 11	Purchases A/c ...Dr. To Kishore (Being the goods purchased from Kishore)		30,500	30,500
April 15	Kishore ...Dr. To purchases Return a/c (Being the goods returned to Kishore)		1,500	1,500
April 18				

April 22	Furniture & Fixture a/c ...Dr. To bank a/c (Being the Furniture & Fixture bought and paid by cheque)	9,000	9,000
April 26	Purchases A/c ...Dr. To cash a/c (Being the goods purchased against cash)	1,000	1,000
April 30	Carriage a/c ...Dr. TO cash a/c (Being the carriage paid)	50	50
	Interest on Loan A/c ...Dr. To Cash A/c (Being the payment of interest on Loan)	500	500
	Total	1,57,550	1,57,550

4. Transactions are posted in Ledger account: Secondary set of books includes ledger accounts. Now let us see format of a ledger account.

Dr.			LEDGER	ACCOUNT			Cr.
DATE	PARTICULARS	J.F.	AMOUNT	DATE	PARTICULARS	J.F.	AMOUNT
1.4.16	To Account credited in Journal		xxx	5.4.16	By Account debited in Journal		Xxx
	against this ledger a/c				against this ledger a/c		

The process of transferring the information contained in a Journal to a Ledger is called Posting.

i. Posting of debited item in a Journal Entry: The steps to be followed are:

Identify in the ledger the account to be debited. Then enter the date of the transaction in the 'Date' column on the debit side of the account. Then write the name of the account which has been credited in the respective entry in the 'Particulars' column on the debit side of the account as "To (name of account credited)". Then record the page number of the Journal where the entry exists in the Journal folio (J.F.) column. Then enter the relevant amount in the 'Amount' column on the debit side. Posting credit item in a journal entry: The steps to be followed are:

Identify in the ledger the amount to be credited then Enter the date of the transaction in the 'Date' column on the credit side of the account. Then write the name of the account which has been debited in the respective entry in the 'Particulars' column on the credit side of the account as 'By (name of account debited)'. Then record the page number of the Journal where the entry exists in the Journal folio (J.F.) column. Then enter the relevant amount in the 'Amount' column on the credit side.

Thus every transaction has two effects viz debit and credit. In a journal entry these are either debited or credited. One should always remember that total of debit should always match the total of credit.

Consider the simple Journal entry to illustrate the above: On April 16, 2014 Motor car Purchased for cash Rs. 12000

April 16	Motor car A/c	....Dr.	Rs. 12,000
	To cash		Rs. 12,000
	(Being the Motor car purchased)		

An amount of Rs. 12,000 will be debited to the Motor car account and credited to cash account. The manner will be: in the Motor car account in the 'Particulars' column we shall write to cash a/c . In the account of cash will be written : 'By Motor car a/c'. The two accounts will, thus appear as under.:

Motor car A/c

Dr. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
April 16	To Cash A/c		12,000				

Cash a/c

Dr. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				April 16	By Motorcar A/c		12,000

Example 2: Received Rs.14,000 in full settlement of a debt of Rs. 15,000 from Ram on Aug 8, 2014.

SOLUTION - Journal Entry

Rs. Rs.

Cash A/c Dr.	14,000	
Discount allowed A/c Dr	1,000	
To Anant		15,000
(Cash received and		
discount allowed)		

Ledger A/c**Cash A/c****Dr****Cr**

Date	Particulars	L.F	Rs.		Date	Particulars	L.F	Rs.
2014								
Aug.8	To Anant		14,000					

Discount Allowed A/c**Dr****Cr**

Date	Particulars	L.F	Rs.	Date	Particulars	L.F	Rs.
2014							
Aug.8	To Anant		10 00				

Anant's Account**Dr****Cr**

Date	Particulars	L.F	Rs.	Date	Particulars	L.F	Rs.
				2014			
				Aug. 8	By cash A/c		14,000
					By		1,000
					Allowed		

5. At the end of the year ledger accounts are closed and balances are found out

Dr.			LEDGE	ACCOUNT			Cr.
DAT	PARTICULARS	J.F.	AMOU	DATE	PARTICULARS	J.F.	AMOU
1.4.1	To abc Account		)(xx	5.4.16	By opq		)(xx
)(xx	To xyz Account		)(xx	xxx	By rst		xxx
)(xx	To Balance c/d		)(xx				
			)(xxx				xxxx

Using the closing balances of the ledger accounts a trial balance is drawn as on last day of the financial year : A trial balance is a list of all the general ledger accounts of a business. This list will contain the name of ledger account and the balance of that ledger. Each nominal ledger account will hold either a debit balance or a credit balance. The debit balance

values will be listed in the debit column of the trial balance and the credit value balance will be listed in the credit column. A trial balance always tallies. Ledger A/Cs which shows a debit balance is put on the Debit side of the trial balance.

The A/c's Showing credit balance are put on the Credit side of the Trial Balance. Accounts which show no balance i.e. whose Debit and Credit totals are equal are not entered in Trial Balance.

Then the two sides of the Trial Balance are totaled. If they are equal it is assumed that there are no arithmetical error in the posting and balancing of Ledger A/cs.

Normally at the year end or whenever a businessman is interested in knowing the position of various A/C s, the accounts are balanced. Various steps for this purpose are

- (1) Debit and Credit sides of each A/c are totalled.
- (2) The difference between the two sides is written on the side which is shorter so as to make their totals equal.
- (3) The words "Balance C/d" i.e. the balance carried down and written against the amount of difference.
- (4) In the next period, the balance is brought down on the other side by writing the words 'Balance b/d'.
- (5) If the Debit side exceeds the Credit Side the difference is a Debit Balance whereas.
- (6) If the Credit side exceeds the Debit side the difference is a Credit Balance.

Objectives or Functions of Trial Balance

It helps in ascertaining the arithmetical accuracy of ledger accounts.

Helps in locating errors.

Provides the summary of Ledger A/cs.

Helps in the preparation of Final A/cs.

ABC Ltd		
Trial Balance as at		
Account Title	Debit	Credit
Share Capital		XXXX
Cash	XXX	
Sales		XXXX
Buildings	XXXXX	
Furniture & Fixture	XXX	
Cost of Sales	XXX	
General Administration Expenses	XXX	
Creditors		XXX
Debtors	XXX	
Total	XXXXX	XXXXX

6. **Closing Adjustment entries are recorded Closing entries are journal entries** made at the end of an accounting period to transfer temporary accounts to permanent accounts. adjusting entries are journal entries usually made at the end of an accounting period to allocate income and expenditure to the period in which they actually occurred. The revenue recognition principle is the basis of making adjusting entries that pertain to unearned and accrued revenues under accrual-basis accounting. Eg Charging depreciation, providing for outstanding incomes and expenses etc.

Treatment of items of Adjustment outside the Trial Balance

Treatment of items of Adjustment outside the Trial Balance

Adjustment	Effects
Closing Stock	Trading A/c Credit Side and Asset Side of balance sheet.
Outstanding expenses	Added with concerned item in trading or profit a loss a/c and liabilities side of BALANCE SHEET as a current liability.
Prepaid expenses	Less from concerned item in trading or profit and loss a/c and assets side of BALANCE SHEET as a current assets.
Accrued Income (income earned but not received)	Add with concerned income in P&L and Assets side of BALANCE SHEET as a current assets
Income received in advance	Less from concerned item in P&L and Liabilities Side of BALANCE SHEET as current liabilities.

Depreciation	Dr. side of P&L A/C & Deduct from concerned assets.
Bad Debts	Dr. side of P&L A/C & Deduct from debtors in Balance sheet.
Provision for doubtful debts	Dr. side of P&L A/C & Deduct from debtors
Provision for discount on debtors	Dr. side of P&L A/C & Deduct from debtors

7. Final accounts are drawn

From the derived trial balance an accountant can prepare final accounts for the year for which information is available.

Format of final accounts differ from organisation to organisation. Let us see format of final accounts for some trading commercial organisations.

An organisation can adopt either horizontal or vertical format, but vertical format is compulsory for joint stock companies.

6.4 FINAL ACCOUNTS

Trading Account

Trading account is prepared to know the gross profit or gross loss arising or incurred as a result of the trading activities of a business. In other words, in case of a manufacturing concern a Manufacturing A/c is prepared to show the result of manufacturing activity, trading account indicates buying and selling of goods. If the amount of sales exceeds the amount of purchases and the expenses directly connected with such purchases, the difference is termed as gross profit. On the contrary, if the purchases, and direct expenses exceed the sales, the difference is called gross loss. The purpose of preparing the Trading Account is to find out the Gross Profit or Gross Loss of a concern during a particular period. The following equations are highly useful for determination of Gross Profit and Importance of Trading Account

Preparation of Trading Account serves the following objectives:

1. It provides information about Gross Profit and Gross Loss: It informs of the gross profit or gross loss as a result of buying and selling the goods during the year. The percentage of Current Year's gross profit on the amount of sales can be calculated and compared with those of the previous years. Thus, it provides data for comparison, analysis and planning for a future period.
2. It provides information about the direct expenses: All the expenses incurred on the purchase and manufacturing of goods are recorded in the trading account in a summarised form. Percentage of such

expenses on sales can be calculated and compared with those of the previous years. In this way it enables the management to control and rationalise the expenses.

3. Comparison of closing stock with those of the previous years: closing stock has to be valued and recorded in a trading account. This stock can be compared with the closing stock of the previous years and if the stock shows an increasing trend, the reasons may be inquired into.
4. It provides safety against possible losses: If the ratio of gross profit has decreased in comparison to the preceding year, the businessman can take effective measures to safeguard himself against future losses. For example, he may increase the sale price of his goods or may proceed to analyse and control the direct expenses.

6.4 (a) Preparation of Trading Account

Trading Account is a Nominal Account and all expenses which relate to either purchase or manufacturing of goods are written on the Debit side of the Trading Account.

Item written on the Debit side of the Trading Account:

1. Opening Stock: The stock of goods remaining unsold at the end of the previous year is termed as the opening stock of the current year. In other words, the closing stock of the last year becomes the opening stock of the current year. Opening Stock will include the following:

- I. Opening Stock of Raw Material.
- II. Opening Stock of Semi-finished goods, and
- III Opening Stock of Finished goods.

2. Purchases and Purchases Returns: Goods which have been bought for resale are termed as Purchases and goods which are returned to suppliers are termed as purchase returns or returns outwards. Purchase Account will be given on the debit side of the trial balance and Purchase Return Account on the credit side of the trial balance. Purchase returns will be shown as a deduction from Purchases on the debit side of the trading account. Purchases include cash as well as credit purchases.

3. Direct Expenses: All expenses incurred in purchasing the goods, bringing them to the godown and manufacture of goods are called direct expenses. Direct expenses include the following:

I. Wages: Wages are paid to workers who are directly engaged in the loading, unloading and production of goods and as such are debited to the trading account. It should be noted that:

- (i) If the item 'Wages and Salaries' is given in the question it will be shown on the trading account. On the contrary, if 'Salaries and Wages' is given it will be shown on the profit & loss account.

(ii) If wages are paid for bringing a new machine or for its installation it will be added to the cost of the machine and hence will not be shown in the trading account.

II. Carriage or Carriage Inwards or Freight: These expenses should be debited to trading account because these are generally paid for bringing the goods to the factory or place of business. However, if any carriage or freight is paid on bringing an asset, the amount should be added to the asset account and must not be debited to trading account.

III. Manufacturing Expenses: All expenses incurred in the manufacture of goods are shown on the debit side of the trading account such as Coal, Gas, Fuel, Water, Power, Factory Rent, Factory Lighting etc.

Items written on the Credit Side of the Trading Account:

1. Sales and Sales Returns: Both Cash and Credit sales will be included in sales. The sales account will be a credit balance whereas, the sales return account or returns inwards account will be a debit balance. Sales return will be deducted out of Sales on the credit side of the trading account.

2. Closing Stock: The goods remaining unsold at the end of the year is known as Closing Stock. It is valued at cost price or market price whichever is less. It includes the closing stock of raw material, Closing Stock of semi-finished goods and Closing Stock of finished goods.

Normally, the Closing Stock is given outside the Trail Balance. This is so because its valuation is made after the accounts have been closed. It is incorporated in the books by means of the following entry:

Closing	Stock
A/c	Dr.
To Trading A/c	
(Closing Stock transferred to Trading A/c)	

When the above entry is passed, the Closing Stock Account is opened. On the one hand, it will be posted to the credit side of the trading account and on the other hand, will be shown on the Assets side of the Balance Sheet, in order to complete the double entry. Sometimes, the Closing Stock is given inside the Trail Balance. This mean that the entry to incorporate the closing stock in the books has already been passed. It would imply that the Closing Stock must have been deducted out of Purchases Account. Hence, in such a case, Closing Stock will not be shown in the Trading Account but will appear on the Assets side of the Balance Sheet only.

6.4 (b) Profit And Loss Account

Trading account only discloses the gross profit earned as a result of buying and selling of goods. However, a businessman has to incur a number of expenses which are not taken to trading account. Hence, a businessman is more interested in knowing the net profit earned or net loss incurred during the year. As such, a Profit & Loss Account is prepared which contains all the items of losses and gains pertaining to the accounting period. According

to Prof. Carter, “A Profit & Loss Account is an account into which all gains and losses are collected, in order to ascertain the excess gains over the losses or vice-versa”

Need and Importance of Profit & Loss A/c

1. To determine the Net Profit or Net Loss: A Trading Account only discloses the Gross Profit earned as a result of trading activities, whereas the Profit & Loss Account discloses the net profit (or net loss) available to the proprietor and credited to his capital account.
2. Comparison with previous years' profit: The net profit of the current year can be compared with that of the previous years. It enables the businessman to know whether the business is being conducted efficiently or no.
3. Control on Expenses: Profit & Loss Account helps in comparing various expenses with the expenses of the previous year. Also the percentage of each individual expenses to net profit is calculated and compared with the similar ratio of previous years. Such comparison will be helpful in taking concrete steps for controlling the unnecessary expenses.
4. Helpful in the preparation of Balance Sheet: A Balance Sheet can only be prepared after ascertaining the Net Profit through the preparation of Profit and Loss Account.

Preparation of Profit and Loss Account

A Profit and Loss Account is started with the amount of gross profit or gross loss brought down from the Trading Account. As such, all those expenses and losses which have not been debited to the Trading Account are now debited to Profit &

Loss Account. These expenses include administrative expenses, selling expenses, distribution expenses etc. These are called 'Indirect Expenses'. Profit and Loss Account is a Nominal Account and as such, all the expenses and losses are shown on its debit side and all the incomes and gains are shown on its credit side.

Items written on the Debit side of Profit & Loss Account

1. Gross Loss: If trading account discloses Gross Loss, it is shown on the debit side first of all.
2. Office and Administrative Expenses: Such as salary of office employees, office rent, lighting, postage, printing, legal charges, audit fee etc.
3. Selling and Distribution Expenses: Such as advertisement charges, commission, carriage outwards, bad-debts, packing charges etc.
4. Miscellaneous Expenses: Such as interest on loan, interest on capital, repair charges, depreciation, charity etc.

Items written on the Credit side of Profit & Loss Account

1. Gross Profit: the starting point of the Cr. side of Profit and Loss Account is the gross profit brought down from the Trading Account.
2. Other Incomes and Gains: All items of incomes and gains are shown on the credit side of the Profit & Loss Account, such as income from investments, rent received, discount received, commission earned, interest received, dividend received etc.

If the credit side of the profit and loss account exceeds that of debit side, the difference is termed as net profit. On the other hand, the excess of the debit side over the credit side is termed as net loss. Net profit is added to the capital whereas net loss is deducted from the capital.

6.5 HORIZONTAL OR 'T' FORMAT OF TRADING & P&L A/C

Particulars	Amount (Rs)	Particulars	Amount (Rs)
To opening stock	By sales	.....
To purchases	less: returns	.....
less: returns	By closing stock	.....
To carriage inward		
To wages		
To gross profit c/d (in case of gross profit)	By gross loss c/d (in case of gross loss)	.....

To gross profit b/d (in case of gross loss)	By gross profit b/d (in case of gross profit)	.....
To salaries	By interest earned	.....
To carriage outward	By dividend earned	.....
To rates and taxes	By rent earned	.....
To insurance	By discount received	.....
To depreciation	By profit on sale of fixed assets	.....
To bad debts	By profit on sale of investments	.....
To advertising		
To interest paid		
To travelling expenses		
To discount allowed		
To loss on sale of fixed assets		
To loss on sale of investments		
To loss by fire		
To net profit transferred to B/S (in case of net profit)	By net loss transferred to B/S (in case of net loss)	.....

E.g. Prepare Trading Account for the year ended 30st March, 2013 from the following balances.

	Rs		Rs.
Stock(1 st April, 2012)	10,000	Purchases	1,00,000
Wages	5,000	Carriage Inwards	1,000
Sales	1,70,000	Returns Inward	5,000
Returns Outward	8,000	Sales Tax paid	20,000
Freight	500	Octroi duty	2,500

Closing stock as on 30st March, 2013 was valued at Rs. 20,000 Also, pass the Closing Entries.

Solution:

TRADING ACCOUNT

Dr. for the year ended 30st March, 2013 Cr.

Particulars	Rs	Particulars	Rs
To opening stock	10,000	By Sales	
To Purchases	1,00,000	1,70,000	1,60,000
Less: Returns Outward	5,000	Less : Sales tax	20,000
10,000	1,000		
To Wages	500	By Closing Stock	
To Carriage Inwards	2,500		
To freight	71,000		
To Octroi Duty			
To Profit and loss A/c (Gross profit)	1,80,000		1,80,000

VERTICAL FORMAT OF REVENUE STATEMENT TRADING & P&L A/C

Particulars	Schedule	Amount (Rs)
Income		
Sales and operating income	1	.....
Other income	2	.....
Total		.....
Expenditure		
Cost of goods sold	3	.....
Operating and other expenses	4	.....
Depreciation/Amortisation		.....
Interest		.....
Total		.....
Add/(Less): Exceptional items		.....
Profit/(Loss) before tax		.....
Less: Tax		.....
Profit/(Loss) after tax		.....

HORIZONTAL OR 'T' FORMAT OF BALANCE SHEET

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Share capital		Fixed assets	
Add: net profit/less: net loss		Land & building	.....
Less: drawings		Plant & machinery	.....
Long-term liabilities		Furniture & fixtures	.....
Debentures		Vehicles	.....
Loans & advances from banks		Goodwill	.....
Other loans & advances		Investments	.....
Current liabilities		Current assets, loans & advances	
Sundry creditors		Sundry debtors	.....
Bills payable		Cash in hand	.....
Bank overdraft		Cash at bank	.....
Outstanding expenses		Bills receivable	.....
Income received in advance		Prepaid expenses	.....
Provisions		Closing stock	.....
For taxation			
For dividend			

6.6 VERTICAL FORMAT OF BALANCE SHEET

Particulars	Schedule	Amount (Rs)
Sources of Funds		
Shareholder's funds		
Share capital	1	.....
Reserves and surplus	2	.....
Loan funds		
Secured loans	3	.....
Unsecured loans	4	.....
 Total		.....
Application of Funds		
Fixed assets		
Gross block	5	.....
Less: depreciation		.....
Net block		.....
Capital work-in-progress		.....
Investments	6	.....
Current assets, loans & advances		
Inventories	7	.....
Sundry debtors	8	.....
Cash & bank balances	9	.....
Loans & advances	10	.....
Other current assets		.....
Less: current liabilities & provisions		
Current liabilities	11	.....
Provisions	12	.....
Net current assets		.....
 Total		.....

**FINAL ACCOUNTS AS PER REVISED SCHEDULE VI FORMAT
BALANCE SHEET**

Balance Sheet as at 31st March, 2011

Particulars	Note No	Figures as at the end of current reporting period	Figures as at the end of previous reporting period
I. EQUITY AND LIABILITIES			
(1) Shareholder's Funds			
(a) Share Capital			
(b) Reserves and Surplus			
(c) Money received against share warrants			
(2) Share application money pending allotment			
(3) Non-Current Liabilities			
(a) Long-term borrowings			
(b) Deferred tax liabilities (Net)			
(c) Other Long term liabilities			
(d) Long term provisions			
(4) Current Liabilities			
(a) Short-term borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short-term provisions			
Total			
II. Assets			
(1) Non-current assets			
(a) <i>Fixed assets</i>			
(i) Tangible assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under development			
(b) Non-current investments			
(c) Deferred tax assets (net)			
(d) Long term loans and advances			
(e) Other non-current assets			
(2) Current assets			
(a) Current investments			
(b) Inventories			
(c) Trade receivables			
(d) Cash and cash equivalents			
(e) Short-term loans and advances			
(f) Other current assets			
Total			

STATEMENT OF PROFIT AND LOSS

Profit and Loss statement for the year ended 31st March, 2011

Particulars	Note No	Figures as at the end of current reporting period	Figures as at the end of previous reporting period
I. Revenue from operations			
II. Other Income			
III. Total Revenue (I +II)			
<u>IV. Expenses:</u>			
Cost of materials consumed			
Purchase of Stock-in-Trade			
Changes in inventories of finished goods, work-in-progress and Stock-in-Trade			
Employee benefit expense			
Financial costs			
Depreciation and amortization expense			
Other expenses			
Total Expenses			
V. Profit before exceptional and extraordinary items and tax	(III - IV)		
VI. Exceptional Items			
VII. Profit before extraordinary items and tax (V - VI)			
VIII. Extraordinary Items			
IX. Profit before tax (VII - VIII)			
X. Tax expense: (1) Current tax (2) Deferred tax			
XI. Profit(Loss) from the period from continuing operations	(VII-VIII)		
XII. Profit/(Loss) from discontinuing operations			
XIII. Tax expense of discounting operations			
XIV. Profit/(Loss) from Discontinuing operations (XII - XIII)			
XV. Profit/(Loss) for the period (XI + XIV)			

SUMS FOR PRACTICE

Example : Journalize the following transactions:

2016			Rs.
May.	1	Ajay Started business with cash	50,000
May.	3	Deposited cash into Bank	40,000
May.	5	Sold goods to Ganesh	22,000
May.	9	Goods returned by Ganesh	2,000
May.	11	Goods purchased from Kishore	30,500
May.	15	Goods returned to Kishore	1,500
May.	18	Bought Furniture & Fixture for office	9,000
May.	22	use by cheque	1,000
May.	22	Purchased goods for cash	50
May.	30	Paid carriage	500
		Paid interest on loan	

Journal

Solution:

Date	Particulars	L.F.	Dr.(Rs.)	Cr. (Rs.)
2012	Cash A/c ...Dr.			
May. 1	To Ajay's Capital A/c (Being the business started with cash)		50,000	50,000
May 3	Bank A/c To Cash A/c (Being the amount deposited into the bank)		40,000	40,000
May 5	Ganesh ...Dr. To sales A/c (Being the goods sold to Ganesh)		22,000	22,000
May 9	Sales Returns A/c To Ganesh (Being the goods returned by Ganesh)		2,000	2,000
May 11	Purchases A/c To Kishore (Being the goods purchased from Kishore)		30,500	30,500
May 15	Kishore To purchases Return a/c (Being the goods returned to Kishore)		1,500	1,500
May 18	Furniture & Fixture a/c To bank a/c (Being the Furniture & Fixture bought and paid by cheque)		9,000	9,000

May 22	Purchases A/c To cash a/c (Being the goods purchased against cash)		1,000	1,000
May 26	Carriage a/c TO cash a/c (Being the carriage paid)		50	50
May 30	Interest on Loan A/c To Cash A/c (Being the payment of interest on Loan)		500	500
	Total		1,57,550	1,57,550



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MODULE - V

7

CAPITAL AND REVENUE EXPENDITURE- DEFERRED REVENUE EXPENDITURE- CAPITAL AND REVENUE RECEIPTS

Unit Structure

- 7.0 Objectives
- 7.1 Introduction
- 7.2 Misclassification and effect of error
- 7.3 Capital and Revenue-
- 7.4 Revenue expenditure
- 7.5 Distinction between capital expenditure and Revenue expenditure
- 7.6 Distinction between capital receipt and Revenue receipt
- 7.7 Tests to be applied to transactions
- 7.8 For Capital Receipt/ Revenue Receipt
- 7.9 Deferred Revenue Expenditure-(DRE)

7.0 OBJECTIVES

- ❖ To help the learner understand the concept of Capital and Revenue
- ❖ To help the learner distinguish between capital and revenue transactions
- ❖ To help the learner understand the importance of correctly identifying the capital and revenue transactions, the effect of errors due to misclassification and its presentation in the financial statements
- ❖ To help the learner know about the deferred revenue expenditure and its presentation in financial statements.

7.1 INTRODUCTION

The Final Accounts prepared at the end of the year consists of Profit and Loss account and Balance sheet. The final accounts are prepared from Trial balance which gives a list of accounts showing debit balances and

credit balances. The accounts appearing in the trial balance are to be taken to the trading, profit and loss account or balance sheet. The profit and loss account (also known as Revenue Statement) shows the income and gains on the credit side and the various expenses and losses are shown on the debit side. The balance sheet is a statement showing the financial position as on a particular date and shows the capital and liabilities and assets.

It is necessary to classify the items appearing in the trial balance as capital or revenue so that they can be correctly shown in the trading, profit and loss account or balance sheet as the case may be. Such classification is necessary to comply with the concept of matching costs and revenue in a given period.

7.3 MISCLASSIFICATION AND EFFECT OF ERROR

Any misclassification impacts the correctness and accuracy of the financial statements – the profit and loss account will not show the correct Profit/ Loss and the Balance Sheet will not show the true position of assets and liabilities. Thus due to misclassification, the accuracy of the financial statements are affected and the statements do not depict the true and fair view of the state of affairs of the business enterprise.

For example- A computer is purchased and the accountant records the purchase along with purchase of raw materials in the trading account. The error will affect the profit or loss position as the transaction has been wrongly shown in trading account. The computer purchased should have been recorded as an asset in the balance sheet. In this way the error due to misclassification affects both the revenue statement and the balance sheet.

Effect of error in classification

- 1) Trading account will not show correct gross profit/ gross loss.
- 2) Profit and loss account will not disclose true net profit/ net loss.
- 3) Balance sheet will not disclose true value of Assets and Liabilities.
- 4) Financial statements will not disclose True and Fair view of the state of Affairs of the organization.
- 5) It will be difficult to understand the capitalization of business.
- 6) These errors affect the accounts of the subsequent years

Error in classification	Impact on profit and impact on balance sheet/ value of asset
1) Revenue expenditure is wrongly treated as capital expenditure	Profit will be inflated , Value of asset will be inflated.
2) Capital receipt is treated as revenue receipt	Profit will be inflated , Value of asset will be inflated.
3) Capital expenditure treated as revenue expenditure	Profit will be deflated , Value of asset will be deflated.
4) Revenue receipt wrongly treated as capital receipt	Profit will be deflated.

It is thus clear that any error in classification or misclassification impacts the accuracy and correctness of the financial statements and hence it is very important to classify the transactions as capital or revenue and disclose the same correctly in the financial statements .

7.4 CAPITAL AND REVENUE

Receipt or Expenditure transactions are to be classified as capital or revenue and further classified as capital expenditure, revenue expenditure capital receipt or revenue receipts.

TRANSACTIONS

Expenditure or receipt

Expenditure transactions

(involves outflow of cash)

Capital expenditure /

Revenue expenditure

Receipt transactions

(involves inflow of cash)

Capital receipt/

Revenue receipt

Capital transactions are further classified as capital expenditure and capital receipt and revenue transactions are classified as revenue expenditure and revenue receipt.

Capital expenditure is any expenditure which has any one or all of the following-

- ❖ It is a non- recurring expenditure
- ❖ The benefit of such expenditure is seen for more than one year.

- ❖ The expenditure increases the revenue earning capacity of the organization.

In short, if the benefits of the expenditure are expected to accrue for a long time, the expenditure is capital expenditure. Thus capital expenditure is that expenditure which results in the acquisition of an asset, tangible or intangible.

Some common examples of capital expenditure are-

1) Purchase of an asset

Any expenditure that is incidental to the purchase of an asset or has been incurred to put the asset in working condition for example – installation charges or commissioning expenses incurred with reference to purchase of asset is also to be treated as capital expenditure. All the expenses incurred on the assets till they yield income are capital in nature.

2) Expenditure during construction-

Any expenditure incurred during construction period or capital work in progress is considered as a capital expenditure.

3) Expenditure that improves the standard of performance of an existing asset.

Any expenditure which extends the useful life of the asset or improves the efficiency of the asset is to be capitalized and added to the cost of the fixed asset

4) Cost of an addition or extension to an existing asset

5) Investment in shares, debentures, immoveable properties

6) Cost of acquiring intangible assets like goodwill, patents, copyrights.

7) Cost of acquisition and development of wasting assets like mines, oil-wells.

Accounting of capital expenditure- Capital expenditures are shown in the asset side of Balance sheet

7.5 REVENUE EXPENDITURE

Revenue expenditure is any expenditure which has any one or all of the following-

- ❖ The expenditure is incurred in the day to day conduct of business and necessary to carry on the business.
- ❖ The expenditure is recurring in nature
- ❖ The benefit of such expenditure usually lasts for a short period of time

Kohler defines Revenue expenditure as an expenditure charged against operations.

Any expenditure which is not a capital expenditure and which is incurred for carrying out the day to day activities of business is called revenue expenditure.

Some common examples of revenue expenditure are-

1) Expenses relating to business activities- Expenses of production- Purchase of raw materials, Expenses of administration -Payment of Office salaries, Expenses of selling and distribution

Finance expenses

2) Expenses which are incurred to maintain the asset in a working condition-

Repairs and maintenance expenses

3) Expenses incurred to earn income- -Interest on loan taken for purchase of shares

Accounting of Revenue expenditure-Revenue expenditures are shown on the debit side of Trading/ profit and loss account.

Capital Receipt-

Any receipt or cash inflow which has any one or all of the following

- ❖ The receipt is non- recurring in nature
- ❖ The receipts do not arise through normal activities of business
- ❖ Some common examples of capital receipt are-

- a) Amount received on account of issue of fresh share capital/ debentures
- b) Amount of loans raised
- c) Proceeds on sale of fixed assets
- d) Deposits

Accounting of capital receipt- Capital receipts are shown in the balance sheet.

Revenue receipt

Revenue receipts are those items of income which are received or accrued in the ordinary course of business.

Any cash inflow generated in the normal course of business activities are to be treated as revenue receipts- Income generated from cash/ credit sales, or from services rendered.

Accounting of revenue receipt-Revenue receipts are shown on the credit side of trading/ profit and loss account

Concept of capital and revenue can be summarized as under-

Capital transactions will be recorded in the balance sheet while revenue transactions will be shown in the revenue statements- Trading, profit and loss account

Trading, Profit and loss account (debit side)	Trading, Profit and loss account(credit side)
Revenue expenditure	Revenue receipts
To Salary	By sale of goods
To rent	

Balance sheet(Liability side)	Balance sheet (asset side)
Capital receipt	Capital expenditure
Loan from bank	Plant and Machinery purchased

7.6 DISTINCTION BETWEEN CAPITAL EXPENDITURE AND REVENUE EXPENDITURE

CAPITAL EXPENDITURE	REVENUE EXPENDITURE
It is non- recurring in nature	It is recurring in nature
It is shown in the Balance sheet	It is shown in the revenue account
It is incurred for acquiring fixed assets intended for use in business	It is incurred for carrying out the day to day activities of the business
It increases the revenue earning capacity of the concern	It does not increase the revenue earning capacity of the concern.
Benefit of this expenditure extends for more than one year	The benefit of this expenditure is for a short period
Example- purchase of fixed asset	Example – Payment of salaries

7.6 DISTINCTION BETWEEN CAPITAL RECEIPT AND REVENUE RECEIPT

CAPITAL RECEIPT	REVENUE RECEIPT
They are non recurring in nature	They are recurring in nature
They appear in the balance sheet- It is disclosed as a liability in the balance sheet	They appear in Revenue account- It is disclosed as an income in the P&L A/c
Capital receipts which are liabilities are to be repaid	Revenue receipts are not to be repaid as they are not liabilities.
They are not gains to the concern	They are gains to the concern
It represents capital brought in by the proprietor which are not of recurring nature	It represents income such as sale of goods, interest received
Example-Amount received on issue of debentures	Example-Interest received, recovery of bad debts

7.8 TESTS TO BE APPLIED TO TRANSACTIONS

To classify a transaction as capital or revenue, one may use the following tests as indicators-

FOR CAPITAL/ REVENUE EXPENDITURE

- 1) **What is the period of benefit from expenditure?**
- 2) **What is the effect of expenditure?**
- 3) **What is the amount of expenditure?**

Period of benefit from expenditure- if the benefit is for short period and recurring in nature, it is generally treated as Revenue expenditure. Expenditure which will give benefit for a long period of time and which is non- recurring in nature will be generally classified as Capital expenditure. A non- recurring expenditure is always capital in nature unless materiality concept emphasizes the importance of recognizing it as revenue expenditure.

Effect of Expenditure- If the expenditure gives rise to a tangible asset or right, treat it as capital expenditure

Amount of expenditure- Generally the capital expenditures involve huge amounts but this cannot always be treated as a conclusive , reliable test for classification

7.9 FOR CAPITAL RECEIPT/ REVENUE RECEIPT

- 1) What is the source or cause of receipt or profit?
- 2) What is the nature of the receipt?
- 3) What is the impact of the receipt transaction on the profit / loss ?

Source of receipt- If the receipt is from trading transaction, then it should be treated as revenue receipt. Eg -sale of goods. If the receipt is from other transactions, then it should be considered as capital receipt. eg Loan taken from bank, amount realized on sale of fixed assets. Thus if receipt arises in the course of business activity, then it is to be treated as revenue receipt. If it arises out of financing activity, it is to be treated as Capital receipt.

Nature of receipt- Non- recurring receipts are capital receipts while recurring receipts are revenue receipts.

Impact of the transaction on profit/ loss during the year- Capital receipts have no bearing on the profit made or loss incurred during the year . Only revenue receipts are taken into account to ascertain the profit made by the business. This is a fairly reliable indicator/ parameter for classifying transactions as capital receipt/ revenue receipt.

In case of receipts, the general rule is that if the receipt is against the supply of goods or services and related to period under review, the receipt is revenue receipt. This will be shown in the P&L A/C .Capital receipts are to be shown as liability or reduced from assets appearing in Balance sheet.

Sometimes a part of the receipt may be capital and a part of it may be revenue-

For example proceeds on sale of asset-

- 1) If the sale proceeds is less than book value of asset , the receipt is capital receipt to be deducted from asset
- 2) If the sale proceeds is more than book value but less than cost , the receipts is to be segregated as-
 - a) equal to book value of asset is capital receipt to be reduced from asset
 - b) excess as revenue receipt giving rise to revenue profit.
- 3) If sale proceeds is more than cost, the receipts are to be accounted for as under-
 - a) equal to book value capital receipt to be reduced from asset

- b) between book value and cost, revenue receipt giving rise to revenue profit
- c) excess over cost, revenue receipt giving rise to capital profit.

However it is not always easy to classify transactions as capital/ revenue . There is a good deal of difference of opinion in deciding whether a particular item is capital or revenue. Hence it has to be decided based on the facts of the case on a case to case basis .

For example- Purchase of motor car is a capital expenditure as it involves acquisition of an asset. However purchase of Motor car by a car dealer who deals with purchase and sale of motor cars on a regular basis is not a capital expenditure In the second case the purchase of car is to be treated as revenue.

Expenditure incurred in converting an ordinary screen in a cinema hall to a cinemascope – It is difficult to accurately ascertain the nature of this transaction. It may be argued that as the seating capacity of the hall has not changed, it should be treated as revenue expenditure. However, the second argument could be cinemascope pictures attract large audience and as the expenditure will result in higher earnings, it is to be treated as capital expenditure.

7.10 DEFERRED REVENUE EXPENDITURE-(DRE)

According to the Guidance note issued by ICAI, “Deferred Revenue Expenditure is that expenditure for which payment has been made or a liability incurred but which is carried forward on the presumption that it will be of benefit over a subsequent period/ periods.”

For example- Normal annual advertising expenses is considered as revenue expenditure and debited to the profit and loss a/c. If the heavy expenses are incurred on advertising campaign to launch a new product, then the whole amount should not be debited to P&L a/c of that year. The benefit accrues for a long period of time. Hence so much of the expenditure as benefits the current year may be considered as revenue and debited to profit and loss a/c the balance to be shown as deferred expenditure- revenue expenditure which is deferred or postponed.

There are some transactions which may appear revenue in nature but the benefits of such expenditure are seen for a long period of time .Such expenses are treated as deferred revenue expenditure. For example- Heavy advertisement expenses or promotion expenses to launch a product- As such expenditure yields the benefit for a long period ,it is necessary to spread the amount over such number of years . If not spread over the years, then the revenue statement of the year in which the expenditure was incurred may not show the true picture of Profit/ loss Hence in order to have more credible financial statements the expenditure is deferred and a part of the expenditure is shown in the current year Profit and loss

account. The balance amount (not yet written off) is shown as a debit balance in the asset side of the balance sheet.

Other common examples of Deferred revenue expenditure are-

- Preliminary expenses
- Cost of market research for a new product
- Commission on issue of debentures
- Cost of issuing shares / debentures or raising loans

Accounting for Deferred Revenue expenditure-For eg -Association fees paid Rs 60,000 for three years (2016-17, 2017-18,2018-19).

1st year-Accounting for the year 2016-17-This expenditure has to be shown in Profit and loss a/c. However it is evident that the expenditure is incurred in the financial year 2016-17, but the benefit of the expenditure is enjoyed in the subsequent periods too. Hence the amount of Rs 60,000 should be spread over three years and the annual amount to be determined ($60000/3$) Rs 20,000 .The profit and loss account of the year 2016-17 will be debited with Rs 20,000. The balance(60,000-20,000) Rs 40,000 not written off will be shown in the asset side of balance sheet . Here the expenditure is – deferred and hence known as DRE.

2nd year-Accounting for the year 2017-18- The amount of Rs 20,000 will be debited to profit and loss account and the balance Rs 20,000 (40000-20000) not written off will be shown in the asset side of balance sheet

3rd year-Accounting for the year 2018-19- The amount of Rs 20,000 will be debited to profit and loss account and there is no balance to be shown in the balance sheet

Thus the amount has been spread over three years and accounted for in the books.

Revenue expenditure that becomes capital expenditure-

The following revenue expenses under certain circumstances becomes capital expenditure

Expenses	Circumstances
1) Repairs	Amount spent on repairs of plant and machinery, furniture, building which are regular in nature and incurred to maintain the asset in a working condition are to be considered as revenue expenditure. However repairs to the second hand assets to improve the operational efficiency is to be treated as capital expenditure.
2) Wages	Wages paid is a revenue expenditure. Wages paid for installation of machinery or construction of fixed assets is considered as capital expenditure.
3) Legal charges	Legal charges are basically revenue in nature and are shown in the debit side of P&L a/c. Legal charges incurred in connection with purchase of fixed asset are capital in nature
4) Transport charges	Transport charges are basically revenue in nature. Transport charges incurred for purchase of machinery , furniture are capital in nature.
5) Interest on capital	Interest on capital paid during the construction of works, building and plant is capital in nature.
6) Raw material and stores	This is basically a revenue expenditure but if it is used for construction of fixed assets, it is considered as capital and added to the cost of the asset
7) Development expenditure	The development expenditure incurred during the development period with reference to tea and rubber plantations should be treated as capital expenditure

To summarize the revenue expenditure incurred in connection with purchase of asset or which is incidental to the purchase of asset, expenses incurred in development of asset is to be treated as capital expenditure.

Problems-

Q1- Error in classification or misclassification-

The following is the Trading account for the year ended 31 st March 2016

Particulars	Amt(Rs)	Particulars	Amt (Rs)
To opening stock	60,000	By Sales	4,00,000
To purchases	3,00,000	By Closing stock	1,00,000
To wages	1,00,000		
To Gross Profit	40,000		
	5,00,000		5,00,000

Additional Information-

- 1) Sales included sales of old furniture Rs 10,000
- 2) Purchases included purchase of machinery Rs 70,000
- 3) Some workers were employed for construction of a gallery to the office building. Wages of these workers amounting to Rs 30,000 were included in the above wages.

Redraft the trading account to arrive at the correct profit after considering the above additional information-

Solution- There has been an error in the classification of items as capital/ revenue.

- 1) Sale of old furniture is a capital receipt. The same has been wrongly shown as revenue receipt. Hence Rs 10,000 has to be deducted from sales.
- 2) Purchase of Machinery is a capital expenditure. It has been wrongly shown as revenue and included in the purchases. Rs 70,000 has to be deducted from purchases and shown in the asset side of Balance sheet.
- 3) The wages of workers who have been employed for construction of gallery to office building are of capital nature .Rs 30,000 should be deducted from wages and added to the cost of office building.

The corrected trading account will be redrafted as under-

Particulars	Amt (Rs)	Particulars	Amt(Rs)
To opening stock	60,000	By sales	
To Purchases		Less sale of old furniture	3,90,000
Less machinery purchased	2,30,000	By closing stock	1,00,000
To wages	70,000		
Less capitalized	1,30,000		
To gross profit			
	4,90,000		4,90,000

Q2 How would you treat the following items?

- 1) Carriage paid on purchases Rs 1,000- **Revenue expenditure**
- 2) Expenditure on advertising campaign Rs 500-**Revenue expenditure**
- 3) Freight and carriage of a new machinery purchased Rs 2,000- **Capital expenditure**
- 4) Spent Rs 6,000 as legal expenses for abuse of trademark – **Revenue expenditure**
- 5) Received Rs 1,00,000 on issue of equity shares-**Capital receipt**
- 6) Paid to the government excise duty Rs 50,000- **Revenue expenditure**
- 7) Paid Rs 70,000 for construction of railway sidings- **Capital expenditure**
- 8) Purchased Land Rs 1,00,000-**Capital expenditure**
- 9) Labour charge on plant and Machinery Rs 3,000-**Capital expenditure**
- 10) Repairs to furniture Rs 1,500- **Revenue expenditure**

Q3 State with reasons whether the following are capital ,Revenue or Deferred revenue expenditure

- 1) Legal expenses in issuing shares and debentures Rs 12,500
- 2) Legal expenses incurred in an action for infringement of trademarks

- 3) Rs 25,000 spent on air-conditioning the office of the Managing Director
- 4) Rs 7,000 spent on registration of design
- 5) Legal expenses incurred in an Income tax appeal
- 6) Legal expenses Rs 5,000 incurred in connection the purchase of business premises
- 7) Rs 1,00,000 paid for the application and allotment of a plot of land
- 8) Legal expenses Rs 8,000 incurred in defending a suit for breach of contract to supply of goods

(Mumbai University April 2008)

Solution

- 1) **Deferred Revenue expenditure**-These expenses should be written off over certain number of years. These expenses benefit the organization for many years
- 2) **Revenue expenditure**-These expenses are incurred in the normal course of operation
- 3) **Capital expenditure**-It is capitalized as per AS-10
- 4) **Capital expenditure**-It is to be added to the cost of design which is an asset
- 5) **Revenue expenditure** These expenses are incurred in the normal course of operation
- 6) **Capital Expenditure** It increases the cost of business premises
- 7) **Capital Expenditure** It increases the cost of land
- 8) **Revenue expenditure** These expenses are incurred in the normal course of business operations. The benefit is exhausted within one year.

Q4 State with reasons the nature of the following expenses/ receipts

- 1) Sold investments 4% government securities for Rs 1,40,000
- 2) Preliminary expenses paid Rs 42,000
- 3) Carriage outward paid Rs 40,000
- 4) Import duty paid on purchase of computer equipment Rs 85,000 to be used in the office
- 5) Received Rs 5,00,000 on the issue of 5% Debentures
- 6) Paid Rs 10,000 underwriting commission on issue of shares

- 7) Legal expenses Rs 6,000 paid in connection with purchase of land
- 8) Repairing charges Rs 15,000 paid for keeping the machinery in working condition

(Mumbai University March 2006)

Solution

- 1) Capital receipt-The amount is received on sale of investment and not from normal business activity
- 2) Deferred Revenue expenditure -The expenditure benefits the current year and subsequent years and hence the amount has to be written off over a certain number of years.
- 3) Revenue expenditure- It is incurred in normal business operations
- 4) Capital expenditure- It is a direct cost on acquiring of fixed assets and hence has to be capitalized as per AS-10
- 5) Capital receipt- The amount is received on issue of Debentures and not from normal business activity
- 6) Deferred Revenue expenditure--The expenditure benefits the current year and subsequent years and hence the amount has to be written off over a certain number of years.
- 7) Capital expenditure-It is a cost incurred in acquisition of fixed asset
- 8) Revenue expenditure-it is incurred for keeping the machinery in working condition

Summary-

An organization has to incur various expenses and receives different incomes. Some expenses are regular while some are onetime expenses .The expenses whose benefits will be enjoyed over a long period are called capital expenditure. Revenue expenditure refers to those expenses which are incurred for the day to day operations of business.

Receipts whose benefits will be enjoyed over a long period are classified as capital receipts while day to day operational receipts such as sales are revenue receipts.

ONLY MAIN POINTS (for revision)

Capital expenditure- Large amount, Increases cost of fixed asset, increases life of fixed asset, non- recurring in nature, increases profit earning capacity of the business enterprise, brings the fixed asset into working condition, benefit of expenditure is not exhausted within one year, shown in balance sheet

Revenue expenditure- smaller amount, recurring in nature, benefit is exhausted within the year, shown in P&L A/c

Capital receipts do not arise in the normal course of operation

Revenue receipts are received in the normal course of operation

Deferred revenue expenditure- basically revenue in nature, benefit not exhausted within one year, expenditure to be written off over certain number of years.

Key terms-

Capital expenditure- It is the expenditure which is incurred to raise earning capacity of an organization.

Revenue expenditure – It is the expenditure which is recurring in nature incurred in connection with day to day operations of an organization.

Capital receipt- It is a receipt which is not received in the normal course of operation

Revenue receipt- Revenue receipt is the receipt which is recurring and received in the normal course of operation.

Deferred Revenue expenditure –It is the revenue expenditure the benefit of which is not exhausted within one year.



MODULE VI

8

DEPRECIATION

Unit Structure

- 8.1 Objectives
- 8.2 Meaning, Definition and Features of Depreciation
- 8.3 Depreciation, Depletion and Revaluation

8.1 OBJECTIVES

- To help the learner understand the concept of Depreciation
- To help the learner understand the need for providing depreciation
- To help the learner understand the causes of depreciation
- To help the learner understand the calculation of depreciation, the methods of providing depreciation and accounting in the books of accounts

8.2 MEANING, DEFINITION AND FEATURES OF DEPRECIATION

The word depreciation has been derived from the Latin word 'Depretium' which means decline or reduction in price or value. Fixed assets have a definite life but they lose their value due to usage or passage of time. Depreciation refers to this decline in value due to usage, passage of time or due to obsolescence.

According to William Pickles, Depreciation is the gradual and permanent decrease in the value of the asset. Depreciation refers to the decline or reduction in the value of fixed asset. Depreciation is the permanent and continuing diminution in the quality, quantity or value of an asset.

The Institute of Chartered Accountants of India (ICAI) defines depreciation as "a measure of the wearing out, consumption or other loss of a value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes"

Reduction in the value of the asset due to their productive use is called Depreciation. Depreciation in the value of asset is also due to natural wear and tear.

Features of Depreciation-

Depreciation is a gradual reduction in the value of an asset

The reduction could be due to various reasons.

Depreciation is charged on assets- fixed assets

Depreciation is a part of operating expenses. It is non cash in nature as there is no real cash outflow even if it is accounted as an expense. It is to be provided on fixed assets which are used in the process of production and in the conduct of business. It is charged to profit and loss account.

The amount of Depreciation charged to P&L Account has to be deducted from value of asset shown in the balance sheet.

Depreciation is to be provided even if the business is incurring a loss.

Depreciation is a gradual and permanent decrease in the value of asset which is to be accounted for in the financial statements to arrive at the correct profit/ loss.

Thus, Depreciation means a fall in the quality or value of an asset.

Accounting Standard (AS) -6 (Revised) deals with Depreciation Accounting.

Depreciation is to be provided on pro-rata basis for the period for which the asset was used in a particular year at the specified rate.

The company adopts a policy regarding depreciation and as per AS-1- namely, disclosure of Accounting Policies, the method adopted in providing depreciation should be disclosed in the notes to accounts.

8.3 DEPRECIATION, DEPLETION AND REVALUATION

Depreciation refers to a decrease in the value of the asset while depletion refers to the decrease in the value of wasting assets like oil wells, mines.

Revaluation refers to a revision in the value of the asset which could mean a decrease or an increase in the value of the asset.

8.2 (A) Need for depreciation-The Companies Act requires companies to write off or provide for depreciation in a specified manner.

1) To ascertain true and correct profit/ loss-Depreciation is an operating expense which is provided on assets used in the process of production. Thus it is an expense to be included in the cost of production. It is therefore logical that it must be matched with the income earned and charged to P&L Account to calculate the true and real profit/ loss of the business. Unless depreciation is charged to P&L Account, the correct profit/ loss cannot be arrived at.

2) To present a true financial position of business-Balance sheet is a statement which shows the financial position of the business enterprise as on a particular date. The fixed assets are to be shown at their true values. The balance sheet shows the true financial position only if the depreciation is deducted from the value of the asset. If the depreciation is not provided on assets, the assets will be overvalued and the balance sheet will not reflect the true financial position.

3) Replacement of asset-Every asset has a useful life. At the end of the useful life of the asset, it needs to be replaced. Providing the depreciation enables the business to replace the asset.

4) Statutory requirement-It is necessary to charge depreciation to comply with the provisions made under the Companies Act and the Income Tax Act. Providing the depreciation enables the business to compute and pay correct tax on taxable profit.

8.2 (B) Causes of Depreciation

1) Natural wear and tear-Wear and tear is the main cause of depreciation. Wear and tear takes place in case of tangible fixed assets like furniture, machinery due to its use. If the asset is used more, the wear and tear is also more.

2) Efflux of time-Even if the asset is not used and kept idle, its value falls over a period of time. Hence depreciation is provided on idle machinery too.

3) Obsolescence- A loss or reduction on account of new invention is called as obsolescence. With the new technological improvements, inventions and improvements in techniques of production, the old machinery becomes outdated and needs to be replaced.

4) Depletion-An asset like mines, oil wells may get exhausted due to continuous extraction due to which the value of the asset goes on diminishing. There comes a stage when the asset has been completely utilized and there is nothing left to be extracted. Such a decrease in the value of the asset is depletion.

5) Natural calamities- An asset may be damaged due to fire, flood and lose its value and may be disposed off as scrap. The loss of value is written off as depreciation.

8.2 (C) Factors affecting Depreciation

a) Cost of the asset-The cost of the asset refers to the purchase price of the asset. The expenses related to the purchase of the asset are to be added to the purchase price to arrive at the cost of the asset. Incidental expenses like installation charges, wages for erection of asset, freight and transport charges are to be added to the purchase price. For example- purchase price of machinery is Rs 1,00,000 and Rs 5,000 were incurred on installation of machinery. The total cost of the asset is $\text{Rs } 1,00,000 + 5,000 = 1,05,000$

b) Residual value or estimated scrap value-Residual value refers to the value that can be realized at the end of the useful life of the asset when the asset will be sold as scrap .Such scrap value is to be deducted from the cost of the asset.

c) Estimated useful life of the asset-The useful life of the asset in terms of number of years that the asset can be put into productive use needs to be estimated for calculating depreciation.

8.2 (D) Formula for calculating depreciation- After considering the above factors, the amount of depreciation can be calculated by using formula-

Depreciation per annum=Original cost of the asset-estimated scrap value
Estimated useful life of the asset.

Depreciation = original cost of the asset x rate of depreciation (where the estimated scrap value is zero)

Where the original cost of the asset = Purchase price +incidental charges.

A company purchased machinery for Rs 44,000 and spent Rs 1,000 on the installation. It is estimated that the useful life of the asset is 10 years and at the end of the useful life the residual value is Rs 5,000. The depreciation per year will be worked out as under Cost of the asset= 44,000+1,000= 45,000

Depreciation p.a = $\frac{45,000-5,000}{10}$ =4,000

10

Depreciation as per Companies Act 2013 for Financial year 2014-15 and thereafter. (These provisions are applicable from 01.04.2014 vide [notification dated 27.03.2014.](#))

a) Depreciation is calculated by considering useful life of asset, cost and residual value.

b) Any method WDV or SLM can be used.

c) Schedule – II contains a list of useful life according to class of assets and the residual value shall not be more than five percent of the original cost of asset. However companies are free to adopt a useful life different from what specified in Schedule II and residual value more than 5%. The financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice.

8.2 (E) Methods for providing depreciation-

Straight line method or fixed instalment method Reducing balance method or Written down value method Annuity method

Depreciation fund method Insurance fund method Revaluation method
Sum of the digits method Depletion method Machine hour rate method
Repairs provision method.

The first two methods are discussed.

- **Straight line method (SLM) or fixed instalment method (FIM) or original cost method**

Meaning-Under this method a fixed percentage of the original value of the asset is written off every year. The value of the asset is reduced to zero at the end of the useful life of the asset. As the amount of depreciation remains constant every year, this method is called as fixed instalment method.

- **Reducing balance method (RBM) or Written down method(WDV)**

Meaning- Under this method, depreciation is charged at a certain percentage each year on the balance of the asset which is brought forward from the previous year . The amount of depreciation charged in each year is not fixed but goes on reducing at the later years . As the amount of depreciation keeps reducing , it is known as reducing balance method. The depreciation is charged on the written down value of the asset hence known as written down value method.

8.2 (F) Distinction between FIM and WDV methods –

The following illustration will help to bring out the distinction between the two methods-

Let us assume the machinery was purchased for Rs 1,00,000 and Depreciation is to be provided @10% p.a.

Year	Depreciation as per FIM @10%	Depreciation as per WDV @10%
1	1,00,000 x 10% for 1 year=10,000 Value of asset at the end of the first year is 1,00,000-10,000= 90,000	1,00,000x10%for 1 year=10,000 Value of asset at the end of the first year is 1,00,000-10,000= 90,000
2	Depreciation @ 10% on 1,00,000= Rs 10,000. Value of asset at the end of the second year is 90,000-10,000=80,000	Depreciation @ 10% on 90,000= Rs 9,000. Value of asset at the end of the second year is 90,000-9,000=81,000
3	Depreciation @ 10% on 1,00,000= Rs 10,000. Value of asset at the end of the third year is 80,000-10,000=70,000	Depreciation @ 10% on 81,000= Rs 8,100. Value of asset at the end of the third year is 81,000-8,100=72,900

4	Depreciation @ 10% on 1,00,000= Rs 10,000. Value of asset at the end of the fourth year is 70,000-10,000=60,000 Thus depreciation is always @ 10% of original cost	Depreciation @ 10% on 81,000= Rs 8,100. Value of asset at the end of the fourth year is 72,900-7,290=65,610 Thus depreciation is always on 10% on the balance or WDV
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The following points are observed from the above table-

The amount of depreciation remains same for all the years as per the FIM method while it keeps decreasing as per the WDV method.

The value of asset at the end of the tenth year would be zero as per the FIM while the asset value will never become zero as per the WDV method.

There is no difference in the amount of depreciation and the value of asset after charging depreciation in the first year under both the methods.

Fixed instalment or straight line method	Written down value or Reducing balance method
1)It is a method of depreciation in which depreciation at fixed percentage (rate) is charged every year on original cost of fixed asset and the amount of depreciation remains the same (constant) every year	1)It is a method of depreciation in which depreciation at fixed percentage (rate) is charged every year . The amount of depreciation goes on reducing every year
2)The amount of depreciation is charged on the original cost of the asset	2)The amount of depreciation is charged on the written down value of the asset
3)After certain number of years the value of the asset becomes zero	3) The book value of the asset never becomes zero
4)This method of depreciation is not accepted for Income tax purposes	4)This method of depreciation is accepted for calculation and payment of Income tax
5)This method of depreciation is easy to calculate and more suitable for assets of lower value	5)This method of depreciation is suitable for assets of higher value having longer life requiring heavy expenditure in later life of the asset

8.2 (G) Accounting treatment of Depreciation- The transactions relating to purchase of asset and depreciation are recorded through journal entries and later posted in the relevant ledger accounts. Journal entries

A) When Provision for depreciation account is not maintained-

The transactions of purchase of asset, providing depreciation on asset, sale of asset, profit/ loss on sale of asset are recorded in the asset account.

For purchase of asset for cash-	Asset a/c Dr To cash/ bank a/c
For purchase of asset on credit	Asset a/c Dr To supplier/party a/c
For payment of installation charges	Asset a/c Dr To cash/ bank a/c
For providing depreciation	Depreciation a/c Dr To Asset a/c
For transfer of depreciation to Profit and Loss a/c	Profit and Loss a/c Dr To Depreciation
For sale of asset	Cash/ bank a/c Dr To Asset a/c
For loss on sale of asset	Profit and Loss a/c Dr
	---To Asset a/c
For profit on sale of asset	Asset a/c Dr To Profit and Loss a/c

After passing the journal entries the relevant ledger accounts are to be prepared. The balance in the asset account will be carried down to the next accounting period and the balance in the depreciation account will be transferred to profit and loss a/c.

At the end of the year, while preparing final accounts, Depreciation amount will be shown on the debit side of profit and loss account.

The asset will appear in the balance sheet at the written down value (value after providing for depreciation on the asset)

When the above entries are posted in the asset a/c the entries will be appearing in the asset account as under

Dr			ASSET A/C			Cr		
Date	Particulars	Amt	Date	Particulars	Amt			
	To cash/ bank a/c (cash Purchase)			By Depreciation (yearly depreciation)				
	To suppliers a/c (Credit purchase)			By cash/ Bank (sale of asset)				
	To cash/ Bank (installation charges)			By profit and loss a/c (loss on sale)				
	To profit and loss a/c (profit on sale)							
	To balance c/d (balancing figure)							

B) When provision for depreciation account is maintained-

- For purchase of asset for cash-

Asset a/c Dr
To cash/ bank a/c

- For purchase of asset on credit

Asset a/c Dr
To supplier/ partys a/c

- For payment of installation charges

Asset a/c Dr
To cash/ bank a/c

- For providing depreciation-

Depreciation a/c Dr
To Provision for Depreciation a/c

- For transfer of depreciation to Profit and Loss a/c

Profit and Loss a/c Dr
To Depreciation

- For sale of asset

Cash/ Bank a/c Dr
To Asset a/c

- On sale of asset, the amount of provision created for the asset sold is to be transferred to Asset a/c

Provision for Depreciation a/c Dr
To Asset a/c

- For profit on sale of asset

Asset a/c Dr
To Profit and Loss a/c

- For loss on sale of asset----

Profit and Loss a/c Dr
To Asset a/c

Under this method, the amount of depreciation to be provided is not recorded in the Asset a/c but is shown in the Provision for Depreciation a/c.

The asset account will always show a debit balance and the provision for depreciation account will show a credit balance.

The Asset a/c appears in the Balance sheet at its original value on the Asset side and the provision for depreciation appears in the balance sheet on the liability side.

Solved Problems- straight line method

1) M/s Raj and Sons purchased Machinery on 1st October 2007 at Rs 90,000 and spent Rs 10,000 on its installation. The firm provides depreciation at 10% p.a. under straight line method.

Show machinery a/c and depreciation a/c for the years 2007-08, 2008-09 and 2009-10 assuming books of accounts are closed on 31st March every year.

Solution- In the books of Raj and Sons

Working note for calculation of depreciation under SLM @ 10% p.a.

1 Oct 2007- cost of asset (90,000+10,000) = 1,00,000

Less depreciation @ 10% for 6 months = -5,000

WDV as on 31 March 2008 = 95,000

Less depreciation @ 10% for 1 year = - 10,000

WDV as on 31st March 2009 = 85,000

Less depreciation @ 10% for 1 year = - 10,000

WDV as on 31st March 2010 = 75,000

Dr Machinery account Cr

Date	Particulars	Amt	Date	Particulars	Amt
2007 1 oct	To Bank	90,000	2008 31 march	By Depreciation	5,000
	To Bank	10,000		By balance c/d	95,000
		1,00,000			1,00,000
2008 1 April	To balance c/d	95,000	2009 31 march	By depreciation	10,000
		95,000		By balance c/d	85,000
2009 1 April	To balance b/d	85,000	2010 31 march	By Depreciation	10,000
		85,000		By balance c/d	75,000
2010 1 April	To balance b/d	75,000			85,000

Dr Depreciation account Cr

Date	Particulars	Amt	Date	Particulars	Amt
2008 31 march	To Machinery a/c	5,000	2008 31 march	By P&La/c	5,000
		5,000			5,000
2009 31 march	To Machinery a/c	10,000	2009 31 march	By P&La/c	10,000
		10,000			10,000
2010 31 march	To Machinery a/c	10,000	2010 31 march	By P&La/c	10,000
		10,000			10,000

2) Written down value method-

On 1st April 2005, Karan Bros purchased furniture for Rs 40,000. On 1st October, 2005, additional furniture was purchased for Rs 20,000.

On 1st October 2007, they sold furniture which was purchased on 1st April 2005 for Rs 28,000. The accounts were closed on 31st March every year. Depreciation was provided @10% p.a. by WDV method

Prepare Furniture account and Depreciation account.

Solution-Working note for calculation of Depreciation @ 10% p.a. on WDV

Particulars	Furniture1	Furniture 2	Depreciation
Cost of furniture	40,000	20,000	
Less depreciation(on F-2 for 6 months)	4,000	1,000	5,000
WDV	36,000	19,000	
Less Depreciation	3,600	1,900	5,500
WDV	32,400	17,100	
Less Depreciation (on F-1 for 6 months)	1,620	1,710	3,330
WDV	30,780	15,390	
Sold for	28,000		
Loss on sale	2,780		

In the books of Karan Bros

Dr

Furniture a/c

Cr

Date	Particulars	Amt	Date	Particulars	Amt
2005 1 April 1 Oct	To Cash/ Bank To Cash/ Bank	40,000 20,000	2006 31march	By Depreciation By balance c/d	5,000 55,000
		60,000			60,000
2006 1 April	To balance b/d	55,000	2007 31march	By Depreciation By balance c/d	5,500 49,500
		55,000			55,000
2007 1April	To balance b/d	49,500	2007 1 oct 2008 31March	By Depreciation By cash/ bank By P& La/c By Depreciation By balance c/d	1,620 28,000 2,780 1,710 15,390
		49,500			49,500
2008 1April	To balance b/d	15,390			

Dr			Depreciation a/c		Cr	
Date	Particulars	Amt	Date	Particulars	Amt	
2006 31march	To Furniture	5,000	2006 31march	By P&La/c	5,000	
		5,000			5,000	
2007 31march	To Furniture	5,500	2007 31march	By P&La/c	5,500	
		5,500			5,500	
2007 1 oct 2008 31march	To Furniture To Furniture	1,620 1,710	2008 31march	By P&La/c	3,330	
		3,330			3,330	

3) Provision for depreciation-

On 1st April 2009, following balances appeared in the books of Mangesh Traders

Machinery a/c Rs 4,00,000 Provision for Depreciation a/c Rs 1,60,000

On the above date, they decided to sell the machinery for Rs 1,00,000 which was purchased on 1st April 2006 for Rs 1,50,000. The firm provides Depreciation on 31 March every year @ 10% p.a. under straight line method.

Show Machinery account and Provision for depreciation account as on 31 March 2010.

Solution- Working note Depreciation @10% on SLM

Original cost of the machinery sold - 1,50,000 and depreciation at 10% p.a. is 15,000

Depreciation for three years (1-April 2006 to 31 March 2009) is 15000×3 years = 45,000

WDV as on 31 March 2009 = $150000 - 45,000 = 105000$

Sold for 1,00,000

Loss on sale of machinery 5,000

In the books of Mangesh Traders

Dr Machinery account Cr

Date	Particulars	Amt	Date	Particulars	Amt
2009 1april	To balance b/d	4,00,000	2009 1april	By cash/bank	1,00,000
				By Provision for Depreciation a/c	45,000
				By P&L a/c (	5,000
				Loss on sale)	
			2010 31march	By balance c/d	2,50,000
		4,00,000			4,00,000
2010 1april	To balance b/d	2,50,000			

Dr Provision for Depreciation a/c Cr

Date	Particulars	Amt	Date	Particulars	Amt
2009 1 april	To Machinery a/c	45,000	2009 1april	By balance b/d	1,60,000
2010 31march	To balance c/d	1,40,000	2010 31march	By Depreciation	25,000
		1,85,000			1,85,000
			2010 1april	By balance b/d	1,40,000

Summary

Depreciation is the gradual and permanent decrease in the value of the asset. Depreciation refers to the decline or reduction in the value of fixed asset. Depreciation is the permanent and continuing diminution in the quality, quantity or value of an asset. Depreciation is required to be provided on fixed assets and charged to Profit and loss account so that the correct profit or loss can be ascertained and the balance sheet reflects the true financial position .Depreciation is caused due to natural wear and tear, efflux of time, obsolescence, depletion, natural calamities .The three factors affecting depreciation are- cost of the asset, estimated useful life of the asset and the residual or scrap value of the asset at the end of its useful life. Thus, Formula for calculating depreciation ----

Depreciation per annum=Original cost of the asset-estimated scrap value
Estimated useful life of the asset.

There are two methods of calculating depreciation . They are-

Straight line method (SLM) or fixed instalment method (FIM) or original cost method -Under this method a fixed percentage of the original value of the asset is written off every year. The value of the asset is reduced to zero at the end of the useful life of the asset. As the amount of depreciation remains constant every year, this method is called as fixed instalment method.

Reducing balance method (RBM) or Written down method(WDV)- Under this method, depreciation is charged at a certain percentage each year on the balance of the asset which is brought forward from the previous year . The amount of depreciation charged in each year is not fixed but goes on reducing at the later years . As the amount of depreciation keeps reducing , it is known as reducing balance method. The depreciation is charged on the written down value of the asset hence known as written down value method.

Accounting Standard (AS) -6 (Revised) deals with Depreciation Accounting.

Depreciation is to be recorded in the debit side of Profit and Loss account and deducted from the value of the asset in the balance sheet.

Key terms

Depreciation- Depreciation is the gradual and permanent decrease in the value of the asset

Cost of the asset- The cost of the asset refers to the purchase price of the asset. The expenses related to the purchase of the asset are to be added to the purchase price to arrive at the cost of the asset.

Residual value - Residual value refers to the value that can be realized at the end of the useful life of the asset when the asset will be sold as scrap .Such scrap value is to be deducted from the cost of the asset.

Straight line method- It is a method of providing depreciation where the amount of depreciation remains constant or fixed every year . The depreciation is charged at a certain rate on the original cost of the asset.

Written down value method- It is a method of providing depreciation where the amount of depreciation goes on reducing every year. The depreciation is charged on the written down value of the asset.



MODULE - VII

9

INVENTORY CONTROL

Unit structure

- 9.1 Objectives
- 9.2 Introduction
- 9.3 Definition of Inventory
- 9.4 Purchase of Materials
- 9.5 Methods of Stock Taking
- 9.6 Inventory / Material Control Systems or Techniques
- 9.7 Stock Levels
- 9.8 Economic Re-Order Quantity Solved Problems
- 9.9 Inventory Turnover Ratio
- 9.10 Questions

9.1 OBJECTIVES

After studying the unit the students will be able to

- Define the concept Inventory and explain the various costs related to Inventory.
- Explain the material purchase procedure.
- Discuss about the function in storing the material.
- Know the techniques of Material Control.
- Solve the practical problems related to Stock Levels, EOQ and Inventory Turnover Ratio.

9.2 INTRODUCTION

Inventory means stock of items kept in reserve for certain period of time. It includes raw materials, work-in-progress or semi-finished goods, finished goods and spare parts for the maintenance of equipment etc. Raw materials are those inputs that are converted into finished products. Work in progress represents semi-finished goods that requires some work before they are ready for sale. Finished products are those which are ready for sale. Inventory is the physical stock of items that a business or production organisation keeps in hand for efficient running of its production function.

9.3 DEFINITION OF INVENTORY

9.3.1 Meaning and Definition

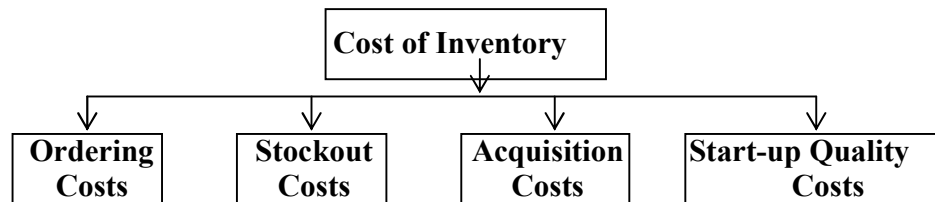
According to **Gordon B. Carson**, inventory includes raw materials and component parts. Inventories consist of raw material, component parts, supplies and finished assemblies which an organisation purchases from an outside source and parts, assemblies and finished products which the company manufactures itself. In simple words inventory means 'stock items' or items in stock.

It is very essential that material of the correct quantity and quality is made available as and when required, with due regard to economy in storage and ordering costs, purchase prices and working capital. Inventory control involves (i) Assessing the items to be held in stock. (ii) Deciding the extent of stock holding of items individually and collectively. (iii) Regulating the input of stock into the store houses and (iv) Regulating the issue of stock from the stores houses.

9.3.2 COST OF INVENTORY

Inventory control is generally concerned with the procurement of raw-materials and purchased parts (i.e. components) and their supply to the production departments. Supplies and stores are the indirect materials. They do not form a part of the finished products. They are closely related to the maintenance services and so they should be controlled by the maintenance department. Work-in-progress is primarily concerned with the manufacturing department, because it is results from the various operations performed on the shop. It is proper to assign the control functions of work-in-progress to manufacturing department.

Every business organisation, however big or small, has to maintain inventory and it constitutes as integral part of the working capital. It has been estimated that inventory in Indian industries constitutes more than 60% of current assets. Inventories are significant elements in cost process. Inventories require a significant investment, not only in acquiring them but also in holding them. The various types of cost of inventory are as follows :



1. Ordering Costs: Each time we purchase a batch of raw material from a supplier, a cost is incurred for processing the purchase order, expediting, record keeping, and receiving the order into the warehouse. Each time we produce a production lot, a changeover cost is incurred for changing production over from a previous product to the next one. The larger the lot

sizes, the more inventory we hold, but we order fewer times during the year and annual ordering costs are lower.

2. Stockout Costs: Each time we run out of raw materials or finished-goods inventory, costs may be incurred. In finished-goods inventory, stockout costs can include lost sales and dissatisfied customers. In raw-materials inventory, stockout costs can include the cost of disruptions to production and sometimes even lost sales and dissatisfied customers. Additional inventory, called **safety stock**, can be carried to provide insurance against excessive stockouts.

3. Acquisition Costs: For purchased materials, ordering larger batches may increase raw-materials inventories, but unit costs may be lower because of quantity discounts and lower freight and materials-handling costs. For produced materials, larger lot sizes increase in-process or finished-goods inventories, but average unit costs may be lower because changeover costs are amortized over larger lots.

4. Start-up Quality Costs: When we first begin a production lot, the risk of defectives is great. Workers may be learning, materials may not feed properly, machine settings may need adjustment, and a few products may need to be produced before conditions stabilize. Larger lot sizes mean fewer changeovers per year and less scrap.

9.4 PURCHASE OF MATERIALS

There is a purchase department which carries out the function of purchases of materials. The purchase manager is responsible for ensuring the items ordered are of the standard quality, lower cost and received in time. The purchase procedure vary with different business firms. The purchase procedure is given below:

a) Purchase Requisition:

Purchase requisition is the formal request made by the storekeeper to the purchase department for giving order of raw materials or stores. It serves the dual purpose of authorizing the purchase department to make purchases and provides a record of the description and quantity of materials required. It also fixes the responsibility of the department or personnel making purchase requisition.

b) Purchase order:-

After receiving the duly approved requisition, the purchase department has to place an order with a supplier. It is an offer to buy certain materials at stated price and terms. For routine purchases, the order is placed through established supplies. In other cases, the purchase department may ask for bids or send out request for quotation before placing an order. The purchase order is a formal contract for the supply of materials. Copies of the purchase order are sent to the departments concerned.

c) Receiving and Inspection of materials:

The stores department is responsible for taking delivery of packages and to get a physical verification of the contents. When the materials are received, the stores official gets the packages, open them and make a detailed verification of the contents. After the contents of the packages are checked, the details are entered into a Goods Received Note. Copies of the G.R.Note are issued to the supplier, purchase and accounts department, where the factory has to test the materials received for quality and specifications. It has to ensure that the quality of materials is as per purchase order.

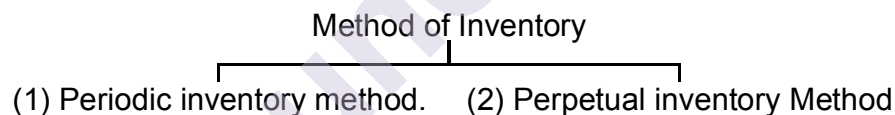
d) Approval of Invoices and Payment

Invoice received by the purchase department is forwarded to the Accounts department for payment with their recommendation. Accounts department has to check the authenticity, arithmetical accuracy and G. R. Note in order to make sure that the goods are as per purchase order. When it is found that everything is in order, it is passed for payment by the Accountant. Then the cashier will draw the cheque as per terms and conditions of the purchase order and invoice and finally payment is made to the supplier.

9.5 METHODS OF STOCK TAKING

9.5.1 Meaning

Methods of taking inventories / stock



1. Periodic inventory method :

Under this method of taking inventories, value of stock is determined by physical counting of the stock on the accounting date of preparation of the final accounts. It is possible that stock taking may take a week or so in large enterprises and purchases and sales may have to be suspended for that period to get correct figure of closing inventory. This method of ascertaining the value of stock at the end of the year is also known as annual stock taking. Thus this method is based physical stock taking. It provides data once in a year is simple and economical method of stocktaking can be adopted in small concerns, but it does not provide basis for control.

2. Perpetual Inventory Method :

Perpetual inventory defined as a system if records maintained by the controlling department, which reflects the physical movements of stock and their current balance. Under this method stock registers are maintained to make a record of the physical movements of stock and their

current balance. Stores ledger is maintained to keep a record of the receipt and issue of the materials and also reflects the balance in store. Similarly, work-in-progress ledger is maintained to give the value of work-in-progress on hand and a finished goods ledger is maintained to know the value of finished goods on hand. Thus this system provides a running record of inventories on hand at any time. To ensure the accuracy of perpetual inventory records physical verification of the inventory is made by a program of continuous stock taking.

It is possible that the balance of stock by the perpetual inventory may differ from the actual balance of stock as ascertained by physical verification. Any difference noted between actual stocks as disclosed by the physical verification and the stocks shown by stock records should be investigated and rectification made then and there. If the physical verification reveals that actual balance of stock, is more than the balance shown by the stores ledger or work-in-progress ledger or finished goods ledger debit note is prepared and stock record are adjusted accordingly so that balance may reconcile with actual balance. A Stock Adjustment Accounts is prepared and debited with the shortage of stock and credited with surplus.

Continuous stock taking is an essential feature of the perpetual inventory system. But the two terms, perpetual inventory and continuous stock taking should not be taken as one; perpetual means the system of stock records and continuous stock taking whereas continuous stock taking means only the physical verification of stock records with actual stocks.

In continuous stock taking, physical verification is spread throughout the year. Every day 10 to 15 items are taken at rotation and checked so that surprise, element in short verification is maintained and each item is checked for a number of times during the year. On the other hand, surprise element is missing in case of periodical checking because checking is usually done at the end of the year. In short this method is based on records. It requires a lot of recording and is thus expensive. It can be adopted only in big concerns. It provides data on running basis and thus facilitates the preparation of financial statements at shorter intervals. It also provides basis for control by investigation the basis for control by investigation the discrepancies arising from the comparison of physical stock with their book values.

Difference between Periodic inventory and Perpetual inventory.

The following are the main differences between the two methods of taking inventory.

Periodic Inventory	Perpetual Inventory
1. It is based on physical stocktaking	1. It is based on records.
2. It provides data periodically i.e. once in year.	2. It provides the data on running basis and thus facilitates the preparation of financial statements at shorter intervals.
3. It does not provide basis control.	3. It provides basis for control by investigating the discrepancies arising from the comparison of physical stock with book values.
4. It is simple and economical method of taking inventory and can be adopted in small concern.	4. It is expensive as it requires a lot of recording due to an elaborate method of taking inventory. It can be adopted by big concerns only.

9.6 INVENTORY CONTROL SYSTEMS OR TECHNIQUES :

9.6.1 Meaning

Material control is the function of ensuring that the sufficient stocks are maintained to meet all requirement without any problem. It also includes to avoid carrying unnecessary stock. It is for safeguarding company's priority in the form of materials by keeping systematic records and maintaining them at optimum level considering requirements and financial resources of company's business. It needs proper planning organising and controlling the receipt and issues of material and its storage to achieve the objectives of the company efficiently.

9.6.2 Objectives of material control

- a) To maintain continuous supply of material.
- b) To avoid over stocking of materials
- c) To obtain minimum quantity of materials from reliable sources.
- d) To minimize total cost.
- e) To avoid waste and loss of stock during storage period.
- f) To maintain up dated stock level.
- g) To supply required information to the management in decision making and its execution process.

9.6.3 Techniques of Material Control

Various techniques are used in controlling the inventories. Some popular and important techniques are as under :

- A. Re-order Point (ROP).
- B. Economic Ordering Quantity (EOQ).
- C. ABC Analysis.

A. RE-ORDER POINT (ROP) :

Receiving and issuing of inventories are the common and recurring phenomena in a manufacturing organisation. When the inventories fall below a particular point, they are replenished by the fresh purchases. Re-order point (ROP) is the point when the inventories have to be replenished by fresh order. It fundamentally deals with 'when to order' or to replenish the inventories.

Re-order point is a stock level at which fresh supplies of materials should be ordered. The level is fixed somewhere between minimum level and maximum level. It is fixed in such a way that fresh supply of materials are received before the level reaches the minimum level. The re-order point also called re-order level depends upon two factors:

(a) Maximum consumption and (b) Lead time i.e. the anticipated time lag between the dates of issuing orders and receiving supplies. The formula for calculating re-order level is :

$$\text{Re-order Level} = \text{Maximum usage} \times \text{Minimum re-order period.}$$

Re-order Quantity : Re-order quantity is the quantity for which an order is placed when stock reaches the re-order level. The term is used generally in synonymous with the Economic Order Quantity since order is placed only in such size which will be economical for the enterprise in all respect.

B. ECONOMIC ORDER QUANTITY :

The Economic Order Quantity (also known as re-order quantity) refers to the size of the order which gives the maximum economy in purchasing any material. It is an optimum or standard order size. When the stock reaches the recorder level, the company should give a fresh order of optimum size.

This quantity is also called "Economic Purchase Quantity, or Economic lot size, or optimum lot size or Minimum Cost Inventory."

In fixing the economic order quantity, the following costs are considered:

1. Ordering Cost : This is the cost of placing an order with the supplier and includes cost of stationery, salary of those who are engaged in placing

a order and in receiving and inspecting the materials. It is a fixed cost and therefore cost of placing an order varies from time to time depending upon the number of order placed and the quantity of items ordered. The number of orders increase, the ordering cost goes up and vice-versa.

2. Inventory Carrying Cost : It is the cost of holding the stock in storage and includes interest on investment, obsolescence losses, store keeping cost, such as rent of warehouse, salary of store keeper, stationery used in maintaining records of stores, etc, insurance cost, deterioration and wastage of material. The larger the volume of inventory, the great will the inventory carrying cost and vice-versa.

The above two costs are of opposite nature. If for example, an attempt is made to reduce of inventory carrying cost by holding the stores as low as possible, the number of orders will increase and consequently the ordering cost will go up. On the other hand, if orders are placed for a larger quantity, the inventory carrying cost will increase and ordering cost, the economic order quantity (EOQ) is fixed to keep the aggregate cost to the minimum.

Assumptions of Economic Order Quantity (EOQ) : The EOQ model is based on the following assumptions:

(i) There is only one product involved; (ii) Annual usage (demand) requirements are known; (iii) Usage is spread evenly throughout the year so that the usage rate is reasonably constant; (iv) Lead time does not vary; (v) Each order is received in a single delivery and (vi) There are no quantity discounts.

Precautions in Applying EOQ : The following precautions are necessary in applying E.O.Q.

1. Simplification of Routine : If the E.O.Q. formula tells us that 13 orders have to be placed in a year, we may place 12 orders, i.e. once a month.

2. Ordering in Package Sizes : Many goods are packed in units of one gross. If figure shows a quantity of 11 dozens, it should be changed to 12 dozens.

3. Economical Freight Rates : If the mathematical figure gives 9/10th of a lorry or rail wagon load, it is better to increase the quantity to have one full lorry load or one full wagon load. This would be cheaper, because the full wagon load rates would be lower than transporting the material as smalls.

4. Perishable Articles : For perishable articles whose shelf-life is very low, E.O.Q. should be very much less than the theoretical figure and should be based on practical considerations.

5. Seasonal Articles : For articles of a seasonal nature, e.g., cotton or groundnuts or oilseeds, bulk purchases during the season will be cheaper than purchases based on E.O.Q.

6. Bulk Purchases : In certain cases, considerable discounts would be available for bulk purchases. This should be compared to the savings as a result of the application of E.O.Q. formula and a decision should be taken based on which is cheaper.

7. Import of Materials : E.O.Q. cannot be successfully applied in the case of imports of materials which is based on import licences.

Importance of Economic Order Quantity (EOQ) : If re-order quantity is determined in advance and adjusted it ensures the following advantages

1. The cost of storage can be kept at a minimum.
2. Purchase orders can be easily prepared at intervals.
3. The advantages of placing large orders can be derived as far as possible.

Limitations of Economic Order Quantity (EOQ) : The following are the limitations of EOQ:

- (a) Where rate of consumption fluctuates very often ordering a fixed quantity may lead to over or under stocking.
- (b) Very often, consumption rate cannot be anticipated because of certain unavoidable reasons such as power failure, slackening of customers' demand etc.
- (c) Sometimes, estimating of carrying cost and ordering cost in advance is not easy.

C. A.B.C. ANALYSIS:

A most useful guide to devising stock control system is often known as 'Pareto Analysis' (after the name of an Italian Philosopher). The term is also known as ABC analysis because it analyses the range of stock items held into three sectors, known as A, B and C.

ABC analysis is a new technique of classifying and controlling production and store inventories both purchased and manufactured in accordance with value of the item. It is the starting point for material management. It is the basic analytical management tool which enables top management to place the effort where the results will be greatest. The technique is popularly known as Always Better Control or the Alphabetical approach. The technique tries to analyse the distribution of any characteristic by money value of importance in order to determine its priority. In materials management the technique has been applied in areas needing selective control such as inventory, criticality of items, obsolete stocks, purchasing orders, receipt of materials, inspection, store-keeping and verification of bills.

ABC analysis or classification is the principle of Selective Control of inventories and a technique of grouping thousands of stock items handled by an organisation. The principle involved is that the degree of control on

stock items and amount of safety stock carried should vary directly with the consumption value of the item involved.

Advantages of ABC Analysis : The following are the advantages of ABC Analysis :

1. Selective Control : This approach helps the materials manager to exercise selective control and focus his attention only on a few items when he is concerned with lakhs of store items.

2. Control Inventories : By concentrating on 'A' class items, the materials manager is able to control inventories and show visible results in a short span of item.

3. Obsolete Stocks : By controlling the 'A' items obsolete stocks are automatically pin pointed.

4. Clerical Cost : The system also helps in reducing the clerical cost and better planning and improved inventory turnover.

5. Equal Attention : ABC Analysis has to be resorted to because equal attention to A, B and C items will not be worthwhile and would be very expensive.

Material cost is defined as cost of material of any kind or nature used for the purpose of production of goods or services. Direct materials are the materials whose cost can be attributed to a cost object in economical feasible way and indirect materials are those whose cost cannot be directly attributed to a particular cost object.

9.7 STOCK LEVELS

9.7.1 Meaning

Stock levels is the technique which fixes the stock control level in terms of quantity for ensuring the optimum quantity of materials purchased and stored. This raise the questions when to buy and where from to buy and helps the management while preparing budget and schedule of purchases.

A. Maximum Level :-

This level of stock indicates the maximum figure of inventory quantity held in stock at any time. The quantity of stock should not exceed the level.

Following factors should be considered while fixing the maximum level of various stock.

- 1. Re-order level :-** The product of maximum consumption of inventory item and its maximum delivery period.
- 2. Minimum Consumption:-** Minimum Consumption and minimum delivery period for each stock should be known.

3. **Adequacy of working capital :-** It should know to maintain maximum level of inventory.
4. **Storage space :-** It should be stored properly in stores.
5. **Additional storage cost :-** Cost required for additional storageshould be considered.
6. Additional insurance cost should be considered.
7. **Regular supply :-** In case of importance materials due to their irregular supply, the maximum level should be high.

Maximum Level= (Reorder level) + (Reorder quantity) – (Maximum consumption x Minimum Reorder period)

B. Minimum Level :-

Minimum level shows the lowest figure of inventory balance, which must be maintained in hand at all times, so that there is no stoppage of production due to non-availability inventory. This level is possible to maintain fixed level after takking into consideration the rate of consumption and the time required to acquire sufficient material to avoid dislocation of production.

Factors responsible to maintain minimumlevel of inventory.

- a. Average rate of consumption for each inventory items.
- b. Maximum consumption and maximum delivery period in respectof each item to determine its re-order level.
- c. Average re-order level to each item. This period can becalculated by averaging minimum and maximum period.

Minimum level = (Re order level) –

(Average consumption x Average/Normal Reorder Period)

C. Re-order level

This level is between the minimum and maximum levels in such away at which purchase requisition should be made out for fresh supply. The object of maintaining this level is to place order so that stock is not reduced to a level less than the minimum level.

Following factors are considered white maintain this re-order level.

1. Maximum consumption
2. Maximum Re-order period
3. Minimum level

Re-order level = Minimum level + (Normal Consumption x Normal Reorder Period)

OR

$$= (\text{Maximum Consumption} \times \text{Maximum Re-order Period})$$

C. Average stock/ inventory level :-

It is the level of average of minimum level and Maximum level. It means the average level is maintained in states.

$$\text{Average stock level} = \frac{\text{Maximum level} + \text{Minimum level}}{2}$$

E. Danger level :- OR

$$= \text{Minimum level} + \frac{1}{2} \text{ reorder quantity}$$

This is the level below the minimum stock level. When stock reaches this level, immediate action is needed to take for replacement of stock. If the stock is reached at this level, the normal lead time is not available and hence regular purchase procedure can not be adopted. This may result in high cost remedial action only. If this is fixed below the re-order level and above minimum level it will be possible to take preventive action.

$$\text{Danger level} = (\text{Average rate of consumption}) \times \text{urgent supply time}$$

OR

$$= (\text{Normal consumption}) \times (\text{maximum re-order period} + \text{emergency purchases})$$

9.3.2 SOLVED PROBLEMS

- 1) In Aniket and Co, weekly minimum and maximum consumption of material 'A' are 50 and 120 units respectively. The reorder quantity as fixed by the company is 350 units. The material is received within 4 to 6 weeks from issue of supply order.

Calculate the following.

- a) Minimum level
- b) Maximum level
- c) Re-Order level

Solution :- Average consumption = $(50 + 120)/2 = \frac{170}{2} = 85$

$$\text{Average re-order period} = (4 + 6) \times 2 = 5 \text{ weeks}$$

a) Re-order level = Maximum consumption \times Maximum Re-order period
 $= 85 \times 6$

$$= 510 \text{ units}$$

b) Minimum level = (reorder level)

(Average consumption x Average re-order period)

$$= 510 (85 \times 5)$$

$$= 510 - 425$$

$$= 85 \text{ units}$$

c) Maximum level = Re-order level + Re-order quantity

(minimum consumption x minimum Re-order period)

$$= 510 + 350 (50 \text{ units} \times 4 \text{ weeks})$$

$$= 860 - 200$$

$$= 660 \text{ units.}$$

2) The following information is available in respect of material in ABC Co. Ltd of Aurangabad,

a) Re-order quantity = 2,500 units

b) Re-order period = 6 to 8 weeks

c) Maximum consumption = 600 units per week

d) Normal consumption = 300 units per week

e) Minimum consumption = 200 units per week calculate

i) Re-order level

ii) Minimum level

iii) Maximum level

iv) Average stock level

Solution

i) Re-order level = Maximum consumption x Maximum Reorder period

$$= 600 \times 8 = 4800 \text{ units}$$

ii) Minimum level = (Re-order level) (Normal consumption x

(Average Reorder period)

$$= 4800 - (300 \times \frac{8+6}{2})$$

$$= 4800 - (300 \times 7)$$

$$= 4800 - 2100$$

$$= 2700 \text{ units}$$

- iii) Maximum level = Re-order level + Reorder quantity
 (Minimum consumption = Minimum Re-order period)
- $$= 4800 + 2500 - (200 \times 6)$$
- $$= 7300 \text{ (1200)}$$
- $$= 7300 - 1200$$
- $$= 6100 \text{ units}$$

- iv) Average stock level = $\frac{\text{Minimum level} + \text{Maximum level}}{2}$
- $$= \frac{2700 + 6100}{2}$$
- $$= \frac{8800}{2}$$
- $$= 4400 \text{ units}$$

9.8 ECONOMIC RE-ORDER QUANTITY SOLVED PROBLEMS

9.8.1 Formula to calculate EOQ

Economic order Quantity
$$\sqrt{\frac{2 \times A \times O}{C}}$$

Where A = Annual unit consumed / used
 O = Ordering cost per order

C = Annual carrying cost of one unit i.e. Carrying cost percentage p.a x cost per unit.

9.3.3 Solved Problems Illustration 3

From the following particulars, calculate Economic Order Quantity and number of order to be placed in the year by using

- Tabulation method
 - Formula method
- Annual consumption of material - 6000 kg
 - Cost of placing an order - ₹ 60

iii) Cost per kg - ₹ 5

iv) Storage and carrying cost - 10 % an average inventory.

Ans.

a) Tabulation method

Particulars	Formula	1	2	3	4	5	6	7	8	9	10
Annual usage	A	6000	6000	6000	6000	6000	6000	6000	6000	6000	6000
Order size	Q	6000	3000	2000	1500	1200	1000	857	750	667	600
Ordering cost p.u.	O	60	60	60	60	60	60	60	60	60	60
Carrying cost p.u.	C = 10% of ₹ 5	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
No. of orders	N = A/Q	1	2	3	4	5	6	7	8	9	10
Total carrying cost	TC = Q × C	1500	750	500	375	300	250	214	188	167	150
Total Ordering cost	TO = N × O	60	120	180	240	300	360	420	480	540	600
Total Annual cost	TAC = TC + TO	1560	570	680	615	600	610	634	668	707	750

Box indicates EOQ = 1200 unit. When 5 order of 1200 kg each are placed, the carrying cost 300 and the total cost 600 is the lowest.

Tabulation method is useful for computing EOQ when the order size / lot is shifted, ii) Supplier offers volume discount that higher discount for large quantities.

b) Formula method

$$EOQ = \sqrt{\frac{2AO}{C}}$$

Where, A=Annual consumption – 6000

kgO = costing of placing an order – ₹ 60

C = storage and carrying cost per unit = $\frac{5 \times 10}{100} = ₹ 0.50$

$$EOQ = \sqrt{\frac{2 \times 6000 \times 60}{0.50}} = \sqrt{\frac{2 \times 6000 \times 60 \times 100}{50}} = \sqrt{1440000}$$

= 1200 unit

Illustration 4

From the following figures, calculate Economic order Quantity and order to be placed for number kg in each year.

Annual consumption of material : 4000 kg Cost per unit = Rs. 20 Per kg

Cost of Buying per order = Rs 5 /-

Storage and carrying cost = 87.0 average inventory

Ans.
$$EOQ = \sqrt{\frac{2AO}{C \times S}}$$

Where A = Annual usage - 4000 kg

O = cost of buying per order = 5 /-

C = cost per unit = 20 /-

S = storage and carrying cost

$$\begin{aligned} \therefore EOQ &= \sqrt{\frac{2 \times 4000 \times 5}{20 \times 87.0}} \\ &= \sqrt{\frac{40000}{1740}} \\ &= \sqrt{22988.5} \\ &= 151.6 \text{ kg} \end{aligned}$$

Illustration 5

From the following information, calculate EOQ

Semi - Annual consumption — 6000 units Purchase price of input unit — ₹ 25 /-

Ordering cost per order — ₹ 45 /- Quarterly carrying cost — 3 %

$$EOQ = \frac{\frac{2A}{O}}{C}$$

Where, A = Annual consumption = 6000 x 2 = 12000 units

O = Ordering cost per order = ₹ 45 /-

C = Annual carrying cost of one unit = 3 % of 25 x 4

$$= \frac{3 \times 25}{100} \times 4 = ₹3$$

$$\therefore EOQ = \sqrt{\frac{2 \times 12000 \times 45}{3}}$$

$$= \sqrt{3,60,000}$$

$$= 600 \text{ units}$$

Illustration 6

PQR Ltd produces a product which has monthly demand of 52,000 units. The product requires a component x which purchased at 15 /- per unit. For every finished product, 2 unit of component x are required. The ordering cost is 350 /- per order and carrying cost is 12 % p.a.

You are required

- Calculate Economic Order Quantity for component 'X'.
- If minimum lot size is supplied 52000 units what is the extracost, the company has to incur?
- What is the minimum carrying cost, the company has to incur?

Ans. Annual consumption of component "x"

$$52000 \text{ units} \times 12 \text{ months} \times 2 = \sqrt{\frac{2AO}{C}} = 12,48,000 \text{ units}$$

a) Economic order Quantity =

Where A=Annual consumption=12,48,000 units
O= Ordering cost Due order = ₹ 350 /-

$$C = \text{Annual carrying cost} = \frac{12^3}{100 \times 15}$$

$$\begin{aligned} \times \text{EOQ} &= \sqrt{\frac{2 \times 1248000 \times 350}{0.60}} \\ &= \sqrt{87,36,00000} \\ &= \sqrt{87,36,00000} \end{aligned}$$

=22030 units

Illustration 7

A manufacturer has to supply to his customer 600 units of his produce per year. Storage is not allowed and the inventory carrying cost amounts to ₹ 0.60 per unit per year. The set up cost per run is ₹ 80

Find the

- Economic order Quantity,
- Minimum average yearly cost,
- Optimum number of order per year and
- Optimum period of supply per optimum order.

a) Economic order Quantity =

Where A = Annual usage - 600 units

S = set – up cost per run - ₹ 80

C = carrying cost per unit - ₹ 0.60

$$\times \text{EOQ} = \sqrt{\frac{2 \times 600 \times 80}{0.60}}$$

$$= \sqrt{1,60,000}$$

$$= 400 \text{ units}$$

Optimum number of orders p.a

$$\text{Optimum number of order per year} = \frac{\text{Annual usag}}{\text{EOQ}}$$

$$= \frac{600}{400}$$

$$= 1.5$$

Since number of order can not be fractional we round it off to the next whole number. Thus, optimum number of order per year = 2

Minimum Average yearly cost

Minimum Average yearly cost = set up cost + carrying cost

$$= ₹ 160 + ₹ 120$$

$$= ₹ 280$$

$$\text{x set - up cost} = ₹ 80 \times 2 = ₹ 160$$

Carrying cost = Average inventory x carrying cost per unit

$$= \frac{400 \times 0.60}{2}$$

$$= ₹ 120$$

Optimum supply period per optimum order

Optimum supply period per optimum order = EOQ/Average monthly requirement

=

$$= \frac{400}{\frac{600}{400}}$$

Illustration 8

A firm's inventory planning period is one year. Its inventory requirement for this period is 1,600 units. Assume that its order costs are ₹ 50 /- order. The carrying cost expected to be

₹ 1 per unit per year for an item.

The firm can produce inventories in the various lots as follows :

- i) 1,600 units ii) 800 units iii) 900 units iv) 200 units and
v) 100 units

Which of these order quantities is the economic order quantity ? Use

- a) Equation method b) Tabulation method.

Ans : a) Equation method

$$EOQ = \sqrt{\frac{2AO}{C}}$$

Where, A = Annual usage – 1600 units

O = Ordering cost per order - ₹ 50

C = Carrying cost per unit per annum. ₹ 1

$$\square EOQ = \sqrt{\frac{2 \times 1600 \times 50}{1}}$$

$$= \sqrt{160,000}$$

$$= 400 \text{ units}$$

b) Tabulation method

Inventory cost for different order Quantities

Particulars	Formula	1	2	3	4	5
Annual usage	A	1600	1600	1600	1600	1600
Order size	Q	1600	800	400	200	100

Ordering cost per order	O	50	50	50	50	50
Carrying cost p.u.p.a.	C	1	1	1	1	1
No. of orders	$N = A/Q$	1	2	4	8	16
Total Ordering cost	$TO = N \times O$	50	100	200	400	800
Total carrying cost	$TC = Q \times C$	800	400	200	100	50
Total Annual cost	$TAC = TC + TO$	850	500	400	500	850

It can be seen from the table that the carrying and ordering cost taken together are the lowest for the order size 400 units. Therefore, Economic order Quantity is 400 units.

9.9 INVENTORY TURNOVER RATIO

9.9.1 Meaning

There are several items in the stores which are issued to the production after long gap from the date of purchases. There are several other items which are never issued to the production as they have become outdated which needs to be disposed off. These items need to be identified so that management can avoid the capital locked up in such items. It is necessary to compute the inventory turn over ratio for finding these items. This ratio indicates not only replacement of stock during the year but the efficiency or inefficiency with inventories are maintained in the organisation. This ratio measures how quick sales of inventories is done. It is the test of efficient inventory management. A higher inventory turnover ratio indicates good inventory management. A low inventory turnover ratio may adversely affect the ability of an organisation to meet consumer's demand and not cope up with requirement.

9.9.2 Formula

This ratio measures relationship between cost of goods sold and the inventory level. Inventory turnover ratio is calculated as follows :

Inventory turnover ratio = $\frac{\text{Cost of goods sold or material consumed}}{\text{Average Inventory or Stock}}$

=times

Where, cost of material consumed = opening stock + purchases - closing stock

Average Inventory = $\frac{\text{Opening stock} + \text{Closing stock}}{2}$

This ratio can also be calculate in days as follows :

$$\text{Inventory turnover ratio} = \frac{\text{Number of days in a year}}{\text{Inventory Turnover Ratio}}$$

= Number of days

However serious limitation of this approach is that detailed data may not be available in respect of inventory level and cost of goods. In order to overcome this difficulties another approach for computation of inventory turnover Ratio is used which is based on the relationship between sales and closing inventory. Alternatively,

$$\text{Inventory turnover Ratio} = \frac{\text{Sales}}{\text{Closing Inventory}}$$

In short, of the two approach of calculating inventory turnover ratio, the first which relates to the cost of goods sold to average inventory and theoretically it is superior whereas advantages of second approach is that it is free from practical problems of computations.

9.9.3 Solved Problems Illustration 9

The following date are available in respect of material 'Y' for the year ended 31st march 2015

Particulars	
Opening stock	1,10,000
Closing stock	1,50,000
Purchases during the year	320000

Calculate) Inventory turnover Ratio

ii) Number of days for which average inventory is held.

Ans :-

Cost of material consumed = Opening stock + Purchases – closing stock

$$= 11,0000 + 32,0000 - 1,50,000$$

$$= 2,80,000$$

$$\begin{aligned}
 \text{Average Inventory} &= \frac{\text{Opening stock} + \text{Closing stock}}{2} \\
 &= \frac{110000 + 150000}{2} \\
 &= \frac{260000}{2} \\
 &= 130000
 \end{aligned}$$

$$\begin{aligned}
 \text{Inventory turnover Ratio} &= \frac{\text{Cost of material consumed}}{\text{Average Inventory}} \\
 &= \frac{280000}{130000} \\
 &= 2.15 \text{ times}
 \end{aligned}$$

ii) Number of days for which average inventory is held

$$\begin{aligned}
 &= \frac{\text{Number days in a year}}{\text{Inventory turnover ratio}} \\
 &= \frac{360}{2.15} \\
 &= 167.44 \text{ days} \quad \text{OR} \quad 170 \text{ days}
 \end{aligned}$$

Illustration 10

Inventory records of Aishwarya Ltd. Shows as following information

Particulars	Material A	Material B	Material C
Opening stock	1400 kg	400 liters	200 kg
Purchases	23,000 kg	2200 liters	3600 kg
Closing stock	400 kg	2400 liters	2400 kg

Inventory is valued of ₹ per kg and ₹ 2.5 per liter. Calculate material turnover ratio for each of the materials.

Ans : Material consumed = opening stock + purchases – closing stock

$$\text{Material A} = 1400 + 2300 - 400 = 2400 \text{ kg}$$

$$\text{Material B} = 400 + 22000 - 2400 = 20,000 \text{ liter}$$

$$\text{Material C} = 200 + 3600 - 2400 = 1400 \text{ kg}$$

Average Inventory = $\frac{\text{Opening stock} + \text{Closing stock}}{2}$

$$\text{Material A} = \frac{(1400 + 400)}{2} = 900 \text{ kg}$$

$$\text{Material B} = \frac{(400 + 2400)}{2} = 1400 \text{ liter}$$

$$\text{Material C} = \frac{(200 + 2400)}{2} = 1300 \text{ kg}$$

$$\text{Material turnover ratio} = \frac{\text{Cost of material consumed}}{\text{Average Inventory or Stock}}$$

$$\text{Material Inventor} = \frac{\text{Number days in a year}}{\text{I.T. ratio}}$$

$$\text{Material A} = \frac{365}{2.67} = 136.704 \text{ or } 137 \text{ days}$$

$$\text{Material B} = \frac{365}{14.29} = 25.542 \text{ or } 26 \text{ days}$$

$$\text{Material C} = \frac{365}{1.08} = 337.962 \text{ or } 338 \text{ days}$$

Illustration 11

From the following data for the year ended 31st March 2015, calculate the inventory turnover ratio of two items and put forward your comments on them.

Particulars	Material 'X'	Material 'Y'
Opening Stock (01.04.2014)	30,000	27,000
Purchases (01.04.2014 to 31.05.2014)	1,56,000	81,000
Closing Stock (31.03.2014)	18,000	33,000

Ans : Cost of Material consumed = Opening stock + Purchase - closing stock

$$\text{Material X} = 30,000 + 156,000 - 18,000 = ₹ 168,000$$

$$\begin{aligned} \text{Average Inventory} &= \frac{27,000 + 33,000}{2} = ₹ 30,000 \\ &= \frac{(\text{opening stock} + \text{closing stock})}{2} \end{aligned}$$

$$\text{Material 'X'} = \frac{168,000}{30,000} \times 2 = 11.2 \text{ Times}$$

$$\text{Material 'Y'} = \frac{75,000}{30,000} \times 2 = 5 \text{ Times}$$

$$\text{Inventory turnover ratio} = \frac{\text{Cost of material consumed}}{\text{Average Inventory or Stock}}$$

$$\begin{aligned} \text{Material 'X'} &= \frac{₹ 168,000}{₹ 30,000} \times 2 \\ &= 11.2 \text{ Times} \end{aligned}$$

$$\begin{aligned} \text{Material 'Y'} &= \frac{₹ 75,000}{₹ 30,000} \times 2 \\ &= 5 \text{ Times} \end{aligned}$$

Comment :

Result : Comparatively inventory turnover ratio of material 'X' is higher than that of material Y (5 times)

Decision :- The management of this organisation needs to concentrate on material y as its turnover is 5 times only. It has to analysis the causes and take remedial measures for remaining material idle for long time / period in warehouse.

Illustration 12

From the following information supplied by Sanket Ltd, calculate

- Inventory turnover Ratio
- Number of days for which the inventory is held.

Particulars	Material 'P' (₹)	Material 'Q' (₹)
Opening stock	30,000	45,000
Purchases	2,00,000	3,00,000
Closing stock	45,000	50,000
Sales	36,000	4,50,000

Ans :-

Cost of Material consumed = opening stock + Purchases - closing stock

$$\text{Material P} = 30,000 + 200,000 - 45,000 = ₹ 185,000$$

$$\text{Material Q} = 45,000 + 300,000 - 50,000 = ₹ 29,500$$

$$\begin{aligned}\text{Average Inventory} &= (\text{Opening stock} + \text{Closing stock}) \times 2 \\ &= (30,000 + 45,000) \times 2 = ₹ 375,000\end{aligned}$$

$$\text{Material Q} = (45,000 + 50,000) \times 2 = ₹ 47,500$$

$$\text{i) Inventory turnover ratio} = \frac{\text{Cost of material consumed}}{\text{Average Inventory}}$$

$$\text{Material 'P'} = \frac{1,85,000}{375,000} = 4.93 = 5 \text{ times}$$

$$\text{Material 'Q'} = \frac{2,95,000}{47,500} = 6.21 = 6 \text{ times}$$

Alternatively, Inventory turnover ratio is as follows :

$$\begin{aligned}\text{Inventory turnover ratio} &= \frac{\text{Sales}}{\text{Closing inventory}} \\ \text{Material 'P'} &= \frac{3,60,000}{45,000} = 8 \text{ times}\end{aligned}$$

$$\text{Material 'Q'} = \frac{4,50,000}{50,000} = 9 \text{ times}$$

ii) Number of days for which the inventory is held

$$\text{Number of days} = \frac{\text{Number of days in a year}}{\text{Inventory Turnover Ratio}}$$

$$\text{Material 'P'} = \frac{365}{5} = 73 \text{ days}$$

$$\text{Material 'Q'} = \frac{365}{6} = 61 \text{ days}$$

9.10 QUESTIONS

1. Define Inventory and explain the various costs of inventory?
2. Why we do not want to hold inventories?
3. What do you understand by inventory control? Explain its objectives and importance.

4. What are the selecting techniques of inventory control?
5. What is the significance of Economic Order Quantity?
6. What are the objectives of Inventory Control?
7. Write short notes on the following :
 - a. Inventory,
 - b. Inventory control
 - c. Cost of inventory,
 - d. ABC analysis/Pareto analysis.
 - e. Inventory Turnover Ratio
8. Practical Problems

1) Following information is available from the books of manufacturing company for material 'X' for the year ending 2015.

Normal usage 900 units per week each

Maximum usage 1200 units per week each

Minimum usage 600 units per week each

Reorder quantity 850 units

Reorder period 4 to 6 week

Calculate Re-order level, Minimum level, Maximum level and Average stock level.

(Ans. Reorder level - 7200 units, Minimum level-2700 units Maximum level - 5650 units, Average level - 4,175 units)

2) From the following information calculate

- a) Re-order stock level
- b) Minimum stock level
- c) Maximum stock level
- d) Average stock level

Re-order quantity-36000 units Time required for delivery -2 to 4 months

Maximum consumption-9000 units per month Normal consumption- 6000 units per month

Ans :

- a) **Re-order -36000 units,**
- b) **Minimum level -18000 units,**
- c) **Maximum level -66000 units,**
- d) **Average level -42000 units**

3) A manufacturing company produces a special product 'Sorbina' the monthly demand for which is 500 units. The following particulars are available in respect of the material used for manufacturing product.

Cost of placing an order	-	₹ 120
Annual carrying cost per unit	-	₹ 12
Normal usage per week	-	60 units
Minimum usage per week	-	30 units
Maximum usage per week	-	90 units
Delivery period	-	4 to 6 weeks

Compute : a) Economic Re-order quantity
b) Re-order level
c) Minimum level
d) Maximum level and
e) Average level

(Ans. EOQ – 250 units, Re-orders level – 540 units. Minimum level – 240 units, maximum level – 670 units, Average level – 455 units.)

4) The following information is available from the books of a company where two types of materials are used, namely A and B.

Normal usage —	300 units per week each
Maximum usage—	450 units per week each
Minimum usage—	150 units per week each
Re-order quantity-	A - 2400 units, B - 3600 units
Re-order period-	A- 4 to 6 weeks, B - 2 to 4 weeks

Compute 1) Re-order level 2) Minimum level 3) Maximum level and 4) Average stock level

Ans.:

	Material A	Material B
a) Re order level	2700 units	1800 units
b) Minimum level	1200 units	900 units
c) Maximum level	4500 units	5100 units
d) Average stock level	2850 units	3000 units

5) From the following particulars, compute Economic order quantity
Annual consumption- 405000 units

Order placing and receiving cost - ₹ 20 per order
Annual stock holding- 20 % of consumption

(Ans. EOQ -9,000)

6) X ltd. Produces a product that has monthly demand of 4000 units. The product requires a component A, which is purchased at ₹ 10 for every finished product one unit at component, is required. The ordering cost is ₹ 60 and the holding cost is 10% of per annum consumption. Calculate Economic order Quantity

(Ans. EOQ = 6,928)

7) From the following information, calculate Economic order Quantity by using formula and tabulation method.

Annual Requirement (unit)	6400
Ordering cost (per order ₹)	100
Carrying cost per unit (₹)	8
Per unit price(₹)	80

The firm can produce inventories in various lots such as

- | | | |
|--------------------|----------------|-----------------|
| i) 6400 units | ii) 3200 units | iii) 1600 units |
| iv) 800 units | v) 400 units | vi) 200 units |
| and vii) 100 units | | |

(Ans. EOQ = 400 units)

(T.Y.B.Com. M. U. Nov. 14)

8) Find the Economic order Quantity from the following information by Tabulation and Formula method.

Annual Demand	-	20000 units
Cost per article	-	₹ 1
Inventory carrying cost	-	15%
Cost per order	-	₹ 15

(Ans. EOQ = 2000 units.)

9) The following information relating to a type of material is available.

Annual demand	-	2000 units
Ordering cost	-	₹ 20/- per order
Storage cost	-	₹ 2%
Unit Price	-	₹ 20 /-
Interest due	-	8%
Lead Time	-	. ½ month

Calculate Economic order Quantity and Inventory cost of rawmaterial.

(Ans. EOQ= 200 units, Inventory cost = 40400)

10) From the following information, calculate Economic orderQuantity and the number of orders to be placed in one quarter of the year.

- i) Quarterly consumption of materials-2000 kg
- ii) Cost of placing an order-₹ 50
- iii) Cost per unit -₹ 40
- iv) Storage and Carrying cost- 8% on average inventory

(Ans. EOQ -500 units, No. of orders per quarter – 04 orders)

11) A manufacturer requires 9600 units of a certain commodity annually. This is currently purchased from a regular supplier at ₹ 50 per unit. The cost of placing an order is ₹ 60 per order and annual carrying cost is ₹5 per piece. What is EOQ for placing an order ?

(Ans. EOQ -480 units)

12) The following information is available from the books of M/sMahi Enterprises for the year 2015.

Particulars	Materials 'A' (₹)	Material 'B' (₹)
Opening stock	2000 3000	
Purchases	26000 7000	
Closing stock	3000 3500	

Calculate the material Turnover Ratio and determine which material is moving fast.

(Ans. Material / Inventory Turnover Ratio – A – 10 times, B - 2 times)

13) From the following for the year ending 31st March 2015.
Compute

- a) Cost of material consumed
- b) Average inventory
- c) Inventory Turnover Ratio
- d) Number of days for which material is held.
- e) Which material is moving fast. Particulars Materials No. 1(₹)

Materials No. 2(₹)	Opening stock (01.04.14)	10000	15000
	Closing stock	25000	
	(31.03.15)	5000	
	Purchases during the year	100000	75000

(Ans. Materials No. 1() Materials No. 2(₹)

a) Material Consumed	85000	
b) Average Inventory	10000	
c) Inventory Turnover ratio	4.85 times	8.5 times
d) No. of days for material held	75.25 days	
	75 days	42.94 days
		43 days
e) Material 1 is moving fast)		

- 14) Calculate stock holding period for material if, Opening stock ₹ 12000, Closing stock - ₹ 10,000 and Purchases during theyear ₹ 53000

Assumption : No. of working days in a year – 364

(Ans. Material / Stock period – 73 days.)

- 15) From the following information, calculate

a) EOQ and b) Total annual carrying ordering cost at that quantity.

Semi annual consumption	-	6000 units
Purchase price of input unit	-	₹ 25
Quarterly carrying cost	-	3%
Order cost per order	-	₹ 45

(Ans. EOQ – 600 units, Total Annual carrying and Ordering Cost - ₹ 1800)

- 16) From the following information, calculate EOQ and Total Annual carrying and ordering cost at that quantity and material holding period also.

Quarterly consumption-750 units

Purchase price per unit-₹ 25/-

Semi – Annual carrying cost-6%

Order cost per order-₹ 45/-

(Ans. EOQ – 300 units, carrying and ordering cost - ₹ 900)

17) Calculate the stock turnover ratio from the following

Opening stock-₹ 80000

Closing stock-₹ 160000

Sales-₹ 620000

Sales Return-₹ 20000

Gross Profit Ratio- 20% on sales

(Ans. Stock Turnover Ratio = 4 times)

Net sales 62000-20000 ₹600000()

G.P. 20% of sales ₹12000

Cost of Goods sold - 480000

18) Calculate stock turnover Ratio and stock of material holding period in days

Opening stock - ₹ 60000

Closing stock - ₹ 140000

Net sales - ₹ 300000

Gross profit @ - 20 % on sales

Working days of year - 365

(Ans. Stock turnover ratio – 4 times, Stock holding period – 91.25 or 91 days)



INVENTORY ACCOUNTING

Unit Structure:

- 10.1 Objectives
- 10.2 Stores Records
- 10.3 Issue of Materials
- 10.4 Pricing of Materials Issued
- 10.5 First In First Out (Fifo)
- 10.6 Average Cost
- 10.7 Solved Problems
- 10.8 Exercise

10.1 OBJECTIVES

After studying the unit students will be able to:

- Know the important store records.
- Explain about issue of material.
- Explain the methods of stock valuation.
- Know the advantages and disadvantages of FIFO method and Average cost method.
- Solve the problems of stock valuation.

10.2 STORES RECORDS

The important function of the storekeeper is to maintain records of receipts, issues and balances of various items of materials. Bin Card and store ledger are two important stores records that are kept for making a record of the various items at stores,

I) BIN CARD :

A bin is a place where the materials are stored. It may be a shelf, an aluvarch, open space etc. depending upon the nature of the commodity. A bin card provides a quantitative record of the receipts, issues and balance of materials. The bin cards are usually attached to or placed near to the bin so that receipts and issues may be entered therein as soon as they

take place. Separate bin cards are prepared for each item of stores. Thus, bin card provides a continuous record of the stock in each bin and assist the storekeeper to control the stock. For each materials, the maximum stock to be held are noted on the card. An ordering level is also indicated therein so that fresh supplies may be ordered before the minimum is reached. A specimen of the bin card is given below:

BIN CARD						
Name			Maximum level			
Description			Minimum level			
Bin No.			Ordering level			
Location Code			Re-ordering quantity			
			Unit			
Date	Receipts	Issues	Balance	Audit		
G.R. No.	Qty.	Date	Req. No.	Qty	Qty	
Date	Initials					

II) Stores Ledger

Stores ledger is a continuous record of stores received and issued and discloses the balance in hand at any time both in quantity and value. It includes an account of each class of materials and facilitates ascertainment of all details relating to the material in minimum time. It provides management with a perpetual inventory. A specimen of the stores ledger is given below:

STORES LEDGER						
Name			Maximum level			
Description			Minimum level			
			Ordering level			
			Re-ordering quantity			
			Unit			
Date	RECEIPTS		ISSUES	BALANCE	Remarks	
G.R. No.	Qty.	Rate	Req. No.	Qty	Amt.	Qty.
Rate	Amt.					

10.3 ISSUE OF MATERIALS

All materials in the stores are meant for issue to various departments. The procedure for the issue is normally laid down by the management. The

storekeeper issues materials to various department against material requisition note, the specimen of which is given below:-

Specimen of Materials Requisition

MATERIAL REQUISITION					
Department			Serial		
Job No.			Date		
Code No.	Description	Quantity	Weight	Bin Card No.	Stores
Ledger Folio	Rate	Amount			
Rs.					
Authorised by			Received by.....		
.....			Checked by		

On receipt of material requisition, the storekeeper issues the necessary materials after obtaining the signature of the person receiving the materials. Materials requisitioned from the storekeeper and not needed or found to be defective are returned to the storeroom and a returned materials report is prepared by the concerned person upon receipt of the materials. Sometimes, it is necessary to return any rejected, excess or damaged materials to the supplier after making correct entries in the stores ledger.

Materials are issued from stores on properly prepared and approved materials requisition. It is a written order to the storekeeper to deliver materials to the place and the department. The materials requisition note includes date, requisition number, department charged, name of the stores, ledger account to be credited, description of materials, quantity, unit price, total value, delivery point and the signature of the person requisitioning the material and signature of the departments executive approving the requisition or comparatively fixed list of materials generally use a special form of material requisition which is called as 'bill of materials'. Materials requisitioned from the stores and not required or found to be defective are returned to the stores, where a returned material report is prepared by the concerned person. The amount and value of materials returned to the stores are deducted from total value of materials issued. Similarly, the amount shown by materials returned is deducted from the total amount charged to each department. It may be necessary to return any rejected, excess or damage materials to the supplier. This also requires some correction entries in the stores ledger.

10.4 PRICING OF MATERIALS ISSUED

When materials are purchased they are recorded at price at which they are purchased after asking necessary adjustments for discounts, transportation charges, cost of containers etc. But, when it comes to the issue of materials, the problem arises with regard to the price at which each issue should be recorded because the different quantities of materials are purchased at different prices. For this purpose, a number of methods of pricing the issue of materials are used which are as follows:-

- a) **FIFO Method :-** The first in first out method is used when the materials received but are to be issued first. The price of the earliest lot/ quantity is taken first and then for the next lot. The value of closing stock confirms more or less, to the current market price. This method is suitable for falling price.
- b) **LIFO Method :-** The last in first out method, is used when materials received last are issued first. The storekeeper will charge the cost price of the latest lot purchased. This is suitable in the times of rising prices.
- c) **Average Rate Method:-** Under this method the materials are issued at a price which is an average price of materials purchased. The simple average is an average of prices without having regard to the quantities involved. Weighted average price is used in order to avoid fluctuation in price and reduce the number of calculations. Weighted average of the total cost and total quantities of materials purchased, is calculated each time a purchase is made.

10.5 FIRST IN FIRST OUT (FIFO)

10.5.1 MEANING

Under the method the earliest lot of materials or goods purchased or goods manufactured are exhausted first and closing stock is out of the latest consignments received or goods manufactured and is valued at the cost of such goods. In other words: cost of goods sold is calculated keeping in view the earliest lots exhausted on the presumption that units are sold in which they were acquired. In short under this method it is assumed that goods or materials which are purchased first are issued first stock consist of latest purchase. Hence items lying in the stock should be valued at latest purchase price.

10.5.2 ADVANTAGES

- (1) This method is simple to understand and easy to operate.
- (2) It is logical method because it takes into consideration the normal procedure of utilizing first those items of inventory which are received or manufactured first.
- (3) This method is very useful when prices are falling because cost of goods so sold will be high on account of using earliest lots which are costly.
- (4) Closing stock is valued nearer the market price as it would consist of recent purchase of units.
- (5) This method is useful when transactions are not too many and prices are fairly steady.
- (6) This method is useful when inventory is subject to deterioration and obsolescence.

10.5.3 DISADVANTAGES

- (1) This method increases the possibility of clerical errors if the price fluctuates, considerably as every time as issue of material is sold, the store ledger clerk will have to go through his account to ascertain the price to be changed.
- (2) If the prices fluctuate, comparison between different jobs executed by the concern becomes difficult because one job started a few minutes later than another of the same nature may have consumed the supply of lower priced or higher priced stock.
- (3) Market prices as it is calculated keeping in view the earliest lot which were purchased at lower rate.

10.6 AVERAGE COST

The principle on which the average cost method is based is that all items on the store are so mixed up that consumption of material or sale of finished goods cannot be at the average cost of the various items on hand. Average may be of two types :

- (a) Simple Average Method (not in syllabus)
 - (b) Weighted Average Method
- .Weighted average method is quite superior to other methods

and it is better to follow this method. This method can be used with advantage in those cases where price and quantity vary widely. The

average rate does not change with issue but would vary with a fresh supply of materials received when a new average will have to be calculated, in a period of fluctuating price this method will even out the fluctuations. This method is also good as the weighted average rate lies in between the extreme rates as shown by FIFO and LIFO method. However the difficulty is that fresh calculations are needed at every purchase of materials or goods.

10.7 SOLVED PROBLEMS

Illustration No. 1

From the following particulars prepared Stores ledger for the month of Mar 08

(a) FIFO to “ABC”, (b) Weighted average to “XYZ”.

	<i>ABC</i>	<i>XYZ</i>
Stocks (kgs) on 1-3-2008	2000 @ Rs. 28	4,000 @ Rs. 13
Purchases (kgs)		
[i] On 11-3-2008	1,800 @ Rs. 27	2,500 @ Rs. 14
[ii] On 21-3-2008	1,700 @ Rs. 25	2,000 @ Rs. 18
Sales (kgs)		
[i] On 6-3-2008 1,300	2,500	
[ii] On 15-3-2008 1,400	2,000	
[iii] On 18-3-2008 700	1,300	
[iv] On 29-3-2008 1,100	1,700	

(IDE, Nov. 1999, adapted)

Solution :

(A) FIFO to “ABC”

STOCK LEDGER OF ABC

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Price	Amt.	Units	Price	value
01-3-2008	Opening	-	-	-	-	-	2,000	28.00	56,000
06-3-2008	-	-	-	1,300	28.00	36,400	700	28.00	19,600
11-3-2008	1,800	27.00	48,600	-	-	-	700 1,800	28.00 27.00	19,600 48,600
15-3-2008	-	-	-	700 700	28.00 27.00	19,600 18,900	1,100	27.00	29,700
18-3-2008	-	-	-	700	27.00	18,900	400	27.00	10,800

Date	Receipts			Issues			<i>Balance</i>		
	Units	Price	Amt.	Units	Price	Amt.	Units	Price	Amt.
21-3-2008	1,700	25.00	42,500	-	-	-	400 1,700	27.002 5.00	10,800 42,500
29-3-2008	-	-	-	400 700	27.002 5.00	10,800 7,500	1,000	25.00	25,000

Therefore, the value of stock of ABC as on 31-3-2004 : 1,000 units @ Rs. 25.00 = Rs. 25,000

(B) Weighted Average (Under Perpetual System of Inventory)

STOCK LEDGER OF XYZ

Date	Receipts			Issues			<i>Balance</i>	
	Units	Price	Amt.	Units	Wt. Avg. Rate	Amt.	Units	Value
01-3-2008	Opening	-	-	-	-	-	4,000	52,000
06-3-2008	-	-	-	2,500	13.00	32,500	1,500	19,500
11-3-2008	2,500	14	35,000	-	-	-	4,000	54,500
15-3-2008	-	-	-	2,000	13.63	27,250	2,000	27,250
18-3-2008	-	-	-	1,300	13.63	17,712	700	9,538
21-3-2008	2,000	18	36,000	-	-	-	2,700	45,538
29-3-2008	-	-	-	1,700	16.87	28,671	1,000	16,867

Working Notes :

- 1] Issued of XYZ on March 15 is valued at Rs. 13.63 which is the weighted average rate, arrived at as follows :

$$\frac{19,500 + 35,000}{1,500 + 2,500} = \frac{54,500}{4,000} = 13.625 \text{ r/o } 13.63$$

- 2] Issue of XYZ on March 29 is valued at Rs. 16.87 per kg. which is the weighted average rate arrived at as follows :

$$\frac{9,538 + 36,000}{700 + 2,000} = \frac{45,538}{2,700} = 16.865 \text{ r/o } 16.87$$

Therefore, the value of stock as on 31-3-2008 : 1,000 units @ Rs. 16.87 = Rs. 16,867

From the following information relating A to Z item, value closing stock on 31-12-2008 applying – (a) FIFO, (b) Weighted average

Purchases (kgs)

[ii] On 23-12-2008 3,800 units @ Rs. 9

Sales (kgs)

[i] On 7-12-2008	1200 units
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[ii] On 16-12-2008	2600 units
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[iii] On 19-12-208 1800 units

[iv] On 30-12-2008 3400 units

(IDE, April 1999, adapted)

(A) FIFO

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Price	Amt.	Units	Price	value
01-12-2008	Opening	-	-	-	-	-	5,000	14.00	70,000
07-12-2008	-	-	-	1,200	14.00	16,800	3,800	14.00	53,200
16-12-2008	-	-	-	2,600	14.00	36,400	1,200	14.00	16,800
18-12-2008	4,200	13.00	54,600	-	-	-	1,200 4,200	14.001 3.00	16,800 54,600
19-12-2008	-	-	-	1,2006 00	14.001 3.00	16,8007 ,800	3,600	13.00	46,800
23-12-2008	3,800	9.00	34,200	-	-	-	3,600 3,800	13.009 .00	46,800 34,200
30-12-2008	-	-	-	3,400	13.00	44,200	200 3,800	13.009 .00	2,600 34,200

145

B] Weighted Average (Perpetual Inventory system)**STOCK LEDGER**

Date	Receipts			Issues			Balance	
	Units	Price	Amt.	Units	Wt. Avg. Rate	Amt.	Units	Value
01-12-2008	Opening	-	-	-	-	-	5,000	70,000
07-12-2008	-	-	-	1,200	14.00	16,800	3,800	53,200
16-12-2008	-	-	-	2,600	14.00	36,400	1,200	16,800
18-12-2008	4,200	13.00	54,600	-	-	-	5,400	71,400
19-12-2008	-	-	-	1,800	13.22	23,796	47,607	47,604
23-12-2008	3,800	9.00	34,200	-	-	-	7,400	81,804
30-12-2008	-	-	-	3,400	11.05	37,570	4,000	44,234

Working Notes :

- [1] Issue on December 19 is valued at Rs. 13.22 which is the weighted average rate, arrived at as follows :

$$\frac{16,800 + 54,600}{1,200 + 4,200} = \frac{71,400}{5,400} = 13.222 \text{ r/o } 13.22$$

- [2] Issue on December 30 is valued at Rs. 11.05 per kg. which is the weighted average rate arrived at as follows :

$$\frac{47,604 + 34,200}{3,600 + 3,800} = \frac{81,804}{7,400} = 11.054 \text{ r/o } 11.05$$

Therefore, the value of stock as on 31-12-2003 : 4,000 units @ Rs. 11.05 = Rs. 44,234

Illustration : 3

Sumit Ltd. has purchased and issued the materials in the following order :

Month	Date	Particulars	Units	Cost Per Unit Rs.
August, 2003	01	Purchases	300	3
	04	Purchases	600	4
	06	Issues	500	-
	10	Purchases	700	4
	15	Issues	800	-
	20	Purchases	300	5
	23	Issues	100	-

Ascertain the quantity of closing stock as on 31st August, 2003 and sales what will be the value under the following methods.

[i] First in first out method. [ii] Weighted Average method.

(IDE, Nov. 2000, adapted)

Solution :

(A) FIFO

STOCK LEDGER

Date	Receipts			Issues			<i>Balance</i>		
	Units	Price	Amt.	Units	Price	Amt.	Units	Price	value
1-8-2003	Opening	-	-	-	-	-	Nil	Nil	Nil
1-8-2003	300	3.00	900	-	-	-	300	3.00	900
4-8-2003	600	4.00	2,400	-	-	-	300 600	3.00 4.00	900 2,400
6-8-2003	-	-	-	300 200	3.00 4.00	900 800	400	4.00	1,600
10-8-2003	700	4.00	2,800	-	-	-	400 700	4.00 4.00	1,600 2,800
15-8-2003	-	-	-	400 400	4.00 4.00	1,600 1,600	300	4.00	1,200
20-8-2003	300	5.00	1,500	-	-	-	300 300	4.00 5.00	1,200 1,500
23-8-2003	-	-	-	100	4.00	400	200 300	4.00 5.00	800 1,500

Therefore, the value of stock as on 31-8-2003 : Rs. 2,300

[B] Weighted Average (Perpetual Inventory System)

STOCK LEDGER

Date	Receipts			Issues			<i>Balance</i>	
	Units	Price	Amt.	Units	Wt. Avg. Rate	Amt.	Units	Value
01-8-2003	Opening	-	-	-	-	-	Nil	Nil
01-8-2003	300	3.00	900	-	-	-	300	900
04-8-2003	600	4.00	2,400	-	-	-	900	3,300
06-8-2003	-	-	-	500	3.67	1,835	400	1,465
10-8-2003	700	4.00	2,800	-	-	-	1,100	4,265
15-8-2003	-	-	-	800	3.88	3,104	300	1,161
20-8-2003	300	5.00	1,500	-	-	-	600	2,661
23-8-2003	-	-	-	100	4.44	444	500	2,217

Working Notes :

- [1] Issue on August 6 is valued at Rs. 3.67 which is the weighted average rate, arrived at as follows :

$$\frac{900 + 2,400}{300 + 600} = \frac{3,300}{900} = 3.666 \text{ r/o } 3.67$$

- [2] Issue on August 15 is valued at Rs. 3.88 per kg. which is the weighted average rate arrived at as follows :

$$\frac{1,465 + 2,800}{400 + 700} = \frac{4,265}{1,100} = 3.877 \text{ r/o } 3.88$$

- [3] Issue on August 23 is valued at Rs. 4.44 per kg. which is the weighted average rate arrived at as follows:

$$\frac{1,161 + 1,500}{300 + 300} = \frac{2,661}{600} = 4.435 \text{ r/o } 4.44$$

Therefore, the value of stock as on 31-8-2002 : 500 units @ Rs. 4.44 = Rs. 2,217

Illustration : 4

Keep stock record on FIFO, and Weighted Average basis from the following transactions:

Purchases : March 2004.

Date	Units	Rate Per unit (Rs.)
01	500	18
04	700	20
09	900	18
15	300	25
25	200	20
31	500	25

Sales : March 2004

02	200	22
07	500	25
11	400	21
18	800	28
27	500	25

Find out the goods sold and the profit.

Solution :

FIFO METHOD

STOCK LEDGER

Date	Purchases		Sales	Stock	
March, 2004	Units	Rate	Units	Units × Rate =	Amount
01	500	18	-	500 x 18 =	9,000
02	-	-	200	300 x 18 =	5,400
04	700	20	-	300 x 18 =	5,400
				700 x 20 =	14,000
					19,400
07	-	-	500	500 x 20 =	10,000
09	900	18	-	500 x 20 =	10,000
				900 x 18 =	16,200
					26,200
11	-	-	400	100 x 20 =	2,000
				900 x 18 =	16,000
					18,200
15	300	25	-	100 x 20 =	2,000
				900 x 18 =	16,200
				300 x 25 =	7,500
					25,700
18	-	-	800	200 x 18 =	3,600
				300 x 25 =	7,500
					11,100
25	200	20	-	200 x 18 =	3,600
				300 x 25 =	7,500
				200 x 20 =	4,000
					15,100
27	-	-	500	200 x 20 =	4,000
31	500	25	-	200 x 20 =	4,000
				500 x 25 =	12,500
					16,500

Value of stock under FIFO is Rs. 16,500.

Profit when stock is valued under FIFO basis.**Opening Stock****Nil Rs.****Add : Purchases**

500	x	18	=	9,000	
700	x	20	=	14,000	
900	x	18	=	16,200	
300	x	25	=	7,500	
200	x	20	=	4,000	
500	x	25	=	<u>12,500</u>	<u>63,200</u>
					63,200

Less : Closing Stock (as valued under FIFO) 16,500

Cost of Goods Sold (A) 46,700

Sales

200	x	22	=	4,400
500	x	25	=	12,500
400	x	21	=	8,400
800	x	28	=	22,400
500	x	25	=	12,500

(B) 60,200**Profit**(B-A) 13,500**[B] Weighted Average (Perpetual Inventory System)****STOCK LEDGER**

Date	Receipts			Issues			<i>Balance</i>	
	Units	Price	Amt.	Units	Wt. Avg. Rate	Amt.	Units	Value
01-3-2004	500	18.00	9,000	-	-	-	500	9,000
02-3-2004	-	-	-	200	18.00	3,600	300	5,400
04-3-2004	700	20.00	14,000	-	-	-	1,000	19,400
07-3-2004	-	-	-	500	19.40	9,700	500	9,700
09-3-2004	900	18.00	16,200	-	-	-	1,400	25,900
11-3-2004	-	-	-	400	18.50	7,400	1,000	18,500
15-3-2004	300	25.00	7,500	-	-	-	1,300	26,000
18-3-2004	-	-	-	800	20.00	16,000	500	10,000
25-3-2004	200	20.00	4,000	-	-	-	700	14,000
27-3-2004	-	-	-	500	20.00	10,000	200	4,000
31-3-2004	500	25.00	12,500	-	-	-	700	16,500
Total			63,200			46,700		

Working Notes :

- [1] Issue on March 7 is valued at Rs. 19.40 which is the weighted average rate, arrived at as follows :

$$\frac{5,400+14,000}{300+700} = \frac{19,400}{1,000} = 19.40$$

- [2] Issue on March 11 is valued at Rs. 18.50 which is the weighted average arrived at as follows :

$$\frac{9,700+16,200}{500+900} = \frac{25,900}{1,400} = 18.50$$

- [3] Issue on March 18 is valued at Rs. 20 which is the weighted average rate on arrived at as follows :

$$\frac{18,500+7,500}{1,000+300} = \frac{26,000}{1,300} = 20$$

- [4] Issue on March 27 is valued at Rs. 20.00 which is the weighted average rate, arrived at as follows :

$$\frac{10,000+4,000}{500+200} = \frac{14,000}{700} = 20$$

Therefore, the value of stock as on 31-3-2000 : 700 units Rs. 16,500.

- [5] Cost of Goods sold = Opening Stock + Purchases – Closing Stock = 63,200 – 16,500 = 46,700

- [6] Profit = Sale – Cost of goods sold = 60,200 – 46,700 = 13,500

Illustration : 7

Following are the purchases and sales of wheat in the months of March, 2004. Prepare a statement showing valuation of stock on the basis of (i) FIFO and (ii) Weighted Average Cost method.

Date	Purchases	Rate	Sales
2004	(Kg.)	(Rs.)	(Kg.)
March 1	600	4	-
4	-	-	300
5	300	3.80	-
10	-	-	200
18	200	4.20	-
23	-	-	400
29	400	4.40	-
31	-	-	300

Out of purchases March 5, 50 Kgs. were returned to the supplier on March 8.

Out of Sales on March 23, a customer returned 20 Kgs. on March 26.

Solution :

FIFO

STOCK LEDGER

Date	Purchases / Returns		Sales / Returns	Stock	
2004	Units (Kg.)	Rate (Rs.)	Units (Kg)	Units × Rate =	Amt.
Mar. 1	600	4	-	600 x 4 =	2,400
04	-	-	300	300 x 4 =	1,200
05	300	3.80	-	300 x 4 =	1,200
				300 x 3.8 =	1,140
					2,340
08	-	-	50	300 x 4 =	1,200
			(Returns)	250 x 3.8 =	9,50
					2,150
					(Note – 1)
10	-	-	200	100 x 4 =	400
				250 x 3.8 =	9,50
					1,350
18	200	4.20	-	100 x 4 =	400
				250 x 3.8 =	9,50
				200 x 4.2 =	840
					2,190
23	-	-	400	150 x 4.2 =	630
26	20	4.20	-	170 x 4.2 =	714
	(returns)				(Note – 2)
29	400	4.40	-	170 x 4.2 =	714
				400 x 4.4 =	1,760
					2,474
31	-	-	300	270 x 4.4 =	1,188

Value of Stock under FIFO is Rs. 1,188.

Note : 1

50 Kgs. returned on March, 8 are out of March 5 Purchases, hence they are shown as issued at a rate of 3.8 per Kg. and accordingly stock is calculated.

Note : 2

Sales returns on March 26 are out of March 23 Sales. Under FIFO method Sales on March 23 are out of Kg. 100 @ Rs. 4 + Kg. 250 @ Rs. 3.8 + Kg. 50 @ Rs. 4.2. Hence 20 Kg. received are priced at Rs. 4.20 per Kg.

B] Weighted Average (Perpetual Inventory System)**STOCK LEDGER**

Date	Receipts			Issues			Balance	
	Units	Price	Amt.	Units	Wt. Avg. Rate	Amt.	Units	Value
01-3-2004	600	4.00	2,400	-	-	-	600	2,400
04-3-2004	-	-	-	300	4.00	1,200	300	1,200
05-3-2004	300	3.80	1,140	-	-	-	600	2,340
05-3-2004	-	-	-	50	3.90	195	550	2,145
10-3-2004	-	-	-	200	3.90	780	350	1,365
18-3-2004	200	4.20	840	-	-	-	550	2,205
23-3-2004	-	-	-	400	4.01	1,604	150	601
26-3-2004	20	4.01	80	-	-	-	170	681
29-3-2004	400	4.40	1,760	-	-	-	570	2,441
31-3-2004	-	-	-	300	4.28	1,284	270	1,157

Working Notes :

[1] Issue on March 5 & March 10 is valued at Rs. 3.90 which is the weighted average rate, arrived at as follows :

$$\frac{1,200 + 1,140}{300 + 300} = \frac{2,340}{600} = 3.90$$

[2] Purchase returns of 50 kg. are out of the total stock of 600 kg. which was valued at Rs. 3.90 per kg.

[3] Issue on March 23 is valued at Rs. 4.01 per kg. which is the weighted average rate arrived at as follows :

$$\frac{1,365 + 840}{350 + 200} = \frac{2,205}{550} = 4.01$$

[4] Sales on March 23 are out of stock valued at Rs. 4.01 per kg. Hence returns of 20 kg. are also taken at a rate of Rs. 4.01 per kg.

[5] Weighted Average Rate on March 31 is arrived at as follows :

$$\frac{681+1,760}{170+400} = \frac{2,441}{570} = 4.28$$

Therefore, the value of stock as on 31-3-2008 : 270 units @ Rs. 4.28 = Rs. 1,157

Illustration : 8

A company deals in 3 products viz. A, B and C. The details for purchases and sales for January 2004 are as under.

Product	A		B		C	
	Units	Rs.	Units	Rs.	Units	Rs.
Selling Price per Unit		100		200		250
Opening Stock	100	60	100	100	50	120
Purchases :						
Jan 9	300	65	200	110	50	135
Jan 20	100	64	50	120	100	140
Jan 29	50	68	50	125	20	130
Closing Stock	140		70		60	

You are required to prepare a trading and profit and loss account for the month assuming the selling and distribution expenses to be Rs. 63,000. Use FIFO method for stock valuation.

Solution

Stock Ledger (FIFO Method)

Product – A

Date	Purchases	Sales	Closing Stock	
	Qty. Rs.	Qty.	Qty. × Rs. =	Amount
01-1-2004	-	-	100 × 60 =	6,000
09-1-2004	4300 × 65	-	100 × 60 =	6,000
			300 × 65 =	19,500
				25,500
20-1-2004	100 × 64	-	100 × 60 =	6,000
			300 × 65 =	19,500

			$100 \times 64 =$	6,400
				31,900
29-1-2004	50×68	-	$100 \times 60 =$	6,000
			$300 \times 65 =$	19,500
			$100 \times 64 =$	6,400
			$50 \times 68 =$	3,400
				35,300
Total Sales		100×60	$90 \times 64 =$	5,760
During		300×65	$50 \times 68 =$	3,400
January		10×64		9,160
		410		

Product – B

Date	Purchases	Sales	Closing Stock	
	Qty. Rs.	Qty.	Qty. \times Rs. =	Amount
01-1-2004	-	-	$100 \times 100 =$	10,000
09-1-2004	200×110	-	$100 \times 100 =$	10,000
			$200 \times 110 =$	22,000
				32,000
20-1-2004	50×120		$100 \times 100 =$	10,000
			$200 \times 110 =$	22,000
			$50 \times 120 =$	6,000
				38,000
29-1-2004	50×125		$100 \times 100 =$	10,000
			$200 \times 110 =$	22,000
			$50 \times 120 =$	6,000
			$50 \times 125 =$	6,250
				44,250
Total Sales		100×100	$20 \times 120 =$	2,400
During		200×110	$50 \times 125 =$	6,250
January		30×120		8,650
		330		

Product C

Date	Purchases	Sales	Closing Stock	
	Qty. Rs.	Qty.	Qty. × Rs. =	Amount
01-1-2004	-	-	$50 \times 120 =$	6,000
02-1-2004	50×135		$50 \times 120 =$	6,000
			$50 \times 135 =$	6,750
				12,750
20-1-2004	100×140	-	$50 \times 120 =$	6,000
			$50 \times 135 =$	6,750
			$100 \times 140 =$	14,000
				26,750
29-1-2004	20×130	-	$50 \times 120 =$	6,000
			$50 \times 135 =$	6,750
			$100 \times 140 =$	14,000
			$20 \times 130 =$	2,600
				29,350
Total Sales		50×120	$40 \times 140 =$	5,600
During		50×135	$20 \times 130 =$	2,600
January		60×140		8,200
		160		

Note : 1

Number of units sold during January :

Product

	A	B	C
Opening Stock	100	100	50
Add : Total Purchase	<u>450</u>	<u>300</u>	<u>170</u>
	550	400	220
Less : Closing Stock	<u>140</u>	<u>70</u>	<u>60</u>
Units Sold	<u>410</u>	<u>330</u>	<u>160</u>

Dr.		Trading Account		Cr.	
Particulars	Rs.	Particulars	Rs.		
To Opening Stock		By sales			
A $100 \times 60 = 6,000$		A $410 \times 100 = 41,000$			
B $100 \times 100 = 10,000$		B $330 \times 200 = 66,000$			
C $50 \times 120 = \underline{6,000}$	22,000	C $160 \times 250 = 40,000$		1,47,000	
To Purchases		By Closing Stock			
A 29,300		A 9,160			
B 34,250		B 8,650			
C 23,350	86,900	C <u>8,200</u>		26,010	
To Gross Profit c/d	64,110				
	1,73,010			1,73,010	

Dr.		Profit & Loss Account		Cr.	
Particulars	Rs.	Particulars	Rs.		
To Selling & Distribution Expenses	63,000	By Gross Profit b/d	64,110		
To Net Profit	1,110				
	64,110			64,110	

10.6 EXERCISE

1. Write short Notes
 - a. FIFO Method
 - b. Weighted average method
2. Practical problems

Problem I

Prepare a Stores Ledger Account from the following transactions assuming that issue of stores have been made on the principle of and also on "First in First Out".

2000			
January 2	Purchased	2000 units	at Rs. 4.00 per unit
January 20	Purchased	250 units	at Rs. 5.00 per unit
February 5	Issued	1000 units	
February 10	Purchased	3000 units	at Rs. 6.00 per unit
February 12	Issued	2000 units	
March 2	Issued	500 units	
March 15	Purchased	2500 units	at Rs. 5.50 per unit
March 20	Issued	1500 units	(P.U.)

Ans. FIFO Stock : 150 units at Rs. 5.50 = Rs. 8,250

Problem 15

Value the stock under Simple Average & Weighted Average method.

Receipt			
01-1-2000	Opening stock	200 units at	Rs. 3.50 per unit
03-1-2000	Purchased	300 units at	Rs. 4.00 per
13-1-2000	Purchased	900 units at	Rs. 4.30 per unit
23-1-2000	Purchased	600 units at	Rs. 3.80 per unit
Issues			
05-10-2000	Issued	400 units	
15-10-2000	Issued	600 units	
25-10-2000	Issued	600 units	

Ans.

Issue Price rate	5 th	15 th	25 th	Closing Stock
a) Weighted Average	3.80	4.25	3.98	400 units Rs. 1,592

1. In times of rising prices, the pricing of issues will be at a more recent current market prices in

2. When prices fluctuate widely, the method that will smooth out the effect of fluctuations is

3. The total cost of goods available for sale with a company during the current year is Rs.12, 00,000 and the total sales during the period are Rs.13, 00,000. If the gross profit margin of the company is 33 % on cost, the closing inventory during the current year is

- iii. Rs.2,25,000 iv. Rs.2, 60,000.

- Total sales Rs. 80,000

Closing stock of goods for the year 2010-11 was. Rs.80,000

- iii. Rs.40,000 iv. Rs.36,000.

- | Date | Quantity | Price per unit |
|----------|----------|----------------|
| | Units | Rs. |
| March 4 | 900 | 5 |
| March 10 | 400 | 5.50 |

March 12	400
----------	-----

iv. None of the three.

6. A firm dealing in cloth has 15000 meters of cloth on April 1, 2005 valued at Rs.1, 50,000 according to FIFO. The firm purchased 20000 meters @ Rs.12 per meter during the year ending 31st March, 2006 and sold 30000 meters @ Rs.25 per meter during the same period. As per FIFO, the closing stock will be valued at:
- Rs.60,000
 - Rs.1,25,000
 - Rs.50,000
 - None of the above.
7. A minimum quantity of stock always held as precaution against out of stock situation is called ____
- Zero stock.
 - Risk stock.
 - Base stock.
 - None of the above.
8. Opening stock of the year is Rs.20, 000, Goods purchased during the year is Rs.1, 00,000, Carriage Rs.2, 000 and Selling expenses Rs.2, 000. Sales during the year is Rs.1, 50,000 and closing stock is Rs.25, 000. The gross profit will be
- Rs.53, 000.
 - Rs.55, 000.
 - Rs.80, 000.
 - Rs.51, 000.
9. The cost of stock as per physical verification of Bharat Ltd. on 10th April, 2011 was Rs.1, 20,000. The following transactions took place between 1st April, 2011 to 10th April, 2011:
Cost of goods sold Rs.10, 000, Cost of goods purchased Rs.40,000, Purchase returns Rs.6, 000
- The value of inventory as per books on 31st March, 2011 will be
- Rs. 1, 56,000.
 - Rs. 1, 51,000.
 - Rs. 1, 50,000.
 - Rs.1, 52,000.

Answers: 1-i, 2-ii, 3-iii, 4-ii, 5-ii, 6-ii, 7-iii, 8-iv, 9-i.



INTRODUCTION TO FUND FLOW STATEMENT

Unit Structure

11.0 Learning Objectives:

11.1 Fund Flow Statement

11.2 Benefits of Fund Flow Statement

11.3 Procedure of Preparation of Fund Flow Statement

11.4 Importance of Fund Flow Analysis

11.0 LEARNING OBJECTIVES

- Understanding the concept of fund
- Calculation of fund from operation
- Calculation of changes in working capital
- Preparation of statement of Sources & Application of Funds

11.1 FUND FLOW STATEMENT

Funds flow statement is a financial statement which shows as to how a business entity has obtained its funds and how it has applied or employed its funds between the opening and closing balance sheet dates (during the particular year/period). It can be described as – WHERE GOT-WHERE GONE statement Funds usually refers to cash resources and funds statement is prepared to show the net effect of various business events on the current resources of the organization. In this topic fund should be understood as working capital & funds flow as to mean any change in working capital.

Funds Flow Statement is a statement prepared to analyse the reasons for changes in the financial position of a company between 2 Balance Sheets. It shows the inflow & outflow of funds i.e. SOURCES and APPLICATIONS of funds for a particular period. In other words Funds flow statement is prepared to explain the changes in the working capital position of a company. There are two types of inflows of funds –

- a. Long term funds raised by issue of Shares, Debentures or sale of Fixed Assets
- b. Funds generated from operations

If the long term fund requirements of a company are met just out of the Long term Sources of funds, then the whole fund generated from operations will be represented by increase in working capital. However if the funds generated from operations are not sufficient to bridge a gap of long term fund requirement, then there will be a decline in working capital.

11.2 BENEFITS OF FUND FLOW STATEMENT

Funds flow statement is useful for long term analysis. It is very useful tool in the hands of the management for judging the financial & operating performance of the company. The Balance Sheet and the Profit & Loss A/c (Income Statement) fails to provide the information which is provided by the funds flow statement i.e. changes in Financial Position of an enterprise. Such an analysis is of great help to the management, shareholders, creditors etc.

Fund Flow Statement answers the following questions

- Where have the profits gone?
- Why is there an imbalance existing between liquidity position and profitability position of an enterprise?
- Why is the concern financially solid in spite of losses

Fund flow statement analysis helps the management to test whether the working capital has been effectively used or not and the working capital level is adequate or inadequate for the requirements of the business. The working capital position helps the management in taking policy decisions regarding payment of dividend etc.

Fund flow statement analysis helps the investors to decide whether the company has managed the funds properly. It also indicates the credit worthiness of a company which helps the lenders to decide whether to lend money to the company or not. It helps the management to take policy decisions and to decide about the financing policies and capital expenditure for the future.

11.3 PROCEDURE OF PREPARATION OF FUND FLOW STATEMENT

Step I - Prepare the statement of changes in working capital

Step II - Analyse the changes in non-current assets and noncurrent liabilities to find out inflow or outflow of funds

Step III - Find out funds from operation

Step IV - Prepare statement of Sources & Application of Funds (Funds Flow Statement)

Step – I

STATEMENT OF CHANGES IN WORKING CAPITAL				
Particulars	Previous Year	Current Year	Change in WC	
			Increase Rs.	Decrease Rs.
A. CURRENT ASSETS				
Stock	xx	xx		
Debtors	xx	xx		
Cash/Bank	xx	xx		
Bills Receivable	xx	xx		
Prepaid Expenses	xx	xx		
Accrued Income	xx	xx		
Short term loans & advances	xx	xx		
Marketable Investments	xx	xx		
Total	xxx	xxx		
B. CURRENT LIABILITIES				
Creditos for Goods	xx	xx		
Bills Payable	xx	xx		
Outstanding Expenses	xx	xx		
Bank Overdraft	xx	xx		
Unclaimed/Unpaid Dividend	xx	xx		
Short term loans & advances	xx	xx		
Prov. For Doubtful debts	xx	xx		
Prov. For Discount on debtors	xx	xx		
Total	xxx	xxx		
WORKING CAPITAL (A-B)	xxx	xxx		
Increase / Decrease in Working Capital	x	x		
Total	xxx	xxx	xxx	xxx

Step – II - Working Capital Changes

- Increase in Current Assets – Increase in Working Capital- Outflow
- Increase in Current Liabilities – Decrease in Working Capital - Inflow
- Decrease in Current Assets – Decrease in Working Capital - Inflow
- Decrease in Current Liabilities – Increase in Working Capital - Outflow

Step III – Finding Funds from Operations

In this step, we need to calculate the funds generated only from the Operating activities of the business and not from the Investing / Financing

activities of the business. The funds from operations shall be prepared as follows:

ADJUSTED PROFIT & LOSS A/C			
Particulars	Amt	Particulars	Amt
		By Balance B/d	xx
To Depreciation	xx	By Profit on sale of non current assets	xx
To Preliminary Expenses w/off	xx	BY Transfer from reserves	xx
To Goodwill w/off	xx	By Income from Investments	xx
To Discount on	xx		
To Loss on sale of non current assets	xx	By Funds from Operations (Bal Fig.)	xx
To Prov. For tax	xx		
To Proposed Dividend	xx		
To Transfer to reserves	xx		
To Interim Dividend	xx		
To Balance C/d	xx		
	xxxx		xxxx

	Particulars	Amt	Amt
	Net Income		xxx
Add	Depreciation on Fixed Assets	xx	
	Amortization of Intangible Assets	xx	
	Amortization of loss on sale of investments	xx	
	Amortization of loss on sale of fixed assets	xx	
	Losses from other non operating incomes	xx	
	Tax provision (created out of current profits)	xx	
	Proposed Dividend	xx	
	Transfer to Reserves	xx	xxx
Less	Deferred Credits	xx	
	Profit on Sale of Investments	xx	
	Profit on sale of Fixed Assets	xx	
	Any written back reserve or provision	xx	xxx

Step – IV – While preparing the fund flow statement, the sources and uses of funds are to be disclosed clearly so as to highlight the sources from where the funds have been generated and uses to which these funds have been applied. This statement is also sometimes referred to as the sources and applications of funds statement or statement of changes in financial position.

Funds Flow Statement as on			
Sources of Funds	Amt	Application of Funds	Amt
Funds from operations	xx	Drawings	xx
Sale of Fixed Assets	xx	Purchase of fixed assets	xx
Issue of Shares	xx	Redemption of Pref. Shares	xx
Issue of Debentures	xx	Redemption of Debentures	xx
Loans Taken	xx	Payment of taxes	xx
Sale of Long Term Investment	xx	Payment of Dividend	xx
Receipts of Dividends, Legal Claims, Refund of tax etc.	xx	Repayment of Loans	xx
Decrease in working capital	xx	Increase in working capital	xx
	xxxx		xxxx

Sources of Funds

- Issue of Equity & Preference Shares
- Receipt of Securities Premium
- Issue of Debentures
- Receipt of Long Term Loans from Banks & Other Financial Institutions
- Receipt of Public Deposits & other Unsecured Loans
- Sales of Fixed Assets, Sale of Investments
- Extraordinary receipt awarded in legal suit
- Income from long term investments
- Funds from operations
- Decrease in Working Capital

Application of Funds

- Redemption of Preference share capital, Redemption of Debentures
- Premium paid on redemption of debentures and preference shares
- Repayment of temporary loans, secured & unsecured
- Purchase of Fixed Assets, Purchase of Investment
- Extraordinary payments and non recurring losses like loss by fire & damages paid
- Payment of Dividend & Interim Dividend, Payment of Tax
- Increase in Working Capital

Formats of Fund Flow Statement

There is no prescribed format as such for the preparation of Funds Flow Statement. The only point to be remembered is that it should be presented in a clear and systematic manner. However, Funds Flow Statements may be prepared in any of the following formats

- Report Form – Remainder Type
- Report Form – Self Balancing Type
- Report Form – Reconciling Type

I	Remainder Type				
A	Sources of Funds		xx		
B	Application of Funds		xx		
C	Change in Working Capital (A-B)		xx		
II	Self Balancing Type				
A	Sources of Funds	xx	Application of Funds		xx
	Decrease in WC (b/f)	xx	Increase in WC (b/f)		xx
		xxx			xxx
III	Reconciling Type				
	Working Capital at the beginning of the year		xxx		
Add	Sources of Funds		xxx		
Less	Application of Funds		xxx		
	Working Capital at the end of the year		xxx		

Fund Flow Analysis

Flow analysis consists of two different analysis namely

Working Capital Analysis – is the analysis & reporting of working capital. Working capital is the excess of current assets over current liabilities. This analysis consist of two statements namely

- Statement of changes in working capital
- Statement of Sources & Application of Funds

Cash Flow Analysis – is the analysis of inflows and outflows of cash. Cash flow analysis results in separate reports viz. Sources and Applications of Cash Funds flow statement explains as to what caused the changes in the balance sheet items between two balance sheet dates

11.4 IMPORTANCE OF FUND FLOW ANALYSIS

Funds flow statement is an important financial tool, which analyze the changes in financial position of a firm showing the sources and applications of its funds. It provides useful information about the firm's operating, financing and investing activities during a particular period. The following points highlight the importance of funds flow statement.

- 1) Helps in identifying the change in level of current assets investment and current liabilities financing.
- 2) Helps in analyzing the changes in working capital level of a firm.

- 3) Shows the relationship of net income to the changes in funds from business operation.
- 4) Reports about past fund flow as an aid to predict future funds flow.
- 5) Helps in determining the firms' ability to pay interest and dividend, and pay debt when they become due.
- 6) Shows the firms' ability to generate long-term financing to satisfy the investment in long-term assets.
- 7) Helps in identifying the factor responsible for changes in assets, liabilities and owners' equity at two balance sheet date.

COMPARATIVE ANALYSIS			
Point	Income Statement	Balance Sheet	Fund Flow Statement
Meaning	Statement showing results of activities conducted during the year	Statement of assets & liabilities of an organisation	Statement of changes in assets & liabilities of an organisation
Objective	To ascertain profit/loss	To ascertain financial position	To know the change in financial position over the year or how the profit has been utilised
Legality	Obligatory to prepared as per schedule VI of the Indian Companies Act, 1956	Obligatory	Non Obligatory
Format	No format but should be subject to certain requirements	Prescribed Format	No prescribed format
Sections	Incomes & Expenses	Assets & Liabilities	Sources & Applications
Basis	Prepared on the basis of nominal accounts & other information	Prepared on the basis of ledger balances and additional information	Prepared on the basis of two consecutive balance sheets

Illustration - 1				
From the records of a company the following information has been extracted.				
	Net profit after providing for the following items			80000
	Loss on sale of equipments			15000
	Premium on redemption of debentures			1000
	Discount on issue of debentures			2000
	Depreciation on buildings			15000
	Depletion of wasting assets			5000
	Goodwill written off			20000
	Interim Dividend			20000
	Profit on sale of fixed assets			35000
	Excess taxation provided			20000
	Income from investments			5000
	Transfer to general reserve			6000
	Preliminary expenses written off			1500
	Profit on revaluation of investments			2000
Solution				
	Net Profit			80000
Add:	Non Cash & Non Operating Expenses			
	Loss on sale of equipments		15000	
	Discount on issue of debentures		2000	
	Depreciation on Buildings		15000	
	Depletion of wasting assets		5000	
	Goodwill written off		20000	
	Excess taxation provided		20000	
	Transfer to general reserve		6000	
	Preliminary expenses written off		1500	
	Premium on redemption of debentures		1000	
	Interim Dividend		20000	105500
				185500
Less:	Non Cash & Non Operating Incomes			
	Profit on revaluation of investments		2000	
	Profit on sale of Non current assets (fixed assets)		35000	
	Income from investments		5000	42000
	Funds from Operations			143500

Illustration 2							
From the following data calculate funds from operations							
Sales		400000	Excess provision for				
Cost of goods sold		280000	tax written back			31000	
Salaries		30000	Loss on sale of Fixed Assets			60000	
Rent		20000	Interest received on Investments			10000	
Selling Expenses		7000	Profit on sale of Investments			20000	
Office Expenses		2000	Profit & Loss A/c				
Preliminary exp. w/off		9000	- Opn Balance			29000	
Trf. To General Reserve		21000	- Closing Balance			60000	
Postage & Telegram		1000					
Solution:							
Operating Incomes							
Sales			400000				
Less: Operating Expenses							
Cost of Goods Sold		280000					
Salaries		30000					
Rent		20000					
Selling Expenses		7000					
Office Expenses		2000					
Postage & Telegram		1000	340000				
Funds from Operations			60000				
Illustration 3							
From the following data, prepare Fund Flow Statement							
Liabilities		2015	2016	Assets		2015	2016
Equity Share Capital		100,000	150,000	Plant & Machinery		200,000	180,000
Pref. Share Capital		50,000	30,000	Furnitures		90,000	130,000
Profit & Loss A/c		40,000	65,000	Investments		80,000	85,000
Debentures		80,000	120,000	Stock		20,000	30,000
Other Secured Loans		90,000	100,000	Debtors		50,000	65,000
Sundry Creditors		65,000	20,000	Bank		5,000	7,000
Bills Payable		5,000	7,000	Cash		1,000	200
Outstanding Expenses		16,000	5,200				
		446,000	497,200			446,000	497,200
Solution							
A. Statement of Changes in Working Capital							
Particulars		2015	2016	Increase in WC	Decrease in WC		
Current Assets (A)							
Stock		20000	30000	10000			
Debtors		50000	65000	15000			
Bank		5000	7000	2000			
Cash		1000	200		800		
Total		76000	102200				
Current Liabilities (B)							
Sundry Creditors		65000	20000	45000			
Bills Payable		5000	7000		2000		
O/s Expenses		16000	5200	10800			
Total		86000	32200				
Working Capital (A-B)		-10000	70000	82800	2800		
Net Increase in Working Capital (82800-2800)							
					80000		
B. Fund Flow Statement							
Sources of Funds				Application of Funds			
Increase in Share Capital		50000		Redemption of Debentures		20000	
Issue of Debentures		40000		Purchase of Furniture		40000	
Secured Loans Received		10000		Purchase of Investments		5000	
Sale of Plant & Machinery		20000		Increase in Working Capital		80000	
Funds from Operations		25000					
(P&L A/c 65000-40000)							
		145000				145000	

Illustration 4						
Liabilities		2015	2016	Assets		2015 2016
Capital - Opn Balance			80,000	Goodwill		10,000 8,000
Add: Capital Introduced			10,000	Plant		30,000 46,000
Add: Net Profit			7,000	Furniture		7,000 6,000
Less: Drawings			6,000	Investment		31,000 57,000
Capital - Cl. Balance		80,000	91,000	Stock		22,000 17,000
Bank Loan		45,000	64,000	Sundry Debtors		15,000 19,500
Creditors		12,000	10,000	Bills Receivable		21,000 18,000
Bills Payable		17,000	14,000	Bank Balance		18,000 7,500
		154,000	179,000			154,000 179,000
Depreciation written off against plant is Rs.4000 & Furniture Rs.1000						
Prepare - Statement of sources & uses of funds						
- Statement of changes in working capital						
Solution						
A. Statement of Changes in Working Capital						
	Particulars		2015	2016	Increase in WC	Decrease in WC
Current Assets (A)						
	Stock		22000	17000		5000
	Debtors		15000	19500	4500	
	Bills Receivables		21000	18000		3000
	Bank Balance		18000	7500		10500
	Total		76000	62000		
Current Liabilities (B)						
	Creditors		12000	10000	2000	
	Bills Payable		17000	14000	3000	
	Total		29000	24000		
Working Capital (A-B)			47000	38000	9500	18500
Net Decrease in Working Capital (47000-38000)						9000
B. Fund Flow Statement for the year 2016						
	Sources			Applications		
	Bank Loan taken		19000	Investments Purchased		26000
	Capital Introduced		10000	Plant Purchased		20000
	Funds from Operations		14000	Drawings		6000
	Increase in Working Capital		9000			
			52000			52000
c. Adjusted Profit & Loss A/c						
To Goodwill Written off			2000	By Funds from		14000
To Depreciation On				Operations		
Plant			4000			
Furniture			1000			
To Net Profit			7000			
			14000			14000
d. Plant A/c						
To Opn Balance			30000	By Depreciation		4000
To Bank (Bal. figure)			20000	By Balance c/d		46000
			50000			50000
e. Capital A/c						
To Drawings			6000	By Balance b/d		80000
To Balance c/d			91000	By Bank		10000
				By Net Profit		7000
			97000			97000
f. Furniture A/c						
To Balance b/d			7000	By Depreciation		1000
				By Balance c/d		6000
			7000			7000

Illustration 5					
Timbaktu Limited furnishes the following details with the direction to prepare Fund Flow Statement for the year 2007					
Liabilities	2007	2006	Assets	2007	2006
Share Capital	90,000	80,000	<i>Working Capital</i>		
Profit & Loss A/c	46,000	30,000	Current Assets	120,000	96,000
			Less- Current Liabilities	42,000	30,000
				78,000	66,000
			Fixed Assets	56,000	40,000
			Share Issue Expenses	2,000	4,000
	136,000	110,000		136,000	110,000
1 An old machine costing Rs.8000/- (WDV Rs.6000) was sold during the year for Rs.7000/-					
2 Depreciation for the year was Rs.2000/-					
3 Interim Dividend of Rs.4000 was paid during the year. Final dividend was not declared					
4 The company made the bonus issue of shares during the year at one equity share for 8 equity shares held by the existing shareholders by utilising the profits.					

Solution 5					
a. Statement of Changes in Working Capital					
Particulars			2006	2007	Increase in WC
Current Assets			96000	120000	24000
Less - Current Liabilities			30000	42000	12000
Working Capital			66000	78000	12000
Net Increase in Working Capital (78000-66000) ... Rs.12000					
b. Funds Flow Statement as on 31.03.2007					
	Sources			Applications	
	Sale of Machinery	7000		Increase in Working Capital	12000
	Funds from Operations	33000		Interim Dividend Paid	4000
				Purchase of Fixed Assets	24000
		40000			40000
c. Adjusted Profit & Loss A/c					
To Depreciation on Fixed Assets	2000		By Balance b/d		30000
To Interim Dividend	4000		By Profit on Sale of Machinery		1000
To Bonus to Shareholders	10000		By Funds from Operations		33000
To Share issue expenses	2000		(Balancing Figure)		
To Balance c/d	46000				
	64000				64000
d. Fixed Assets					
To Balance b/s	40000		By Machine Sold ***		6000
To Bank (Bal. figure)	24000		By Depreciation		2000
			By Balance c/d		56000
	64000				64000
***Working Note					
Machinery at Cost		8000			
Less - Accumulated Depreciation		2000			
WDV (Written Down Value)		6000			
Less - Sale Proceeds		7000			
Profit on Sale		1000			

Important Terms

- ☐ **Fund** – It refers to working capital, **Flow** – It is a movement of fund
- ☐ **Current Items** – It includes current assets and current liabilities
- ☐ **Non Current Items** – It includes share capital, reserves, loans, fixed assets, investments etc
- ☐ **Fund from Operation** – it is the cash profit generated from operations

- **Working Capital** – Excess of current assets over current liabilities is called as working capital.

Theory Questions

1. Why are funds flow statements important?
2. Explain – funds from operations
3. Explain the concept of fund & how the funds flow?

Practical Questions

1 The following are the Balance Sheets of Commerce Colleges Limited as on 31st March, 2011 & 2012					
Liabilities	2011	2012	Assets	2011	2012
Share Capital	120,000	156,000	Goodwill	-	12,000
Reserves	30,000	35,000	Land & Building	89,100	86,550
Profit & Loss A/c	23,814	24,732	Plant & Machinery	67,770	69,720
Sundry Creditors	23,700	19,681	Cash	1,500	1,620
Bills Payables	20,268	6,915	Sundry Debtors	51,105	43,575
Bank Overdraft	35,706	-	Sundry Advances	1,389	441
Provision for Tax	24,000	30,000	Stock	66,624	58,422
	277,488	272,328		277,488	272,328
1 During the year ended 31.03.2012 an interim dividend of Rs.16000/- was paid					
2 Income Tax paid during the year amounted to Rs.15000/-					
3 The assets & Liabilities of another company were purchased for Rs.36000/- payable in fully paid shares of the company. These assets consist of Stock Rs.14984/-, Machinery Rs.11016/- and Goodwill Rs.12000/-, Creditors Rs.2000/-. Additional plant for Rs.3390/- was purchased					

2 The following are the summarised Balance Sheets of Archana Polygraph Ltd as on 31st March, 2010 & 2011					
Liabilities	2010	2011	Assets	2010	2011
Share Capital	460,000	460,000	Land & Building	300,000	300,000
Profit & Loss A/c	32,000	46,000	Machinery	104,000	140,000
Reserve for Contingency	120,000	120,000	Investments	220,000	148,000
8% Debentures	180,000	140,000	Stock	164,000	212,000
Depreciation Fund	80,000	88,000	Debtors	134,000	86,000
Creditors	206,000	192,000	Cash	180,000	180,000
O/s Expenses	26,000	24,000	Prepaid Expenses	2,000	4,000
	1,104,000	1,070,000		1,104,000	1,070,000
1 10% Dividend was paid during the year 2006					
2 Machinery for Rs.6000 was purchased and old machinery costing Rs.24000 (accumulated depreciation Rs.12000) was sold for Rs.8000					
3 Rs.40000 8% Debentures were redeemed by purchase from open market at Rs.96 for a Debenture of Rs.100					
4 Investments worth Rs.72000/- were sold at book value					
You are required to prepare a schedule of changes in working capital and a statement showing sources and application of funds.					



INTRODUCTION TO CASH FLOW STATEMENT

Unit Structure

- 12.0 Learning Objectives
- 12.1 Cash Flow Statement
- 12.2 Analysis of Cash Flow Statement
- 12.3 Cash Flow from Operating Activities
- 12.4 Cash from Investing Activities
- 12.5 Cash from Financing Activities
- 12.6 Benefits/Importance of Cash Flow Analysis
- 12.7 Limitations of Cash Flow Analysis
- 12.8 Accounting Standard – AS3 on Cash Flow Statement
- 12.9 Distinction between Cash Flow V/S Funds Flow

12.0 LEARNING OBJECTIVES

- Understanding concept of cash flow
 - Accounting standard for Cash Flow Statement (AS-3)
 - Preparation of Cash Flow Statement
 - Importance & Limitations of Cash Flow Statement
-

12.1 CASH FLOW STATEMENT

In financial accounting, a **cash flow statement**, also known as **statement of cash flows**, is a financial **statement** that shows how changes in balance sheet accounts and income affect **cash** and **cash equivalents**, and breaks the analysis down to operating, investing and financing activities.

Cash Flow Statement gives information about cash receipts (sources) and cash payments (application). It contains opening balances & closing balances of cash for a given period and explains how the closing balance as per last balance sheet changed by various inflows & outflows of cash to a closing balance of cash as per the next balance sheet. As per AS-3, cash would include cash in hand and savings, current a/c balances with banks & cash equivalents. Cash equivalents are short term & highly liquid investments that are readily convertible into cash. An investment

would normally be called a cash equivalent only when it has a short term maturity of say 3 months or less from the date of acquisition.

12.2 ANALYSIS OF CASH FLOW STATEMENT

The cash flow statement is distinct from the income statement and balance sheet because it does not include the amount of future incoming and outgoing cash that has been recorded on credit. Therefore, cash is not the same as net income, which, on the income statement and balance sheet, includes cash sales *and* sales made on credit. Cash flow is determined by looking at three components by which cash enters and leaves a company: **core operations, investing and financing**,

12.2 (a) Operations

Measuring the cash inflows and outflows caused by core business operations, the operations component of cash flow reflects how much cash is generated from a company's products or services. Generally, changes made in cash, accounts receivable, depreciation, inventory and accounts payable are reflected in cash from operations.

Cash flow is calculated by making certain adjustments to net income by adding or subtracting differences in revenue, expenses and credit transactions (appearing on the balance sheet and income statement) resulting from transactions that occur from one period to the next. These adjustments are made because non-cash items are calculated into net income (income statement) and total assets and liabilities (balance sheet). So, because not all transactions involve actual cash items, many items have to be re-evaluated when calculating cash flow from operations.

For example, depreciation is not really a cash expense; it is an amount that is deducted from the total value of an asset that has previously been accounted for. That is why it is added back into net sales for calculating cash flow. The only time income from an asset is accounted for in CFS calculations is when the asset is sold.

Changes in accounts receivable on the balance sheet from one accounting period to the next must also be reflected in cash flow. If accounts receivable decreases, this implies that more cash has entered the company from customers paying off their credit accounts - the amount by which AR has decreased is then added to net sales. If accounts receivable increase from one accounting period to the next, the amount of the increase must be deducted from net sales because, although the amounts represented in AR are revenue, they are not cash.

An increase in inventory, on the other hand, signals that a company has spent more money to purchase more raw materials. If the inventory was paid with cash, the increase in the value of inventory is deducted from net sales. A decrease in inventory would be added to net sales. If inventory was purchased on credit, an increase in accounts payable would occur on

the balance sheet, and the amount of the increase from one year to the other would be added to net sales.

The same logic holds true for taxes payable, salaries payable and prepaid insurance. If something has been paid off, then the difference in the value owed from one year to the next has to be subtracted from net income. If there is an amount that is still owed, then any differences will have to be added to net earnings.

12.2 (b) Investing

Changes in equipment, assets or investments relate to cash from investing. Usually cash changes from investing are a "cash out" item, because cash is used to buy new equipment, buildings or short-term assets such as marketable securities. However, when a company divests of an asset, the transaction is considered "cash in" for calculating cash from investing.

12.2 (c) Financing

Changes in debt, loans or dividends are accounted for in cash from financing. Changes in cash from financing are "cash in" when capital is raised, and they're "cash out" when dividends are paid. Thus, if a company issues a bond to the public, the company receives cash financing; however, when interest is paid to bondholders, the company is reducing its cash.

Major Cash Inflows

- Issue of new shares for cash
- Receipt of short term & long term loans from banks, financial institutions etc
- Sale of assets & investments, Dividend & Interest received,
- Cash generated from operations

Major Cash Outflows

- Redemption of preference shares, Purchase of fixed assets or investments
- Repayment of long term and short term borrowings
- Decrease in deferred payment liabilities, Loss from operations
- Payment of tax, dividend etc.

Classification of Activities

As per AS-3 the cash flow statement should report cash flows during the period classified by

- OPERATING ACTIVITIES
- INVESTING ACTIVITIES
- FINANCING ACTIVITIES

12.3 CASH FLOW FROM OPERATING ACTIVITIES

- The cash flows generated from major revenue producing activities of the entities are covered under this head.
- Cash flow from operating activities is the indicator of the extent to which the operations of the enterprise have generated sufficient cash to maintain the operating capability to pay dividend, repay loans & make new investments. Main Examples are
- Cash receipts from sale of goods & services
- Cash receipts from royalties, fees, commission etc
- Cash payments to employees
- Cash payments or refunds (receipt) of income tax
- Cash receipts & payments relating to future contracts, forward contract etc
- Cash receipts and payments arising from purchase and sale of trading securities

12.4 CASH FROM INVESTING ACTIVITIES

- These are the acquisition and disposal of long term assets and other investments not included in cash equivalents. This represents the extent to which the expenditures have been made for resources intended to generate future incomes & cash flows, Examples are
- Cash payments for purchase of fixed assets
- Cash receipts from sale of fixed assets
- Cash payments for purchase of shares/debentures etc. in other entities
- Loans and advances given to third parties
- Repayments of loans given

12.5 CASH FROM FINANCING ACTIVITIES

- Financing activities are the activities that result in changes in the size and composition of the owner's capital and borrowings of the enterprise.
- Separate disclosure is important because it is useful in predicting claims on future cash flows by providers of funds
- Examples
- Cash receipts from issue of share capital , debentures & short term & long term loans
- Cash Repayments of loans borrowed
- Cash payment to redeem preference shares

I	CASH FROM OPERATING ACTIVITIES		
	Net Profit Before Tax (if profit & loss A/c is given)		XX
	Closing Bal - Opening Bal (if profit & loss A/c Balances are given in B/S)		XX
Add	<u>Non Cash & Non Operating Expenses</u>		
	- Depreciation on Fixed Assets	xx	
	- Goodwill written off	xx	
	- Preliminary Expenses written off	xx	
	- Discount on issue of Shares & Debentures	xx	
	- Underwriting commission	xx	
	- Cost of issue of shares & debentures written off	xx	
	- Loss on sale of Investments & Fixed Assets	xx	
	- Foreign Exchange Loss	xx	
	- Interest Paid / Dividend Paid	xx	
	- Loss by fire, theft etc.	xx	
	- Proposed Dividend	xx	
	- Trf. to Gen Reserve, Debenture Red. Fund etc	xx	
	- Loss by fire, theft etc.	xx	
Less	<u>Non Cash & Non Operating Incomes</u>		
	- Gain on sale of Fixed Assets & Investments	xx	
	- Interest & Dividend Received	xx	
	- Any other extra-ordinary income	xx	
	- Foreign exchange Gain	xx	
Add	<u>Increase in Current Liabilities</u>	xx	
Less	<u>Decrease in Current Liabilities</u>	xx	
Add	<u>Decrease in Current Assets</u>	xx	
Less	<u>Increase in Current Assets</u>	xx	
Less	<u>Income Tax Paid</u>	xx	
	CASH FROM OPERATING ACTIVITIES		xxx

II	CASH FROM INVESTING ACTIVITIES		
	- Purchase of Fixed Assets & Investments	(xx)	
	- Sale of Fixed Assets & Investments	xx	
	- Interest Received	xx	
	- Dividend Received	xx	xxx

III	CASH FROM FINANCING ACTIVITIES		
	- Proceeds from Issue of Share Capital, Debentures etc.	xx	
	- Proceeds from Long Term Borrowings	xx	
	- Repayment of Long Term Borrowings	(xx)	
	- Redemption of Debentures & Preference Shares	(xx)	
	- Interest Paid	(xx)	
	- Dividend Paid	(xx)	
IV	Net Increase / (Decrease) in Cash	xx	
	Add: Opening Cash Balance at the beginning of period	xx	
	Closing Cash Balance at the end of period	xx	

	CASH FLOW STATEMENT AS ON		
	PARTICULARS	AMT	AMT
I	CASH FROM OPERATING ACTIVITIES	XX	
II	CASH FROM INVESTING ACTIVITIES	XX	
III	CASH FROM FINANCING ACTIVITIES	XX	
IV	Net Increase / (Decrease) in Cash		XXX
	Add: Opening Cash Balance at the beginning of period		XX
	Closing Cash Balance at the end of period		XXX

12.6 BENEFITS/IMPORTANCE OF CASH FLOW ANALYSIS

- **Efficient Cash Management** – manage the cash resources in such a way that adequate cash is available for meeting the expenses
- **Internal Financial Management** – useful for internal financial management as it provides clear picture of cash flows from operations
- **Knowledge of change in Cash Position** – It enables the management to know about the causes of changes in cash position
- **Success or Failure of Cash Planning** – Comparison of actual & budgeted cash flow helps the management to know the success or failure in cash management
- It is a **supplement to fund flow statement** as cash is a part of fund
- Cash Flow Statement is a **better tool of analysis for short term decisions**

12.7 LIMITATIONS OF CASH FLOW ANALYSIS

- **Misleading Inter Industry Comparison** - Cash flow does not measure the economic efficiency of one company in relation to another company
- **Misleading Inter Firm Comparison** - The terms & conditions of purchases & sales of different firms may not be the same. Hence inter firm comparison becomes misleading
- **Influence of Management Policies** – Management policies influence the cash easily by making certain payments in advance or by postponing certain payments
- **Cannot be equated with Income Statement** – Cash flow statement cannot be equated with income statement. Hence net cash flow does not mean income of the business
- **CFS cannot substitute the B/S & Funds Flow.**

12.8 ACCOUNTING STANDARD – AS3 ON CASH FLOW STATEMENT

Objective of AS-3 is to provide desired information about historical changes in cash & cash equivalents of an enterprise classified in to Operating, Investing and Financing activities.

- An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amount in the cash statement with the equivalent items reported in the balance sheet
- An enterprise should disclose the amount of cash & cash equivalent balance held by the enterprises that are not available for use by it with explanation of Management

12.9 DISTINCTION BETWEEN CASH FLOW V/S FUNDS FLOW

	CASH FLOW	FUNDS FLOW
1	Shows net change in position of "Cash & Cash Equivalents"	Shown net changes in position of "Working Capital"
2	Based on narrower concept of funds i.e. Cash & Cash Equivalents	Based on broader concept of funds i.e. Working Capital
3	Mandatory for all the listed companies & is more widely used in India & Abroad	Not mandatory & not used by many companies
4	Classification of inflow & outflow is done in three categories - Operating, Investing & Financing	Such a meaningful classification is not used in fund flow statement
5	No Statement of changes in working capital is prepared as the changes are adjusted in ascertaining cash from operating activities	Statement of changes in working capital is prepared
6	Increase in CA - Decrease in Cash	Increase in CA - Increase in WC
	Increase in CL - Increase in Cash	Increase in CL - Decrease in WC
	Decrease in CA - Increase in Cash	Decrease in CA - Decrease in WC
	Decrease in CL - Decrease in Cash	Decrease in CL - Increase in WC

Practical Sums

Problem No.1

From the following information, prepare cash flow statement for the year ended 31.03.2014

Opening Cash Balance	10000
Closing cash balance	12000
Decrease in Debtors	5000
Increase in creditors	7000
Sale of Fixed Assets	20000
Redemption of Debentures	50000
Net Profit for the year	20000

Solution

Cash Flow Statement for the year ended 31.03.2014

Particulars	Amt	Amt
I Cash Flow from Operating Activities		
Net Profit for the year		20000
Add: Decrease in Current Assets - Debtors (Inflow)	5000	
Add: Increase in Current Liabilities - Creditors (Inflow)	7000	12000
		32000
II Cash Flow from Investing Activities		
Sale of Fixed Assets (Inflow)		20000
III Cash Flow from Financing Activities		
Redemption of Debentures (Outflow)		-50000
Total Cash Flows Generated		2000
Add: Opening Cash Balance		10000
Closing Cash Balance (Bal. figure)		12000

Problem No.2

From the following information, prepare cash flow statement for the year ended 31.03.2014

by Direct Method

- 1 Cash sales Rs.6586000
- 2 Cash collected from debtors during the year amounted to Rs.3323400
- 3 Cash paid to suppliers was Rs.7936810
- 4 Rs.987500 was paid to and for employees
- 5 Furniture of the book value of Rs.18500 was sold for Rs.11000 and a new furniture costing Rs.83160 was purchased
- 6 Debentures of the face value of Rs.300000 were redeemed at a premium of 2% interest on debentures. Interest on debentures, Rs.84000 was also paid
- 7 Dividend of Rs.450000 for the year ended 31st March, 2014 was distributed in May, 2014
- 8 Cash in hand and at Bank as on 31.03.2013 and 31.03.2014 was Rs.51070 and Rs.574000 respectively

Solution:

Cash Inflows		Cash Outflows	
Cash Sales	6586000	Cash paid to Suppliers	7936810
Cash collected from Debtors	3323400	Paid to employees	987500
Sale of Furniture	11000	Purchase of Furniture	83160
Opening Cash Balance	51070	Interest on Debentures Paid	84000
		Redemption of Debentures	300000
		Int. on Redemption of Debentures	6000
		Closing Cash Balance	574000
	9971470		9971470
Total Cash Inflows	9920400		
Less - Cash Outflows	9397470		
Net Cash Flows	522930		
Add - Opn Cash Balance	51070		
Closing Cash Balance	574000		

Problem No.3

From the summary cash a/c of X Ltd, prepare the cash flow statement for the year ended 31.03.2014 by direct method

DR		CASH BOOK for the year ended 31.03.2014		CR	
Particulars	Amt	Particulars		Amt	
To Balance on 1.4.2013	50000	By Payment to Suppliers		2000000	
To Issue of Equity Shares	300000	By Purchase of Fixed Assets		200000	
To Receipts from Customers	2800000	By Overhead Expenses		200000	
To Sale of Fixed Assets	100000	By Wages & Salaries		100000	
		By Income Tax Paid		250000	
		By Dividend Paid		50000	
		By Repayment of Bank Loan		300000	
		By Balance on 31.03.2014		150000	
	3250000			3250000	

Solution:

Cash from Operating Activities			
Receipt from Customers (inflow)	2800000		
Payment to Suppliers (outflow)	-2000000		
Overhead Expenses (outflow)	-200000		
Wages & Salaries (outflow)	-100000	500000	
Cash from Investing Activities			
Sale of Fixed Assets	100000		
Purchase of Fixed Assets	-200000	-100000	
Cash from Financing Activities			
Issue of Equity Shares (inflow)	300000		
Dividend Paid (outflow)	-50000		
Repayment of Bank Loan (outflow)	-300000	-50000	
Total Cash Flows		350000	
Less - Income Tax Paid		-250000	
Net Cash Flow after Tax		100000	
Add: Opening Cash Balance		50000	
Closing Cash Balance		150000	

Problem No.4

Financial position of ABC Limited as on 31.03.2014 was as follows

Liabilities	2013	2014	Assets	2013	2014
Current Liabilities	72000	82000	Cash	8000	7200
Loan from Z Ltd	0	40000	Debtors	70000	76800
Loan from Bank	60000	50000	Stock	50000	44000
Share Capital	200000	200000	Land	40000	60000
Profit & Loss A/c	96000	98000	Buildings	100000	110000
			Machinery	214000	244000
			Prov for Depreciation	(54,000)	(72,000)
	428000	470000		428000	470000

During the year Rs.52000 were paid as Dividend. Prepare Cash Flow Statement

Solution:

Cash Flow Statement for the year ended 31.03.2014			
Particulars		Amt	Amt
I Cash from Operating Activities			
Net Profit during the year			2000
Less: Increase in Current Assets - Debtors		-6800	
Add: Decrease in Current Assets - Stock		6000	
Add: Increase in current liability - Prov for Depreciation		18000	
Add: Increase in current liability		10000	
Add: Dividend Paid		52000	79200
II Cash from Investing Activities			
Purchase of Land		-20000	
Purchase of Building		-10000	
Purchase of Machinery		-30000	-60000
III Cash from Financing Activities			
Loan from Z taken		40000	
Repayment of Bank Loan		-10000	
Dividend Paid		-52000	-22000
Total Cash Flow			-800
Add - Opening Cash Balance			8000
Closing Cash Balance (Balancing Figure)			7200

Problem No.5					
From the following Financial Statement you are required to prepare cash flow statement of Dolphine Ltd for the year ended 31st March, 2006					
Balance Sheet as on 31.03.2006					
Liabilities	2005	2006	Assets	2005	2006
Share Capital	140000	140000	Plant & Machinery	100000	182000
Secured Loan	0	80000	Inventory	30000	80000
P&L A/c	14000	20000	Debtors	10000	40000
Creditors	28000	78000	Cash	40000	18000
Tax Payable	2000	6000	Preliminary Exp.	4000	4000
	184000	324000		184000	324000
Revenue Statement for the year ended 31.03.2006					
To Opening Inventory	30000		By Sales		200000
To Purchases	196000		By Closing Inventory		80000
To Gross Profit	54000				
	280000				280000
To General Expenses	22000		By Gross Profit b/d		54000
To Depreciation	16000				
To Provision for Tax	8000				
To Net Profit	8000				
	54000				54000
To Dividend Paid	2000		By Balance b/d		14000
To Balance c/d	20000		By Net Profit b/d		8000
	22000				22000
Solution:					
CASH FLOW STATEMENT OF DOLPHINE LIMITED AS ON 31.03.2006					
	Particulars		Amt	Amt	
I	Cash from Operating Activities				
	Net Profit after tax		8000		
	Add - Provision for tax		8000		
	Net Profit before tax			16000	
Add	Non Cash/Non Operating Expenses				
	Depreciation		16000		
Less	Increase in Current Assets				
	Inventory		-50000		
	Debtors		-30000		
Add	Increase in Current Liability				
	Creditors		50000	-14000	
	Total Cash Flow			2000	
Less	Tax Paid (working note - tax payable A/c)			-4000	
	Net Cash Flow from Operating Activities			-2000	
II	Cash from Investing Activities				
	Purchase of Plant & Machinery (working note P&M A/c)			-98000	
III	Cash from Financing Activities				
	Secured Loan taken		80000		
	Dividend Paid		-2000	78000	
	Total Cash Flows			-22000	
Add	Opening Cash Balance			40000	
	Closing Cash Balance (Bal.Figure)			18000	
Tax Payable A/c					
	To Bank A/c	4000	By Balance b/d	2000	
	To Balance c/d	6000	By P&L A/c	8000	
	10000		10000		
Plant & Machinery a/c					
	To Balance c/d	100000	By P&L (dep)	16000	
	To Bank A/c	98000	By Balance b/d	182000	
	198000		198000		

Problem No.6					
Calculate cash flow from operating activities from the following P&L A/C					
Salaries		20000	Gross profit		50000
Rent		10000	Profit on sale of Land & Building		5000
Depreciation		5000	Income Tax Refund		5000
Loss on sale of plant		2000			
Goodwill w/off		5000			
Proposed Dividend		6000			
Provision for taxation		5000			
Net Profit		7000			
		60000			60000
Cash Flow from Operating Activities			Amt	Amt	
	Net Profit			7000	
Add	Proposed dividend		6000		
	Depreciation		5000		
	Loss on sale of Plant		2000		
	Goodwill W/off		5000		
	Provision for taxation		5000	23000	
Less:	Profit on sale of Lands & Building			-5000	
Less:	Income Tax Refund - to be shown separately			-5000	
	Cash Flow from Operating Activities			20000	

Key Terms:

Cash – It includes cash and demand deposits with Banks

Cash Equivalents – These are short term and highly liquid investments

Cash Flows – It is movement of cash

Non Cash Expenses – These are the expenses which do not involve any cash payment

Revenue Activities - These are the activities which are revenue producing

Investing Activities – These are related to acquisition and disposal of long term assets

Financing Activities – These are the activities relating to changes in capital & borrowings

Theory Questions:

1. Explain the technique of cash flow statement?
2. What is utility of cash flow statement to financial management?
3. Explain the concept of “Flow of Cash” & enumerate the sources of cash?
4. What data would you require to prepare a cash flow statement?

Suggested Readings for Fund Flow & Cash Flow Statements

Management Accounting – Bhattacharya Debarshi

Introduction to Management Accounting – Dr.Varsha Ainapure (Manan Prakashan)

Practical Sums:

Problem No.7					
Prepare cash flow statement from the following balance sheets.					
Liabilities	2005	2006	Assets	2005	2006
Share capital	4300	5000	Plant	6250	7450
Reserves	3000	3850	Investment	125	375
Loan	375	625	Stock	1625	2000
Creditors	1375	1125	Debtors	1000	750
O/s Exp for Admin	125	50	Cash	375	325
Prov for Deprec.	200	250			
	9375	10900		9375	10900
Income Statement for 2006					
	Sales			5000	
Less :	Cost of Sales (including depreciation Rs.50)			3750	
				1250	
Less :	Selling & Distribution Expenses		250		
	Other Expense		125		
	Interest on Loan		25	400	
	Net Profit			850	
Problem No.8					
Prepare cash flow statement from the following balance sheets.					
Liabilities	2005	2006	Assets	2005	2006
Eq.Share capital	250000	325000	Fixed Assets	200000	250000
Gen.Reserves	50000	75000	Depreciation W/off		-25000
Profit & Loss A/c	25000	75000	Investment	50000	50000
7% Debentures	100000	100000	Stock	100000	125000
Creditors	100000	100000	Debtors	100000	150000
Proposed Dividend	25000	32500	Cash	75000	157500
			Misc. Expenses	25000	
	550000	707500		550000	707500
Problem No.9					
Prepare cash flow statement from the following balance sheets.					
Liabilities	2005	2006	Assets	2005	2006
Eq.Share capital	70000	70000	Fixed Assets (Net)	45000	43500
Gen.Reserves	37000	52500	Cash	37500	48500
Sundry Creditors	16000	17500	Debtors	21500	20000
Wages O/s	1500	2000	Inventories	24500	29000
Mis. Exp O/s	5500	1500	Prepaid Rent	1500	2500
	130000	143500		130000	143500
Accumulated Depreciation was Rs.8000 for the year ended 31.03.2005 and Rs.9500 for the year ended 31.03.2006					
Other Information					
	Sales		150000		
	Cost of goods sold		95000		
	wages		11500		
	rent		3000		
	Mis. Expenses		23500		
	Depreciation		1500		



INTRODUCTION TO COST ACCOUNTING

Unit structure

- 13.1 Objectives
- 13.2 Introduction
- 13.3 Meaning of Cost, Costing and Cost Accounting
- 13.4 Objectives of Cost Accounting
- 13.5 Cost Centre and Cost Units
- 13.6 Classification of Cost
- 13.7 Elements of Cost
- 13.8 Summary
- 13.9 Exercise

13.0 OBJECTIVES

After studying this unit students will be able to:

- Understand the need of Cost Accounting
- Know the meaning of Cost, Costing and Cost Accounting
- Explain the objectives of Cost Accounting
- Understand the classification of Cost
- Discuss about the Elements of Cost
- Know the methods of Costing

13.2 INTRODUCTION

Cost Accounting is the system of accounting which is concerned with determination of costs of doing something which can be manufacturing or rendering service or even conducting any activity or function. The objective of Cost Accounting is to render detailed and useful information for guidance to Management.

Financial accounting is developed over the time to record, summarise and present the financial transaction or events which can be expressed in terms of money. This function was primarily concerned with record keeping, leading to preparation of Profit and Loss Account and Balance Sheet. The information obtained through financial statements is

useful to the Management or Owner in several respects. However, the information provided by financial accounting is not sufficient for several purposes of decision making in many areas such as : determining output level, determining product selection – addition or dropping or changing product combination in the case of multi product company, determining or revising prices of products, whether Profit earned is optimum as compared with competitors and in comparison to earlier years. The need of data for such details lead to the development of Cost Accountancy.

13.3 MEANING OF COST, COSTING AND COST ACCOUNTING

13.3.1 Cost :

Institute of Cost and Works Accountants of India, defines cost as “measurement, in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services”.

Thus the term cost means the amount of expenditure, actual or notional incurred or attributable to a given thing. It can be regarded as the price paid for attaining the objective. For e.g. Material cost is the price of materials acquired for manufacturing a product.

13.3.2 Costing :

The term costing has been defined as “the techniques and processes of ascertainment of costs. **Whelden** has defined costing as, “the classifying recording and appropriate allocation of expenditure for the determination of costs the relation of these costs to sale value and the ascertainment of profitability.”

Therefore costing involves the following steps.

- Ascertaining and Collecting of Costs
- Analysis or Classification of Costs
- Allocating total costs to a particular thing i.e. product, a contract or a process.

Thus costing simply means cost finding by any process or technique.

13.3.3 Cost Accounting :

Cost Accounting is a formal system of accounting by means of which cost of products or service, are ascertained and controlled.

Whelden defines Cost Accounting as, “Classifying, recording and appropriate allocation of expenditure for determination of costs of products or services and for the presentation of suitably arranged data for the purpose of control and guidance of management.”

Therefore, Cost Accounting is the application of costing principles, methods and techniques in the ascertainment of costs and analysis of savings or / and excesses as compared with previous experience or with standards. It provides, detailed cost information to various levels of management for efficient performance of their functions. The information supplied by Cost Accounting as a tool of management for making optimum use of scarce resources and ultimately add to the profitability of business.

13.4 OBJECTIVES AND SCOPE OF COST ACCOUNTING

13.4.1 Objectives of Cost Accounting are as follows:

- 1) To Ascertain the Cost :** To ascertain the cost of product or a services reveled and enable measurement of profit by proper valuation of inventory.
- 2) To Analyse Costs :** To analysis costs or to classify the expenses under different heads of accounts viz. material, labour, expenses etc.
- 3) To Allocate and Apportion the Costs :** To allocate or charge the direct expenses or specific costs such as Raw Material, Labour to particular product, contract or process and to distribute common expenses to each product, contract or process on a suitable basis.
- 4) Cost Reporting :** Cost Reporting or presentation includes :
 - a) What to report i.e. what is the nature of information to be presented?
 - b) Whom to Report i.e. to whom the report is to be addressed.
 - c) When to Report i.e. when the report is to be presented i.e. Daily weekly monthly yearly etc.
 - d) How to Report i.e. in what format the report is to be presented.
- 5) To Assist the Management :** Cost Accounting assist the management in:
 - a) Indicating to the management any inefficiencies and extent of various forms of waste of Raw Material, Time, Expenses etc.
 - b) Fixing of selling price.
 - c) Providing information to enable management to take decision of various types.
 - d) Controlling Inventory of Raw Material, goods in process, finished goods, spares and consumables etc.

- 6) **Cost Control** : Cost Accounting assist the management in cost control. Cost control includes the following stages.
- a) Setting up of targets of cost and production for each period.
 - b) Measuring the actual figures of performance relating to cost, production etc. for the period concerned.
 - c) The figures of actual performance are to be compared with the targets to find out the variation.
 - d) Analysing the variance, whether favourable or adverse.
 - e) Immediate action has to be taken in case of adverse variation.
- 7) **Optimum Product Mix** : Advise the management in deciding optimum product mix merits and demerits of alternative courses of action viz. make or buy decisions, introduction or Automation mechanization, rationalization, system of production etc.
- 8) **Future Policies** : Advise management on future policies regarding Expansion, growth, capital investment, etc.

13.5 COST CENTRE AND COST UNITS:

13.5.1 Cost Centre :

It is a location, person or item of equipment for which cost may be ascertained and used for the purpose of cost control. It is a convenient unit of the organisation for which cost may be ascertained. The main purpose of ascertainment of cost is to control the cost and fill up the responsibility of the person who is incharge of the cost centre.

- **Types of cost centers :**

I. Personal Cost Centre :

It consists of a person or group of persons.

e.g. machine operator, salesmen, etc.

II. Impersonal Cost Centre :

It consists of a location or an item of equipment or group of these.
E.g. Factory, Machine etc.

III. Operational Cost Centre :

This consists of machines or persons carrying on similar operations.

IV. Process Cost Centre :

This consists of a continuous sequence of operation or specific operations.

V. Production Cost Centre :

This is the centre where actual production takes place or these include, those departments that are directly engaged in manufacturing activity and contribute to the content and form of finished product.

e.g. Cutting, Assembly and Finishing Departments etc.

VI. Service Cost Centre :

This is the Centre which renders services to production centres. These contribute to the production process in an indirect manner.

e.g. Stores department, Repairs and Maintenance department, H.R. Department, Purchase Department.

1.11.2 Cost unit :

It is a unit of product, service or time in terms of which cost are ascertained or expressed. It is basically, a unit of quantity of product or service in relation to which costs may be ascertained or expressed.

Few examples of cost unit are given below.

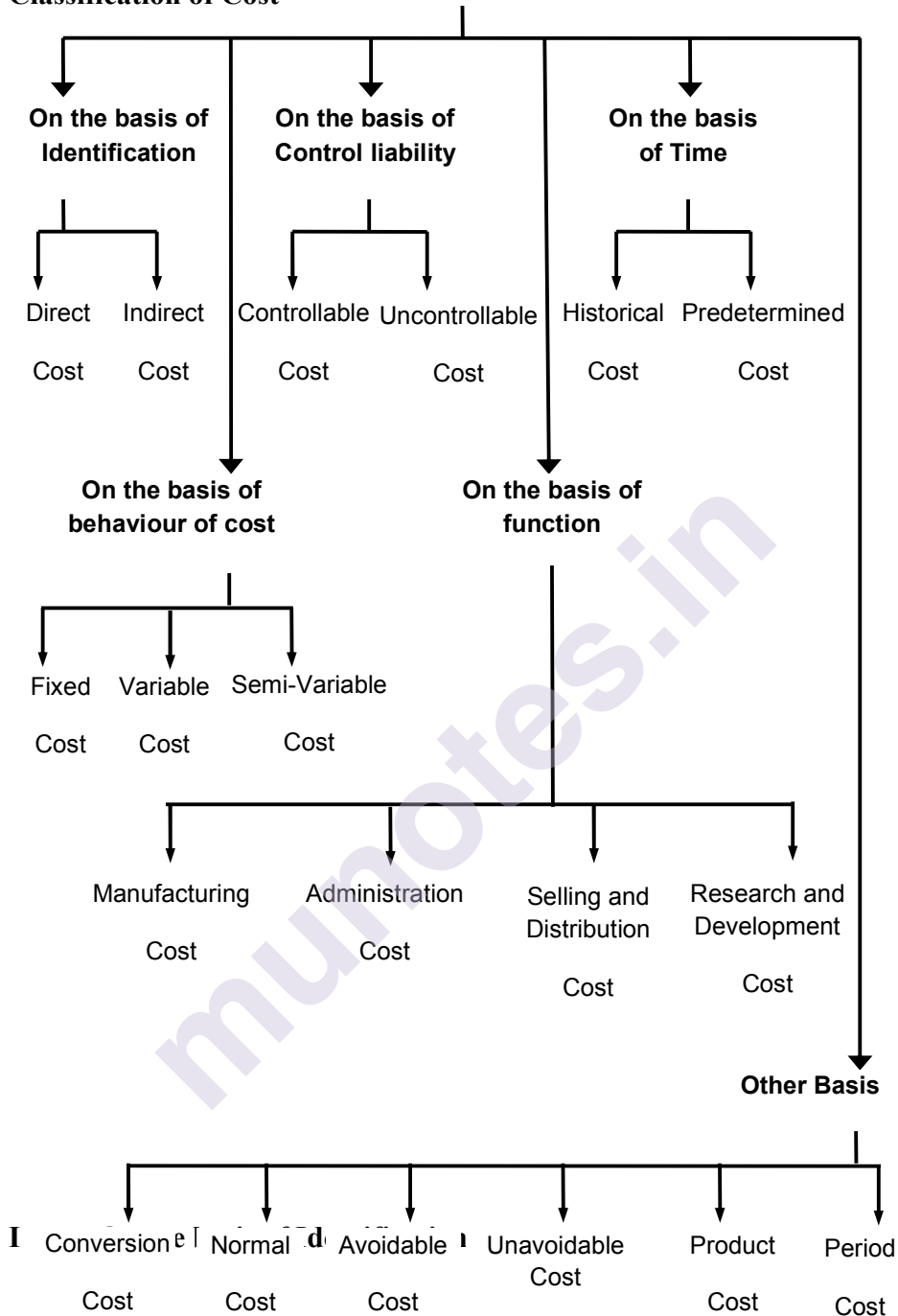
Name of Industry	Cost unit
Textiles	Meter, yards
Transport	Passenger km
Power	Kilowatt – hour
Paints	Litre
Iron and Steel	Tonne
Canteen	Per meal
Chemical	Litre, kilogram
Readymade Garments	Number
Petrol	Litre

13.6 CLASSIFICATION OF COST

Classification is the process of grouping costs according to their common characteristics. It is a systematic placement of like items together according to their common features. There are various ways of classifying costs, according to their common features as given below.

Chart showing classification of cost :

Classification of Cost



On the basis of identification of cost with cost units or jobs or processes, costs are classified into –

1. **Direct Costs** : These are the costs which are incurred for and conveniently identified with a particular cost unit process or department. These are the expenditures which can be directly

allocated to a particular job, product or an activity. E.g. Cost of Raw Material used, wages paid to labourers etc.

2. **Indirect Costs** : These are general costs and are incurred for the benefit of a number of cost units, processes or departments. These costs can not be conveniently identified with a particular cost unit or cost centre. Example : Depreciation of Machinery, Insurance, Lighting, Power, Rent of Building, Managerial Salaries, etc.

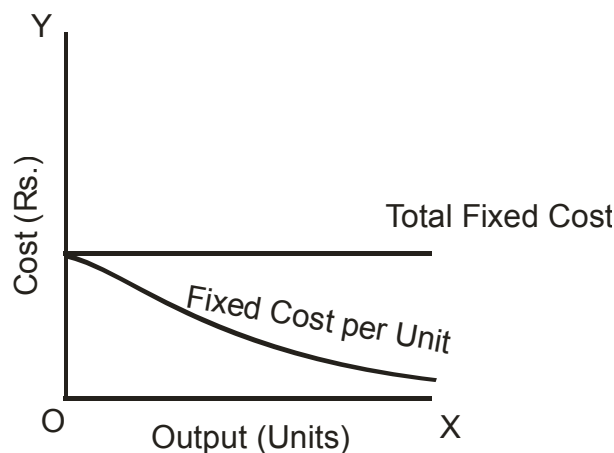
II On the basis of behaviour of Cost

Behaviour means change in cost due to change in output. Costs behave differently when the level of production rises or falls. Certain costs change in direct proportion with production level while other costs remain unchanged. As such on the basis of behaviour of cost – costs are classified into

- 1) **Fixed Costs** : It is that portion of the total cost which remain constant irrespective of output upto the capacity limit. It is the cost which does not vary with the change in the volume of activity in the short run. These costs are not affected by temporary fluctuation in the activity of an enterprise. These are also known as period costs as it is concerned with period. Rent of premises, tax and insurance, staff salaries, are the examples of fixed cost.

Characteristics of Fixed Cost are :

- a. Large in value
- b. Fixed amount within an output range
- c. Fixed cost per unit decreases with increased output
- d. Indirect Cost
- e. Lesser degree of controllability
- f. Influence Variable Cost and Working Capital

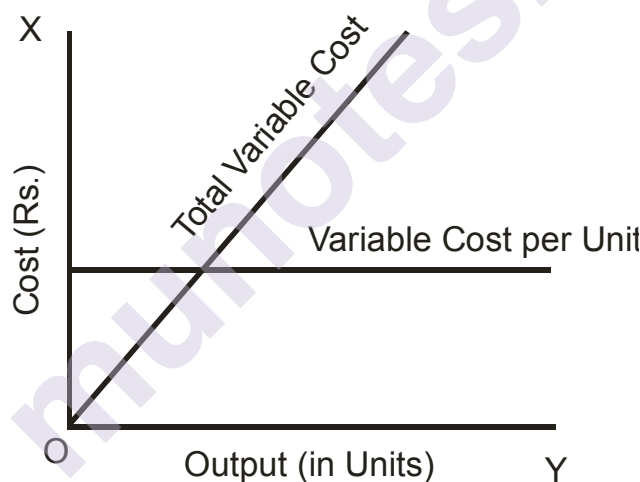


Behaviour of Fixed Cost

- 2) **Variable Cost** : It is that cost which directly varies with the volume of activity. In other words, it is a cost which changes according to the changes in the volume of output. It tends to vary in direct proportion to output. It means when the volume of output increases, total variable cost also increases when the volume of output decreases, total variable cost also decreases. But the variable cost per unit remains same. Direct material, Direct Labour, Direct Expenses are the examples of variable costs.

Characteristics of Variable Cost are :

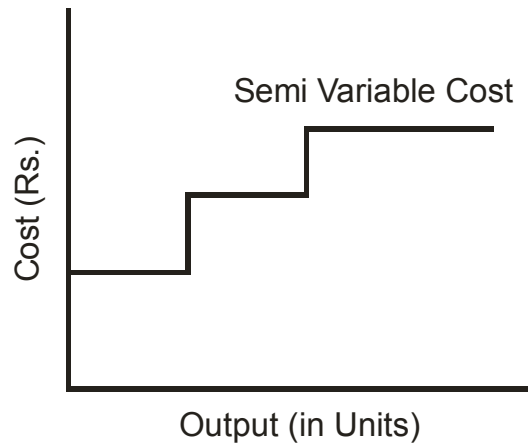
- Total cost changes in direct proportion to the change in total output.
- Cost per unit remains constant.
- It is quite divisible.
- It is identifiable with the individual cost unit.
- Such costs are controlled by functional manager.



Behaviour of Variable Cost

- 3) **Semi-Variable Cost** : This is also referred as semi-fixed costs. These costs include both a fixed and a variable component. i.e. These are partly fixed and partly variable. They remain constant upto a certain level and then change afterwards. These costs vary in some degree with volume but not in direct or same proportion. Such costs are fixed only in relation to specified constant condition.

For example: Repairs and maintenance of machinery, telephone charges, maintenance of building, supervision, professional tax, compensation for accidents, light and power etc.



Behaviour of Semi-Variable Cost

III. On the basis of Controllability

On the basis of controllability, costs are classified into two types :

- 1) Controllable Cost
- 2) Uncontrollable Cost

- 1) **Controllable Cost** : These are the costs which can not be influenced or controlled by the concerned cost centre or responsibility centre. These costs may be directly regulated at a given level of management authority.
- 2) **Uncontrollable Cost** : These are the costs, which can not be influenced or controlled by the action of a specific member of an enterprise. For eg. it is very difficult to control costs like factory rent, managerial salaries etc.

The important points to be noted regarding this classification. First, controllable cost can not be distinguished from non-controllable costs, without specifying the level and scope of management authority. It means cost which is uncontrollable at one level of management may be controllable at another level of management. Eg. Rent and Factory Building may be beyond control for the production department but can be controlled by the administrative department by negotiations. Secondly all costs are controllable in the long run and at the some appropriate management level.

IV On the basis of Functions

An organisation performs many functions. On the basis of functions costs can be classified as follows :

- 1) **Manufacturing Costs** :It is the cost of all items involved in the manufacturing of a product or service. It includes all direct costs and all indirect costs related to the production. It includes cost of direct materials, direct labour, direct expenses, and overhead expenses related to production. Overhead expenses, means all indirect costs

involved in the production process. This is termed as factory overhead or manufacturing overheads. Eg. Salaries of staff for production department, technical supervision, Expenses of stores department, Depreciation of Plant and Machinery, Repairs and maintainance of Factory Building and Machineries etc.

- 2) **Administration Cost :** These are costs incurred for general management of an organisation. It is the cost which is incurred for formulating the policy, directing the organisation of controlling the operations. These are in the nature of indirect costs and are also termed as administrative overhead. Eg. Salaries of Administrative Stall, General Office expenses like rent, lighting, telephone, stationery, postage etc.
- 3) **Selling and Distribution Costs :** Selling costs are the indirect costs relating to selling of products or services. They include all indirect cost in sales management for the organisation. Selling costs include all expenses relating to regular sales and sales promotion activities. Examples of expenses which are included in selling costs are :

- 1) Salaries, Commission and traveling expenses for sales personnel
- 2) Advertisement cost
- 3) Legal Expenses for debt realization
- 4) Market research cost
- 5) Show room expenses
- 6) Discount allowed
- 7) Sample and free gifts
- 8) Rent on Sales room
- 9) After sale services

Distribution costs are the costs incurred in handling a product from the time it is completed in the works until it reaches the ultimate consumer. Distribution expenses include all these expenses which are incurred in connection with making the goods available to customers. These expenses include the following.

- 1) Packing charges
- 2) Loading charges
- 3) Carriage on Sales
- 4) Rent of warehouse
- 5) Insurance and lighting of warehouse
- 6) Transportation costs
- 7) Salaries of godown keeper, driver, packing staff etc.

- 4) **Research and Development Cost** :Research and development costs are incurred to discover new ideas, processes, products by experiment. It includes the cost of the process which begins with the implementation of the decision to produce or improved product.

V On the basis of Time

On the basis of time of computation, costs are classified into historical costs and predetermined costs.

- 1) **Historical Costs** : These are the costs which are ascertained after these have been incurred. Historical costs are then nothing but actual costs. They represent the costs of actual operational performance. These costs are not available until after the completion of manufacturing operations.
- 2) **Pre determined Costs** : These are the future costs which are ascertained in advance of production on the basis of a specification of all the factors affecting cost and cost data. Predetermined costs are future costs determined in advance on the basis of standards or estimates. These costs are extensively used for the purpose of planning and control.

VI Other Basis

- 1) **Normal Cost** : Normal cost may be defined as a cost which is normally incurred on expected lines at a given level of output, in the condition in which that level of output is normally attained. This cost is a part of production.
- 2) **Abnormal Cost** : Abnormal cost is that cost which is not normally incurred at a given level of output, in the condition in which that level of output is normally attained. Such cost is over and above the normal cost and is not treated as a part of the cost of production.
- 3) **Avoidable Cost** : The cost which can be avoided under the present conditions is an avoidable cost. These are the costs which under given conditions of performance efficiency should not have been incurred. They are logically associated with some activity and situation and are ascertained by the difference of actual cost with the happening of the situation and the normal cost. Eg. when spoilage occurs in manufacturing in excess of normal limit, the resulting cost of spoilage is avoidable cost.
- 4) **Unavoidable Cost** : The cost which can not be avoidable under the present condition is an unavoidable cost. They are inescapable costs which are essentially to be incurred within the limits or norms provided for. It is the cost that must be incurred under a programme of business restriction.

CHECK YOUR PROGRESS

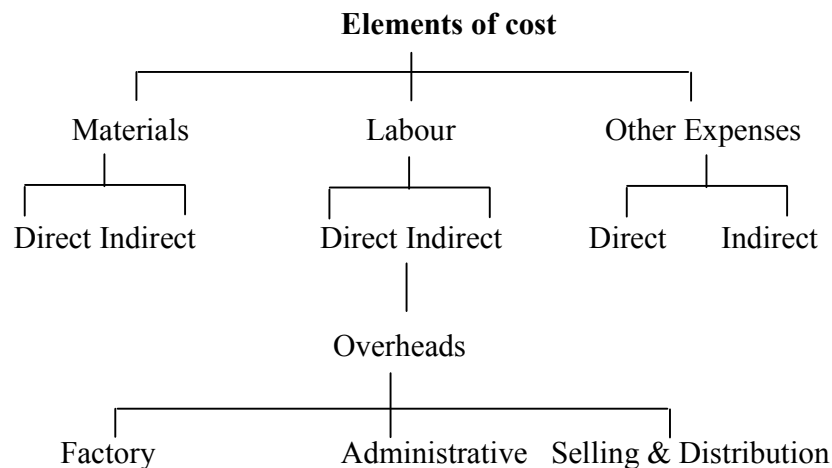
- Draw the chart showing Classification of Cost.
- Define the following terms:
 1. Costing
 2. Cost Accounting
 3. Impersonal cost center
 4. Service Cost center
 5. Direct Cost
 6. Uncontrollable cost
 7. Predetermined cost
- Give Examples:
 1. Fixed cost
 2. Variable cost
 3. Semi variable cost
 4. Manufacturing cost
 5. Administration cost
 6. Selling cost
 7. Distribution Cost

13.7 ELEMENTS OF COST :-

A manufacturing organisation converts raw materials into finished products. For that it employs labour and provides other facilities. While compiling production cost, amount spent on all these are to be ascertained. For this purpose, cost are primarily classified into various elements. This classification is required for accounting and control.

The elements of cost are (i) Direct material (ii) Direct labour (iii) Direct expenses and (iv) Overhead expenses.

The following chart depicts the broad headings of costs and this acts as the basis for preparing a Cost sheet.



13.7.1 Material Cost

It is the cost of material of any nature used for the purpose of production of a product or a service. Materials may be Direct Material or Indirect Material.

- **Direct material** : It is the cost of basic raw material used for manufacturing a product. Direct materials generally become a part of the finished product. No finished product can be manufactured without basic raw material. This cost is easily identifiable and chargeable to the product. For e.g. Leather in leather products, Steel in steel furniture, Cotton in textile etc. Direct material includes the following.

Examples-

- Material specially purchased for a specific job or process.
- Materials passing from one process to another.
- Consumption of materials or components manufactured in the same factory.
- Primary packing materials.
- Freight, insurance and other transport costs, import duty, octroi duty, carriage inward, cost of storage and handling are treated as direct costs of the materials consumed.

In certain cases direct materials are used in small quantities and it will not be feasible to ascertain their costs and allocate them directly. For instance, nails used in the manufacture of chairs and tables, glue used in the manufacture of toys, thread used in stitching garments etc. In such cases cost of the total quantity consumed for the period will be treated as Indirect costs.

- **Indirect material :** It is the cost of material other than direct material which cannot be charged to the product directly. It can not be treated as part of the product. These are minor in importance. It is also known as expenses materials. It is the material which cannot be allocated to the product but can be apportioned to the cost units.

Examples : Lubricants, Cotton waste, Grease, Oil, Small tools, Minor items like thread in dress making, nails in furniture (nuts, bolts in furniture) etc.

Therefore, indirect materials can not be easily identified with specific job. They may not vary directly with the output. It is considered as a part of overheads.

13.7.2 Labour Cost

This is the cost of remuneration in the form of wages, Salaries, Commissions, Bonuses etc. paid to the workers and employees of an organisation.

- **Direct Labour Cost :** Direct Labour Cost is the amount of wages paid to those workers who are engaged on the manufacturing line. It consists of wages paid to workers engaged in converting of raw materials into finished products. The amount of wages can be conveniently identified with a particular line, product, job or process. These workers directly handle machines on the production line. Direct wages include payment made to the following group of workers.

- 1) Labour engaged on the actual production of the product
- 2) Labour engaged in aiding the operation viz. supervisor, foremen, shop Clerks and worker on internal transport.
- 3) Inspectors, Analysts, needed for such production.

Example : Carpenter in furniture making unit, tailor in readymade wear unit, Labour in construction work etc.

- **Indirect Labour Cost :** It is the amount of wages paid to those workers who are not engaged on the manufacturing line. It is of general character and can not be directly identified with a particular cost unit. This indirect labour is not directly engaged in the production operations but such labour assist or help in production operations. It can not be easily identified with specific job, contract of work order. It may not vary directly with the output. It is treated as part of overheads.

Example : Labour in Human Resource department, Labour in payroll department, Labour in stores, Labour in Securities Department, Labour in power house department etc.

13.7.3 Expenses

All costs other than material and labour are termed as expenses. It is defined as the cost of services provided to an undertaking and the notional cost of the use of owned assets.

- **Direct Expenses :**It is the amount of expenses which is directly chargeable to product manufactured or which may be allocated to product directly. It can be easily identified with the product. These are the expenses which are specifically incurred in connection with a particular job or cost unit. They are also called as chargeable expenses.

Example : Hire of special plant for a particular job, Travelling expenses in securing a particular contract, Carriage paid for materials purchased for specific job, Royalty paid in mining or production etc.

- **Indirect Expenses (Overheads):** All indirect costs other than indirect materials and indirect labour costs, are termed as indirect expenses. It is the amount of expenses which can not be charged to the product directly. These can not be directly identified with particular job, process or work order and are common to cost units' or cost centers.
 - Indirect expenses / Overheads can be sub-divided into following main groups.

1. Factory or Works Overheads: Also known as manufacturing or production overheads it consists of all costs of indirect materials, indirect labour and other indirect expenses which are incurred in the factory.

Examples :

Factory rent and insurance. Depreciation of Factory building and machinery.

2. Office or Administration overheads: All indirect costs incurred by the office for administration and management of an enterprise.

Examples:

Rent, rates, taxes and insurance of office buildings, audit fees, directors fees.

3. Selling and Distribution overheads: These are indirect costs in relation to marketing and sale.

Examples :

Advertising, Salary and Commission of sales agents, Travelling expenses of salesmen.

13.8 SUMMARY

Cost Accounting is the process of accounting for costs from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost center and cost units. Cost accounting profession got recognition in 1939 in India. It has been made compulsory for specified manufacturing companies. Cost Accounting has the objectives of determining Product costs, facilitate planning and control of regular business activities and supply information for taking short term and long-term decisions. Cost Accounting is useful in different areas such as materials, labour, overheads, stock valuation etc.

13.9 EXERCISE

1. What is cost Accounting? What are its objectives?
2. What are the various elements of costs?
3. What is meant by Cost Accounting? Explain in brief different ways of Cost Classification.
4. Write short notes on:
 - a. Cost centers
 - b. Cost units
 - c. Elements of costs
5. Choose the correct alternative
 1. Cost accounting is an important system developed for
 - i) shareholders
 - ii) government
 - iii) **management**
 - iv) financial institutions
 2. The costing which determines cost after it has been actually incurred is
 - i) **historical**
 - ii) standard
 - iii) estimated
 - iv) marginal
 3. A cost center is a
 - i) **location for which cost is incurred**
 - ii) an organisation
 - iii) a unit of cost
 - iv) profit center
 4. A cost center which is engaged in production activity is called
 - i) **production cost center**
 - ii) process cost center
 - iii) impersonal cost centre
 - iv) production unit

5. Variable cost per unit remains _____.

- i) **Constant**
- ii) flexible
- iii) (i) & (ii)
- iv) none of the above

6. Cost which is related to capacity is called :

- i) Fixed cost
- ii) Capacity cost
- iii) Plant cost
- iv) **none of the above**

7. Cost which is unaffected by the change in output is called as :

- i) **Fixed cost**
- ii) Variable cost
- iii) Period cost
- iv) **None of the above**

8. Cost which is relevant for decision-making is

- i) Relevant cost
- ii) **Past cost**
- iii) Opportunity cost
- iv) Imputed cost

9. The cost which remains constant irrespective of output upto capacity limit is

- i) **Fixed cost**
- ii) Product cost
- iii) Variable cost
- iv) Sunk cost

10. Variable cost is also known as

- i) Product cost
- ii) Period cost
- iii) **Direct cost**
- iv) Semi fixed cost

11. The cost which is directly chargeable to the product is

- i) Indirect cost
- ii) **Direct cost**
- iii) Overheads
- iv) Period cost



INTRODUCTION TO COST ACCOUNTING

ETHICAL ISSUES IN ACCOUNTING

Unit Structure

14.0 Objectives

14.1 Frauds and Errors – Meaning and Types.

14.2 Difference or Distinction between Errors and Frauds.

14.3 Ethical Issues in Accounting.

14.4 Corporate Governance and Creative Accounting.

14.5 Reasons / Motivations for Creative Accounting.

14.6 Techniques of Creative Accounting.

14.7 Recommendations / suggestions to detect and prevent fraudulent practices of creative accounting.

14.8 Conclusion

14.9 Exercise

14.0 OBJECTIVES

After studying this Unit students will be able

- To know the meaning and types of errors and frauds.
- To understand the difference between errors and frauds.
- To know the ethical issues in accounting, meaning of ethics.
- To know the types of unethical issues in accounting.
- To understand the meaning of Corporate Governance and Creative Accounting and the relationship between the two.
- To know the parties to creative accounting.
- To know the functions of Corporate Governance.
- To know the role of Corporate Governance in detecting creative accounting practices.
- To know the recommendations or suggestions to detect and prevent fraudulent practices of creative accounting.

14.1 FRAUDS AND ERRORS – MEANING AND TYPES

- The secondary objective of auditing is
 - a To detect and prevent errors
 - b To detect and prevent frauds
- If any irregularity is found in the financial statements, it leads to frauds or errors.
- Frauds are intentional mistakes.
- Errors are unintentional mistakes.
- The difference between errors and frauds lies in the intention.
- Fraud is intentionally done, to benefit a certain person or group of persons and causes harmful effect on others.
- Errors are mistakes, which are made, unintentionally.
- Frauds can be done in the following ways (Types of Frauds):

1. Embezzlement of cash

Manipulation of money is found more in big business houses, as compared to small business due to direct control, which is missing in big business houses. In large business houses, there should be an internal check system. An auditor has to deal with cash transactions carefully.

Embezzlement or Misappropriation of cash can be done in the following ways:

- a) Omitting to enter cash, which has been received (suppressing receipts).
- b) Entering lesser amount than what has been actually received.
- c) Making fictitious entries in the cash book, on the payment side. (Fictitious payments).
- d) Entering more amounts, than what has been actually been paid, on the payment side of the cash book.

Misappropriation of Goods

Misappropriation of goods is another type of fraud, done with regard to goods. It becomes difficult to detect this type of frauds, in respect of lesser bulky goods with higher prices (high value).

2. Fraudulent Falsification or Manipulation of Accounts

It is more difficult to detect fraudulent manipulation of accounts because it is usually done by directors, managers and other responsible officials with an intent to:

I. Showing more profits than they are to:

- (a) If they get commission on profits, they get more commission.
- (b) Maintaining shareholders confidence by showing efficiency due to increased profits.
- (c) If they hold shares, they may sell at high price, by declaring higher rate of dividend.
- (d) To get further credit or loans by showing the financial position, better than what actually, it is.
- (e) To attract more subscribers for the sale of companies shares.

II. Showing lesser profits, than actually they are, in order to:

- a Purchase shares in the market at lower price.
- b To reduce or avoid tax payment.
- c To give a wrong impression about business success, to the competitors.

III. Falsification of accounts may be resorted by:

- a Charging more or less depreciation, as per set objective.
- b Showing fictitious purchases or sales or returns, to increase or decrease the profits, as the case may be.
- c Use of secret reserves, during the period, in which concern has earned lower profits, without disclosing, this fact to shareholders.
- d By showing revenue expenditure as capital expenditure or capital expenditure as revenue expenditure.
- e By crediting the revenue account with the income, which will be received in next year and not crediting the profit and loss account, with the income which has accrued, but not received.

It is very difficult to detect such frauds because they are done by people at the top level or people at the helm of affairs, who are presumed to be honest, trustworthy and responsible. So, nobody will suspect them. They are made very carefully and thus the auditor has to be very careful in detecting such frauds.

IV. Misuse (Misappropriation) of company assets / equipments is a fraud.

V. Showing personal expense, as a business expense is a fraud.

VI. Using office computers or laptop, by taking it home and using is a fraud.

VII. Window dressing: When accounts are prepared in such a way that apparently on the face of it, they indicate a position/picture, much better than actually, what they are.

VIII. Creating secret reserves.

IX. Stealing money from the company's resource.

X. Bribery: Taking cash or other consideration in return for doing a favour (or sometimes for even doing one's duty).

XI. Money laundering: Disguising the proceeds of crime as legitimate assets.

XII. Accounting fraud: Manipulation of the number in the financial statements eg. Reporting non-existent revenues and assets

and suppressing expenses and liabilities.

MEANING OF ERRORS

Errors mean unintentional mistakes made by an accountant or clerk while recording business transactions in the books of accounts.

Errors may be due to incorrect accounting knowledge or wrong recording of the transaction in the books of accounts or due to wrong calculations like wrong totaling, wrong balancing, etc.

TYPES OF ERRORS

There are four types of errors.

1. Compensating Errors / Off-setting Errors:

Compensating Errors are those errors which compensate each other. They are those errors in which the effect of one error is offset (nullified), by the effect of another error.

Example (1):

Rent paid Rs.100 is debited to Rent A/c. as Rs.150 Rent A/c. Dr.150

To cash A/c. 150 (Excess Debit of Rs.50/-)

Commission received Rs.200 is credited to the Commission A/c. as Rs.250

Cash A/c. Dr. 250

To Commission A/c. 250 (Excess Credit of Rs.50/-)

The excess debit in rent a/c of Rs.50 is compensated by an excess credit of Rs.50 in commission a/c.

Example(2):

- 10th May 2018. An amount of Rs.3000 paid to Ashok is posted as Rs.300 to the debit of Ashok's A/c.

Ashok's A/c. Dr.300

To Cash A/c. 300 (3000 is less)

- 20th May 2018. An amount of Rs.300 paid to Kumar is posted as Rs.3000 to the debit of Kumar's A/c.

Kumar's A/c. Dr. 3000

To Cash A/c. 3000 (3000 is more)

The Net Effect of both these errors will be zero.

2) Errors of Principle:

Errors of principle are committed because of the ignorance of accounting principles. When a transaction is recorded in contravention of accounting principles, it is known as an error of principle.

Examples:

- Treating revenue expenditure as a capital expenditure.** Rs.250 paid for the repairs of old machinery, is debited to Machinery a/c. instead of Repairs a/c.
- Treating capital expenditure as a revenue expenditure** Wages paid for the installation of new machinery, debited to Wages a/c., instead of Machinery a/c.
- Errors due to inability to make a difference between business expenses and personal expense.**

Proprietor's Life Insurance Premium paid Rs.500, debited to Insurance a/c., instead of Drawings a/c.

So, it is considered as a business expenditure and not a personal expenditure of the proprietor.

3) Errors of Omission:

When a transaction is completely or partially omitted to be recorded in the books of accounts, it is called an error of omission.

Thus errors of omission are of two types:

- Error of complete omission
- Error of partial omission

Goods sold to Aditya on credit not recorded in the books of accounts.

Example of Error of Partial Omission

4) Error of Commission / Clerical Errors

Examples

Goods of Rs.5000 purchased on credit from Mohan is recorded as Rs.50000.

To Mohan's A/c. 5000 Wrong Entry Purchase A/c.
DR 50000

b) Wrong casting / totalling

Example

c) Wrong Posting

Example

Journal Entry Rohan's A/c. Dr. 900 To Sales A/c. 900

Entry passed is correct with right amount, but posting is done with wrong amount.

iii) Posting twice in an account

The posting is done two times in an account.

d) Wrong balancing of an account

The balancing of an account is done wrongly.

14.2 DIFFERENCE OR DISTINCTION BETWEEN ERRORS AND FRAUDS

	Errors		Frauds
	Meaning		
1.	Errors are unintentional mistakes	1.	Frauds are intentional mistakes
	Reason		
2.	Reason of occurrence is ignorance of accounting principles or oversight or incorrect accounting knowledge, wrong transaction recording, wrong calculation.	2.	Frauds are made deliberately.
	Offence		
3.	Generally, errors are not considered as an offence.	3.	Frauds are considered as an offence.
	Result		
4.	Errors can cause undue profit, loss or even no impact.	4.	Frauds always results in loss.
	Detection		
5.	Errors are very easy to detect	5.	Frauds are difficult to identify

ETHICAL ISSUES IN ACCOUNTING

Due to globalization there is free movement of goods, services and capital among the different countries of the world.

The business world requires the accounting profession to give correct and on time financial reports by observing the topmost standards of ethical, moral and accounting professional code of conduct.

Chartered Accountants, Cost Accountants and Management Accountants, who record business transactions have to abide with the guidelines, based on accepted accounting practices, in their country.

The governing body of professional accountants have defined and enumerated the code of conduct in order to attain the highest integrity level by an accountant. In India, the governing body for financial accounting and auditing is the Institute of Chartered Accountants of India (ICAI) and for cost and management accounting, it is the Institute of Cost and Works Accountant of India (ICWAI).

The institute members have to strictly abide the code of conduct, follow the standards and have the highest degree of professional integrity.

Integrity means honesty, impartiality and truthfulness. The accountants have to work with skill, care and diligence.

Overtime, the accounting ethical codes have changed due to two reasons.

- a) Whether the accounting rules accepted and applied are appropriate and reasonable for the public and the firm, who follow them.
- b) Whether the practice enumerated by accounting rules are valid over the period or need to be changed / challenged.

Fraudulent accounting and weak internal control systems are the main reasons of many recent corporate scandals like Enron, WorldCom, Xerox, Reebok India, Tesco, Tyco, Toshiba, Ricod India, Lehman Brothers, etc.

Ethical standards fall very often due to high pressure for performance and exceed market expectations. Managerial compensation is connected to profit and other accounting performance measures. Thus there is temptation to manipulate the accounting reports, sometimes.

- Frauds lead to financial, legal and reputation damage.
- Companies should device systems to prevent, detect and report fraud.
- Due to fraud, companies have collapsed, leading to customers, employees, suppliers, shareholders problems.
- Fraud and ethical compromises, reduce the value of accounting information.

Meaning of Ethics

The word 'ethics' is derived from the Greek word 'ethos' which means 'character' and Latin word 'moras' which means 'customs'.

Ethics is about choices. It signifies how people act in order to make the right choice and produce good behavior.

Ethics is a system of moral principles. It is a sense of right and wrong and goodness and badness of actions and their motives and effects.

Ethics in Accounting

It is very crucial for professionals in accounting, to be ethical in their practices, because of the very, nature of the accounting profession. The accountants are put in a special position of trust, in relation to their clients, employees and the general public, who depend on their professional

judgment and guidance, in making decisions. The stakeholders depend on the accountants due to their professional statutes and ethical standards. Thus, accountants have to be professional and follow ethics, for the clients, public and others to have confidence in them. Public accountants are in a fiduciary relationship with their clients and business accountants are in a fiduciary relationship with the employers. In a fiduciary relationship, it is their responsibility to see that their duties are done in a conformity with the ethical values of honesty, integrity, objectivity, due care, confidentiality and commitment to the public interest, before one's own interest. Thus, accountants as professionals, have to keep a high level of ethical conduct that goes beyond society's laws. This has made the professional accounting bodies like ICAI, to develop a code of professional conduct, which sets rules and standards that define right from wrong, to ensure that members' behavior, complies with perceived public expectations of ethical standards.

But in recent times, accountants involved with large corporate scandals shows that they have not complied with the expected ethical standards.

Accountants should observe a high level of ethics due to the nature of their work, done by them.

The yearly financial statements of the company are depended by the shareholders, potential shareholders and other users or stakeholders because they use this information to make an informed decision about / regarding, investment.

The various stakeholders depend on the accountant's opinion, who prepared the financial statements verified it, to present a true and fair view of the state of affairs of the company. Accountants and auditors can overcome ethical issues by having a knowledge of ethics, allowing for the right choice that, although it may not be beneficial for the company, will be beneficial for the public, who depend on the accountants and auditors reporting.

Ethical Issues in Accounting

1. Underreporting Income

An illegal practice which is prevalent is underreporting of income, to avoid payment of taxes.

When people underreport their income, the government loses tax revenue, which could be utilized for social security, poverty eradication, education of poor people, medical help and such other social welfare projects.

Auditors keep a watch on companies due to the large tax bills at stake each tax year.

Individuals and companies, if caught underreporting (showing less) their income, penalties will be imposed and in extreme cases, criminal charges.

Sometimes, applies to public companies reporting, lower revenues (incomes) in a fiscal quarter, than were actually recorded.

If the company has, already been reporting bad news and the share prices are down, executives may try to take some revenues from the current quarter and push it into the next quarter. This way, the bad news can be “flushed out” and the company can report an upside surprise in the coming quarter, potentially increasing the share price. This is also an illegal practice.

Alteration of financial statements can be easily done by unethical accountants and maneuver number to paint false pictures of company’s success. This may lead to short-term prosperity, but changed financial figure will finally spell the companies downfall, when the regulators detect the fraud.

2. Falsifying Document

Falsifying documents is a type of white collar crime. Falsification of documents is to change details on the original document and try to pass them off as real. Falsifying documents involves altering, changing or modifying a document for deceiving another person. It can also involve the passing along of document copies, which are known to be false.

In many countries, falsifying a document is a crime punishable as a felony.

Documents which are commonly falsified are as follows:

- a) Tax returns and income statements.
- b) Personal checks.
- c) Bank account records.
- d) Business record keeping books.
- e) Immigration documents like Visas, Passports etc.
- f) Identification cards and Birth Certificates.

Different acts, which can be considered as falsifying a document are as follows:

- a) Forging a signature.
- b) Knowingly using or distributing a fake document.
- c) Without authority, using official letterheads.
- d) Hiding assets/property, especially in bankruptcy proceedings.
- e) Giving false information, when requested to give true information.
- f) Changing or misrepresenting factual information like prices or monetary amounts.

A person can be held criminally liable if he is acting, with an intention of deceiving or defrauding another party. So, if a person was using a document, but did not know it was fake, the person cannot be found guilty of document falsifying.

3. Creative Accounting

Creative accounting are the accounting practices that follow required laws and regulations but deviate from those standards intend to accomplish.

Creative accounting capitalizes on loopholes in the accounting standards to falsely show a better corporate image.

Although creative accounting practices are legal, the loopholes they exploit are, often reformed to prevent such behaviours.

Creative accounting can be used to manage earnings and to keep debt off the balance sheet.

14.3 CORPORATE GOVERNANCE AND CREATIVE ACCOUNTING

Corporate Governances is a control system, to reduce the effects of creative accounting, on the reliability of accounting information, directed to the stakeholder interests.

With the rise of Corporate Scandals, confidence of the shareholders and other stakeholders in the corporate financial statements got weakened / collapsed.

A need was felt to find solutions to this problem and an effective regulatory system called 'corporate governance' was found.

Creative Accounting is nothing new. It has been a temptation and a problem, from the time, when accounting principles were first used to report on business performance.

There is an old joke about the accountant who is asked to add up two and two and who produces the response 'What would you like the answer to be?'

It is an appropriate reminder, that financial measurement is not an exact science. **(Kevin, A. Alan, W. 2003:3)**

There are other terms for Creative Accounting. They are

Income Smoothing, Earnings Management, Earnings Smoothing, Financial Engineering, and Cosmetic Accounting.

Definitions of Creative Accounting

1. Barnea et. Al, 1976

"It is the deliberate dampening of fluctuations about "some level of earnings considered being normal for the firm".

2. Merchant and Rockness, 1994

"Creative accounting is an action on the part of management which affects reported income and which provides no true economic advantage to the organization and may in fact, in the long-term be detrimental.

Creative accounting involves using the flexibility in accounting within the regulatory framework, to manage the measurement and presentation of the

accounts, so that they give primacy to the interests of the preparers and not the users.

Parties to Creative Accounting

The main or interested parties to creative accounting are managers, investment analysts auditors, regulators, shareholders, merchant bankers to other users. All these parties play a key role in creative accounting.

1. The Managers, set the creative accounting agenda, they wish to portray the accounts, in a light of favourable to themselves, this may be to increase net assets and the flexibility in accounting techniques which can, deliver the profit figure that serves their interests. Managers may take professional advice from, for example, merchant bank, to devise creative accounting schemes, while complying with the letter of the law, transgress its spirit.

2. Regulators seek to control and limit creative accounting by setting rules and regulations, over time the regulatory framework will be shaped by creative accounting and will in turn shape creative accounting.

3. Auditors will seek to ensure that the accounts are true and fair and will use the regulatory framework as a legitimation tool and reference point.

Whereas the managers set the agenda, the users attempt to detect creative accounting and cope with its effects.

4. Investment Analysts are seeking to price stocks and shares effectively, they will, therefore, seek to adjust the accounts for creative accounting.

5. For ordinary shareholders, creative accounting can affect the share price and they will also try to detect it. If a company goes into problems or even worse, goes bankrupt, they will be major losers.

6. Finally, bankers and creditors would worry that creative accounting could be used to cover poor results and leave them exposed, if the company collapsed.

All the parties are affected by creative accounting in different ways.

14.4 REASONS / MOTIVATIONS FOR CREATIVE ACCOUNTING (Why Creative Accounting is resorted to?)

The reasons or motivations for creative accounting are as follows:

1. To meet internal targets

The managers want to cook the books for meeting internal targets set by higher level management regarding sales, profits and share prices.

2. Meet external expectations

A company has to face many expectations from its shareholders. The employees and customers want, for their interests, the long term survival of the company. Suppliers or sellers on credit want assurance regarding the payment of their dues on time and long term relationships with the company. Company wants to meet analysts forecasts and dividend payout pattern.

3. Provide income smoothing

In order to impress the investors and to keep the share prices stable, companies want to reveal steady income flow. Advocates of this approach favour it due to measure against the short-termism of evaluating an investment on the basis of the immediate yields. It also avoids raising expectations too high to be met by the management.

4. Window dressing for an IPO or a loan

Before corporate events like Initial Public Offer (IPO), acquisition or before taking a loan, window dressing can be resorted to. (Sweeney [1994] reports the companies tendency for violation of debt covenants is 2 or 3 times, to make income increasing, assuming accounting policy changes than other companies).

5. Taxation

A desire for tax benefit especially when taxable income is measured through accounting numbers, can also lead to creative accounting.

6. Management change

New managers have a tendency to show losses due to poor management of old/previous management by some provisions. Dahi (1996) found this tendency in US bank managers.

14.5 TECHNIQUES OF CREATIVE ACCOUNTING

The opportunity or potential for creative accounting or the techniques of creative accounting are as follows:

1. Regulatory Flexibility

Accounting regulation often allows a choice of policy, for example, in respect of asset valuation. (International Accounting Standards allows a choice between carrying non-current assets, at either revalued amount or depreciated historical cost). Business entities may quite validly, change their accounting policies. As Schipper (1989) points out, such changes may be relatively easily to identify in the year of change, but are much less readily discernible thereafter (a few years later).

2. Dearth / Lack of regulation

Some areas are simply not fully regulated. For example, there are (as yet) very few mandatory requirements in respect of accounting for stock items.

3. Management can use their discretionary position

In order to obtain the financial position and stability they assumed. For example, the managers decide to increase or reduce provisions for bad debts (McNichols & Wilson, 1988).

4. The timing of some transactions gives the management an opportunity to increase the revenues, when the operating profit is not satisfactory and to create the desired impression in the accounts. For example, suppose a business has an investment at historic cost, which can easily be sold for a higher sales price, being the current value. The business managers are free

to choose in which year, they sell the investment and so increase the profit in the accounts.

5. Artificial transactions can be entered into for manipulating balance sheet amounts and to move the profits between accounting periods. This is done, by entering into 2 or more related transactions, with an obliging third party, normally a bank. The sale price under such a 'sale and leaseback' can be pitched above or below the correct value of the asset, since the difference can be compensated for by increased or reduced rentals.

6. Reclassification and presentation of financial numbers are relatively under explored in the accounting literature.

CORPORATE GOVERNANCE

Meaning

Corporate governance is a set of rules and conduct, as per which companies are managed and controlled. It usually involves the mechanisms by means of which, company manager's answer for the due and proper running of the corporate performance. The company represents the assets of all the shareholders and in the long term, the company's interests necessarily converge with those of its shareholders.

"Control" means effective performance evaluation, careful management of potential risks and proper supervision of agreed procedures and processes.

The emphasis is on monitoring whether robust control systems are working efficiently, whether potential conflict of interests are being managed and whether sufficient checks are in place, to prevent abuses of power, that may allow personal interests to prevail over company interests.

(Karine, J. Bertrand M, 2001:9)

Corporate Governance is the mechanism in which companies are governed in a transparent manner, by rule of law, in which shareholders participation prevails, in a responsive, efficient and effective way, in order to ensure sustainability and accountability. The concept of corporate governance is getting important day by day, since, each and every country in the recent past, has been a disastrous trail of many big corporate failures / scandals, that shook the entire economy. With globalization, there is more deterritorialization and less of govt. control, which leads in a greater need of accountability. Thus, corporate governance has become a very crucial issue in managing organizations, in the current global and complex environment. So, it is very significant to develop comprehensive corporate governance policies.

Definitions of Corporate Governance

1. Sir Adrian Cadbury (The father of modern corporate governance)

"Corporate governance is the system by which companies are directed and controlled".

2. Lavekar and Tayan

“Corporate governance is the collection of control mechanism that an organization adopts to prevent or dissuade potentially self- interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders.”

Corporate governance is very important/crucial for every organization, since good corporate governance improves firms performance.

Every organization has to enforce corporate governance policy, to achieve a stated goal/objective.

Corporate Governance Functions

Corporate governance is a broad concept, consisting of a set of internal and external mechanisms, designed to align management interests with shareholders interests and to have compliance with applicable laws, rules and standards.

Corporate governance has an important role to play, in improving customer confidence in financial reports and capital markets, by focusing on three institutional factors – ownership structure, legal system and capital markets.

The seven essential corporate governance functions are as under:

a) Oversight function

The oversight function is given to the board of directors, with the fiduciary duty of overseeing the alignment of the managerial function, with the best interests of the company and the shareholders.

b) Managerial function

The management is given the authority to run the company and manage its resources and operations.

c) External Audit function

The external auditors express an opinion, that financial statements truly and fairly represent, in all material respects, the company’s financial position and the results of operations, in conformity with accounting standards and principles.

d) Internal Audit function

It provides both assurance and consulting services to the company in the areas of operational efficiency, risk management, internal controls, financial reporting and governance processes.

e) Compliance function

It is a set of laws, best practices developed by the government regulatory standard-setting bodies and professional organizations, to create a compliance framework for public companies, in which to operate and achieve their goals.

f) Legal and financial advisory function

It provides legal advice and helps the company, its directors, officers and employees in complying, with applicable laws, rules, regulations and other legal obligations and fiduciary duties.

g) Monitoring function

It is exercised by shareholders, particularly, institutional shareholders, who have the power to elect directors and if needed, to remove directors.

The role of Corporate Governance in detecting Creative Accounting Practices

A company requires effective corporate governance to reduce the likelihood of creative accounting and, in particular, fraud. It involves effective internal controls and effective independent scrutiny, of the executive directors, by non-executives.

The four main areas which a company, has to pay attention, in order to mitigate the fraud risk are as follows:

1. Effective internal controls

Internal controls includes a control environment and risk assessment and management, monitoring and control activities. The presence of strong controls, avoids the possibility of financial malpractice. The collection of controls provides a key mechanism, combined with internal audit, whereby, malpractice can be minimized.

2. Division of the responsibility between chief executive and chairman

It is very dangerous for one person, to be the chief executive and also the chairman. It is an essential division of authority in the board room. It prevents the unmitigated use of powers, by one person.

3. Audit Committee

The audit committee is a relatively new development which is responsible for supervising the auditors. For the audit committee to be effective, it should be independent and not staffed by friends, acquaintance or family members of existing executive directors. It has to meet frequently and has to be staffed by experienced persons.

4. Independent board of directors

There is a need for the board of directors itself to be strong. To be effective, there has to be independent non-executive directors. As with the audit committee, the board of directors should not be friends, acquaintances or family members of existing executive directors.

Thus, we should have an effective corporate governance system, to limit or avoid, cases of creative accounting.

In the eyes of law, shareholders are considered supreme and directors are the agents or representatives of shareholders. In reality, the picture is totally different. The shareholders are not supreme, but the directors are supreme due to :

- **Boards** – Family managed with unchallenged control.
- **Shareholders** – Generally scattered, disinterested, ill organized and have little voice.
- **Employees** – Financially poor to act.

Since, the high profile collapses of large number of companies and most of them were involved in accounting fraud, there is a need for better codes and standards on corporate governance, to overcome the creative accounting practices.

The various Committee Reports on Corporate Governance are as follows:

- Sir Adrian Cadbury Committee (UK), 1992
- Greenbury Committee (UK), 1995
- Bosch report (Australia), 1995
- Vienot Report (France), 1995
- Calpers Global Corporate Governance Principles (USA), 1995
- Hampel Committee on Corporate Governance (UK), 1998
- Combined Code of Best Practices (London Stock Exchange), 1998
- Blue Ribbon Committee (USA), 1999.
- OECD Principles of Corporate Governance (Focus on Disclosures) 1991 and then revised in 2004.
- Euro Shareholders Corporate Governance Guidelines, 2000.
- Joint Committee on Corporate Governance (Canada), 2001
- King-II Report on Corporate Governance for South Africa (2002).
- Sarbanes – Oxley (SOX) Act, 2002 (USA).
- Smith Report (UK) on Audit Committee (2003)
- Higgs Report (UK) (2003).
- UNCTAD Guidance on Good Practices in Corporate Governance Disclosure, UK (2008).

Post liberalization, major corporate governance initiatives in India are as follows:

- 1) CII – Confederation of India Industry Taskforce on Corporate Governance – 1996.
- 2) Kumar Mangalam Committee Report on Corporate Governance – 1999.
- 3) Narayan Murthy Committee Report – 2002.
- 4) Naresh Chandra Committee Report – 2002.
- 5) Corporate Governance Voluntary Guidelines 2009.

Regulatory Framework on Corporate Governance in India

- 1) The Companies Act, 2013
- 2) SEBI Guidelines.
- 3) Standard Listing Agreement of Stock Exchanges.
- 4) Accounting Standards issued by ICAI.
- 5) Accounting Standards issued by ICSI.
- 6) SEBI (Insider Trading) Regulation, 1992.
- 7) New Takeover Code and SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 1997.
- 8) SEBI (Prohibition of Fraudulent and Unfair Trade Practices) Regulations, 1995.
- 9) The Depositories Act, 1996.

RECOMMENDATIONS / SUGGESTIONS TO DETECT AND PREVENT FRAUDULENT PRACTICES OF CREATIVE ACCOUNTING

Corporate Governance Code of Conduct has an important role to play, in preventing or curbing curative accounting practices.

The following recommendations can help in detecting and preventing fraudulent practices of creative accounting.

1. Audit Committee

An audit committee consisting of minimum 3 non-executive directors, should be formed, having authority to investigate.

2. Balance of Directors

The board should have a balance of executive director and non- executive directors (in particular independent non-executive directors).

3. Majority independent non-executive directors

The majority of non-executive directors, should be independent of management and free from any business or other relationship.

4. Establish formal and transparent arrangements

To consider how they should apply the financial reporting and internal control principles, the board should establish formal and transparent arrangements.

5. Accountability of External Auditors

The external auditors should be accountable to the Board of Directors and to the Audit Committee.

6. Sufficient Remuneration Level

To attract, motivate and retain directors of the quality required, to successfully run the company, the remuneration level should be sufficient. A company should avoid paying more than is necessary, for their purpose.

7. Timely and Correct disclosure

The framework of corporate governance should see that correct and on time, disclosure is done on all important matters, about the company, including the financial situation, performance ownership and company governance.

8. Financial Statements Certification

The company's chief executive and the chief financial officer, should certify the financial statements.

9. Disclosure in financial reports

There should be certain disclosures in financial reports including information about off balance sheet transaction and orders the SEC to develop rules regarding proforma disclosure.

10. Criminal Penalties

For corporate fraud and document shredding, there should be criminal penalties.

11. Recognition of standards established

The SEC should recognize standards established by a private- sector accounting standard setter, provided that the standard setter is deemed acceptable by the SEC and consider International Conveyance in developing standards.

12. Adoption of IFRS

One act of global financial reporting standard called IFRS, should be adopted by all operators of Accounts or those doing accounting duties.

13. Role of Auditor

In prevention and detection of creative accounting practices, the auditor has an important role to play.

The company's auditor, auditing process can be trusted if he is a well-established entity and has a good track record. The auditor should not be the sole auditor of the company. In other words, there should be more than one auditor and they should be periodically rotated, in order that familiarity between company and auditor, does not lead to decrease in objectivity.

14. System for Investor Education

A proper system should be there to educate investors about the financial terms and its probable impact on financial position, by providing, booklet of methods, adopted by the proposed company, for various items in different situations and expected changes in special circumstances.

15. Reducing alternate choices

The alternate choices of accounting treatment, in accounting standards, should be reduced.

14.6 CONCLUSION

- The relation between Corporate Governance and Creative Accounting is two edged sword.
- These two terms are two sides of a coin, because the presence of creative accounting is connected to the weakness of corporate governance.
- The connection between corporate governance and creative accounting takes place due to conflict between ownership and control i.e. Agency Theory and due to Information Asymmetrical.
- Creative Accounting is the process of manipulating accounting figures, by taking advantage of the loopholes in accounting rules, within the legal framework. It is not illegal.
- It is possible to minimize the negative effects of creative accounting practices, by adopting accounting standards, giving more importance to ethical considerations and decreasing the flexibility in the accounting methods, since flexibility in the accounting method, is the major reason for creative accounting.
- Audit committees play an important role in discouraging creative accounting practices.
- There is a need of modification of corporate system, to curb creative accounting practices, in terms of various codes of conduct.
- The disastrous trail of big corporate failures or scandals like Enron, Satyam, WorldCom, Tyco etc., have led to the initiation of corporate governance reforms process and lead to passing of the Sarbanes-Oxley Act to prevent corporate frauds and ensuring transparency and disclosures.
- India also requires similar type of reforms.
- Even though corporate governance mechanisms cannot prevent unethical activity in top management completely, but they can at least, act as a means of detecting such activity, before it is too late.

14.7 EXERCISE

- 1) What are errors and frauds and explain the types of errors and the types of frauds.
- 2) Distinguish between : Errors and Frauds.
- 3) What is ethics? What are the ethical issues in accounting ?
- 4) What is Corporate Governance?
- 5) What is Creative Accounting ?
- 6) What is the relationship between Corporate Governance and Creative Accounting ?
- 7) Explain the types of unethical issues in accounting.

- 8) State the parties to creative accounting.
- 9) What are the reasons / motivations for creative accounting ?
- 10) Q1.10 What are the techniques of creative accounting ?
- 11) Enumerate the functions of Corporate Governance.
- 12) Discuss the role of corporate governance in detecting creative accounting practices.
- 13) Give suggestions or recommendations to detect and prevent fraudulent practices of creative accounting.

14) Choose the correct alternatives:

1. _____ are intentional mistakes.
 - a) Errors
 - b) Frauds
 - c) Purchases
 - d) Sales
- 2.. _____ are unintentional mistakes.
 - a) Paying wages
 - b) Errors
 - c) Frauds
 - d) Receiving interest
3. _____ errors are errors in which the effect of one error is effect, by the effect of another error.
 - a) Compensating
 - b) Principle
 - c) Omission
 - d) Clerical
4. Errors of _____ are done due to not knowing the accounting principles.
 - a) Clerical
 - b) Principle
 - c) Omission
 - d) Commission
5. When a transaction is completely or partially omitted to be recorded in the books of accounts, it is called an error of _____.
 - a) Omission
 - b) Principle
 - c) Compensating
 - d) Clerical

6. Errors which are done due to wrong casting, wrong recording, wrong posting etc. are errors of_____.

- a) Partial omission
- b) Complete omission
- c) Commission
- d) Principle

7. _____ accounting is taking undue advantage of the loopholes in the accounting system

- a) Cost
- b) Financial
- c) Management
- d) Creative

8. _____ is an art of manipulating the books of accounts, in a manner that desired results can be drawn.

- a) Creative accounting
- b) Financial accounting
- c) Cost accounting
- d) Management accounting

9. _____ accounting is also called cosmetic accounting.

- a) Creative
- b) Cost
- c) Financial
- d) Branch

10. The word 'ethics' is derived from the Greek Word_____.

- a) ethos
- b) etho
- c) eth
- d) et

11. Falsifying document is a / an _____ issue in accounting.

- a) ethical
- b) good
- c) better
- d) best

12. _____ is a set of rules and conduct, as per which companies are managed and controlled.

- a) Financial reporting
- b) Corporate Governance
- c) Ethics
- d) Creative Accounting

13. _____ is a control system to reduce the effects of creative accounting, on the reliability of accounting information directed to the stakeholders interest.

- a) Corporate Reporting
- b) Corporate Scandals
- c) Corporate Governance
- d) Corporate Audit

14. _____ minimizes information asymmetry and answers compliance with mandated reporting requirements and maintains credibility of a firm's financial statements and safeguard against manipulative behavior,

- a) Corporate Accounting
- b) Corporate Statement
- c) Corporate Reporting
- d) Corporate Governance

Ans. 1-b; 2-b; 3-a; 4-b; 5-a; 6-c; 7-d; 8-a; 9-a; 10-a; 11-a; 12-b; 13-c; 14-d

