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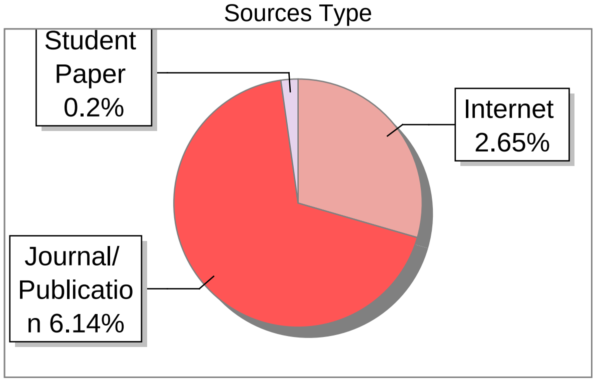

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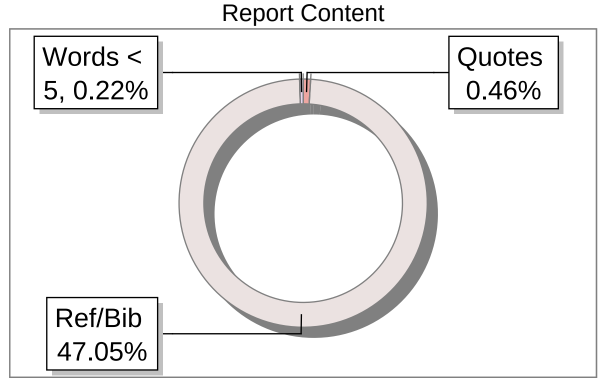

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Unit 1: FUNDAMENTALS OF ACCOUNTING

OBJECTIVES:

After studying this unit, you should be able to:

1. Understand different concepts of Accounting.
2. Identify the objectives of accounting.
3. Different users of accounting information system.
4. Importance of Double entry system of Book keeping.
5. Accounting standards and Principles.

STRUCTURE:

1.1 Introduction

1.2 Meaning of Accounting and Activities covered under Accounting

1.3 Is Accounting a Science or an Art and Accounting as the language of Business

1.4 Accounting as an Information system

1.5 Objectives of Accounting and Functions of Accounting

1.6 Meaning of an Accounting cycle

1.7 Users of Accounting Information and Qualitative characteristics of accounting information

1.8 Unit Summery

1.9 Check your Progress

1.1 INTRODUCTION

Accounting is the backbone of any business, providing the framework for recording, analyzing, and communicating financial information. This unit explores the fundamental concepts and significance of accounting, emphasizing its role as both an art and a science. By understanding the principles of accounting, one can appreciate its dual nature—combining systematic procedures (science) with the skillful application of judgment and presentation (art).

The unit highlights the breadth of activities covered under accounting, including recording transactions, preparing financial statements, and ensuring compliance with legal and organizational standards.

1.2 MEANING OF ACCOUNTING:

American Institute of Certified Public Accountants (AICPA) (1941) Define "Accounting is an art of recording, classifying and summarizing in a signified manner and in terms of money,

transactions and events which are, in part at least of financial character, and interpreting the results thereof."
American Accounting Association (AAA) (1966) Define "Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of information."

Accounting transactions are those transactions which we can measure in monetary value. Any transactions whether related business or non business if money is involved then it is considered an accounting transactions. For example helping out a friend for doing assessment or other task without any monetary benefit cannot be considered accounting transactions. Accounting is much needed for every business organization like manufacturing, trading or service provider organizations. Even, we cannot ignore the role of Accounting in non business organization like schools, colleges, hospitals, temples etc. For every business accounting is the main language Accounting is often called the language of business which serve as a means of communication.

1.2.1: Activities covered under Accounting:

The entire process of accounting starts with identifying transaction and end with communicating information to the users. The following activities are covered in accounting-

1. **Identifying transaction and events:** Any transactions and events which create a change in the wealth position of the business such transactions have to be identified when they occur. For example when you purchase something after making the payment you get a bill or receipt that is the proof of accounting transaction. A transaction is an exchange where each party receives or sacrifices the value.
2. **Measuring the transactions**: These transactions are to be measured or expressed in terms of money. For example, if ten pens are purchased at the rate of Rs. 20 each, then the bill is prepared for Rs. 200. In accounting, transactions are measured in common measurement unit for example India transitions are measured in Indian currency (Rupee)
3. **Recording:** The transactions which are identified and measured are to be recorded in a book called journal then posted to respective ledger account.
4. **Classifying:** The recorded transactions which similar in nature are to be classified in one account with a view to group transactions at one place. The work of classification is done in a separate book called ledger. Here, a separate account is opened for each item so that all transactions relating to it can be brought to one place. For example, all payments of salaries are brought to salaries account.
5. **Summarization:** The summarization is done by preparing different financial statements like profit and loss account which shows the profit or loss incurred in financial year.
6. **Analyzing:** With the help of different financial statement such as profit and loss account, balance sheet, income statement, cash flow statement we can identify the strong and weak areas of the business.
7. **Interpreting**: It is concerned with giving meaning of the outcome of analysis by reviewing different financial statements. The result should be interpreted in meaningful

information so that users can easily understand to take informed decisions.

8. **Communicating**: It is concerned with the passing of summarized, analyzed and interpreted information to the users of accounting information to make informed decisions.

1.3 IS ACCOUNTING A SCIENCE OR AN ART AND ACCOUNTING AS THE LANGUAGE OF BUSINESS

A question arises whether Accounting is a Science or an art? Accounting includes both science and art. It is a science because of its systematic principles and structured approach.

Is Accounting a Science?

Accounting is considered a science because of systematic body of knowledge and principles, like the double-entry system, that are universally applicable. Science relies on a cause-and-effect relationship, observation, and testing. Similarly, accounting involves systematically recording, classifying, and summarizing financial transactions according to established rules. However, unlike pure sciences, accounting does not always follow universal laws because it deals with real-world business situations that can vary widely. So, while it has scientific aspects, it's not a pure science.

Is Accounting an Art?

Accounting is also seen as an art because it requires applying knowledge and skills to meet specific goals. It involves judgment and creativity in interpreting financial data, following accepted rules, principles, and conventions. Art involves practice, and in accounting, the more experience someone has, the more proficient they become. Accountants need to adapt to different situations and use their judgment, especially since accounting rules can sometimes allow for personal interpretation. Therefore, accounting as an art is about the practical application of knowledge, which improves with experience.

Accounting As the Language of Business

Accounting is "language of business" as it is the main way businesses communicate their financial information. For example, financial statements like income statements and balance sheets show a company's profits, expenses, assets, and liabilities. These statements allow investors, managers, or government officials to understand how well a business are doing and what its financial position is.

1.4 ACCOUNTING AS AN INFORMATION SYSTEM

Accounting is also an information system because it gathers, processes, and presents financial data to help users to make decisions. This system is used by different users to understand a company's financial position. For example, when a business owner applies for a loan, the bank will look at the company's accounting reports, such as the balance sheet and profit & loss statement, to decide if the business can repay the loan. Accounting provides a structured way to organize and report financial information, making it accessible for those who need to analyze and act on it.

1.5 OBJECTIVES AND OF ACCOUNTING:

The main objectives of accounting are as follows-

1. **Accurate Record-Keeping**: Establishes a structured process for recording all financial transactions systematically which bring reliability and consistency of financial information.
2. **Providing Financial Information for Decision-Making**: Delivers essential, clear financial data that aids stakeholders—such as managers, investors, and creditors—in making informed, effective decisions.
3. **Determining Financial Performance**: Assesses the profit or loss generated over a specific period, providing a clear view of operational efficiency and profitability.
4. **Evaluating Financial Position**: Provides a snapshot of an organization's financial status at a given time, including its assets,
5. **Facilitating Budgeting and Financial Control**: It helps in resource allocation, preparation of budget and forecasting, enabling effective financial planning and control liabilities, and equity, reflecting overall financial health.

Functions of Accounting:

The functions of accounting and the process of accounting are often considered similar because they both focus on managing, recording, and reporting financial information systematically. The accounting process identifying, measuring, recording, classifying, summarizing, analyzing, interpreting and communicating financial transactions aligns closely with the functions of accounting. While the accounting process refers more to the sequence of steps followed, the functions represent the objectives served by those steps.
The functions of Accounting are listed below-

1. **Recording Transactions**: Recording all the financial transactions systematically and accurately in the books of accounts which create a comprehensive and reliable financial record.
2. **Classifying Financial Data**: Organizing financial information into appropriate categories, such as assets, liabilities, revenue, and expenses, which facilitates easier analysis and interpretation.
3. **Summarizing Financial Information**: Compiling data into financial statements (e.g., balance sheet, income statement, cash flow statement) that provide a clear summary of the organization's financial activities and position.

4. **Analyzing and Interpreting Financial Data**: Evaluating financial statements to provide insights into trends, profitability, and financial health, supporting strategic decisions.
5. **Communicating Financial Information**: Sharing accurate financial reports with stakeholders, including management, investors, and regulatory bodies, to inform decision-making.

1.6 MEANING OF AN ACCOUNTING CYCLE:

The accounting cycle is a systematic process to identify record, classify, and summarize financial transactions over a specific period. This cycle involves a series of steps, from analyzing transactions to preparing financial statements.

The sequential steps involved in accounting cycle are discussed bellow-

Step 1- Identify Transactions: Accounting cycle is the first step to recognize financial transactions.

Step 2- Journalize Transactions: Record each identified transaction in the books of original entry as journal entries which includes the date, accounts affected, and amounts.

Step 3- Post to Ledger Accounts: Transfer each journal entry to the general ledger, where transactions are organized by individual accounts.

Step 4- Preparation of Trial Balance: Considering the data from all ledger accounts, a trail balance is prepared at the end of accounting period which verify whether the **total** debits equal the total credits or not.

Step 5- Income Statement: In this step of accounting cycle, trading and profit and loss account is prepared at the accounting period.

Step 6- Position Statement: In the last phase of an accounting cycle a balance sheet is prepared to ascertain the financial position of a company at the end of accounting period.

1.7 USERS OF ACCOUNTING INFORMATION:

Accounting information provides insights into an organization's financial position, past and present performance also the stability. Accounting information supports diverse stakeholders in making informed decisions. These users range from internal stakeholders such as management and employees who rely on this information for strategic planning and operational control. External users such as investors, creditors and regulatory bodies who assess the organization's compliance, profitability, and risk level.

Some of the users of accounting information are presented in the following table:

Table No.1: Users of accounting information

User	Description
Management	Uses accounting information for planning, controlling, and decision-making within the organization.
Investors	Examine liquidity, profitability and financial health before making investment decisions.
Creditors and Lenders	Evaluate an organization's financial stability and ability to repay loans.
Employees	Employees are Interested in the organization’s profitability position as it affects job security and growth opportunities.
Government and Regulatory Bodies	Require accounting information to ensure compliance with tax laws, regulations, and financial reporting standards.
Suppliers and Trade Creditors	Require financial data to determine the creditworthiness of the organization. They can ensure whether company can meet its payment obligations or not.
Customers	Customers are interested in the financial stability of a supplier to ensure a reliable long-term business relationship.
General Public	Includes potential investors, analysts, and researchers who use accounting information to assess the organization’s contributions to the economy and society.
Shareholders	Interested in financial performance to gauge returns on their investments and the organization's growth potential.

Qualitative characteristics of Accounting Information

The qualitative characteristics of accounting information are given bellow-

a) **Reliability**:
Accounting information furnished should be accurate and dependable. The furnished information should reflect the true financial position of the company which gives inventors confidence. Information is considered reliable information when it is free from bias and errors.

b) **Relevance**: The information provided in financial statements must be relevant to the users i.e. Management, investors, creditors, customer, suppliers etc. to make decisions. C)

c) Understandability: Accounting information should be presented in the financial statement easily and understandable by then different users. For example, presenting revenue and expenses clearly in a standard income statement format makes it easy for people, even without accounting expertise to see how much profit a company made.

d) Comparability: Comparability means users can access financial statement in different time periods or between companies. Suppose, an organization reports its financial results consistently year after year, investors can compare this year's profits with last year's to see if the business is growing. Comparison can also be made with the information of other similar company over different time periods.

1.8: SUMMERY:

This unit provides a clear look at the basics of accounting, covering its main goal of providing accurate financial information for decision-making and reporting. The functions of Accounting are also highlighted in this unit. This unit also discussed the importance of accounting information for different user's internal and external users.

1.9: SELF ASSESSMENT QUESTIONS

1- Mark Multiple Choice Questions

1. **What does the accounting cycle begin with?**
   a) Preparation of financial statements
   b) Recording transactions in the journal
   c) Analyzing the trial balance
   d) Closing the accounts
2. **Accounting known the language of business because:**
   a) It uses numbers to communicate business performance
   b) It is universally understood
   c) It replaces verbal communication in businesses
   d) It involves legal documentation
3. **Which characteristic ensures accounting information is free from significant error or bias?**
   a) Comparability
   b) Relevance
   c) Reliability
   d) Timeliness
4. **Which of the following best describes the dual nature of accounting?**
   a) Science of laws and regulations
   b) Art of recording transactions and science of systematic methods
   c) Science of prediction and analysis
   d) Art of communication and legal compliance

5. **Who are internal users of accounting information?**
   a) Creditors and investors
   b) Government agencies
   c) Managers and employees
   d) Customers

5- Mark Questions

1. Assume that you are the owner of a business, how would you describe the role of accounting in a business?
2. Who are the primary users of accounting information? Give two examples of decisions they might make based on this information.

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UNIT 2: ACCOUNTING PRINCIPLES-CONCEPTS AND CONVENTIONS, ACCOUNTING EQUATION

OBJECTIVES:

After studying this unit, you should be able to:

1. Understand the importance of Double entry system of Book keeping.
2. Understand Accounting standards and Principles.

STRUCTURE:

2.1 INTRODUCTION

Accounting serves as the language of business, enabling businesses to convey the outcomes of their financial activities to various stakeholders. For this communication to be clear, meaningful, and universally understood, it must adhere to established rules, principles, and standards. These foundational guidelines are collectively known as the conceptual framework of accounting. Developed to provide a theoretical foundation, this framework ensures consistency and reliability in accounting practices. At its core, the conceptual framework includes the Generally Accepted Accounting Principles (GAAP), as well as fundamental concepts such as the accounting equation: **Assets = Liabilities + Equity**, which serves as the basis for recording and analyzing financial transactions systematically.

2.2 ACCOUNTING PRINCIPLES:

Accounting assumptions are the guiding principles that make financial statements trustworthy, clear, and comparable across businesses and time periods. As per Accounting Standard (AS-1) issued by the Institute of Chartered Accountants of India (ICAI) three main assumptions:

1. Going Concern
2. Consistency
3. Accrual

1. **Going Concern Assumption**: The going concern assumption assume a company as a "living" entity that will continue their operating for long periods. This assumption means that companies are expected to keep functioning, fulfilling their obligations, continuing their growth and expansion but not liquidating their assets in the near term. As per this assumption, assets and liabilities are valued based on their future earning potential not on their historical cost.

   Implications of going concern assumptions:

   i. Based on this assumption assets are classified as fixed assets and Current Assets.
   ii. Liabilities are classified as long term liabilities and short term liabilities.
   iii. In case of liquidating enterprise unused resources are shown as unlisted cost as against the breakup value.

2. **Consistency Assumption**: This assumption assumes that the entity's accounting policies should not be changed over time. This stability in accounting policies makes financial information comparable across different periods. The result of changing accounting policies from time to time will loss comparability where investors will also loss the relevance of accounting information for decision making purpose. It ensures that the entity's used methods are consistently applied to maintain comparability and relevance. For example, if an asset is depreciated using the written-down value (WDV) method, this method should be applied consistently each year.

3. **Accrual Assumption**: The accrual basis of accounting is a method of accounting in which revenue, costs, assets and liabilities are recorded during the time frame in which they are recognized rather than when actual cash transactions happen. In this assumption,

52 Revenue is recognized when it is earned, even if the payment is received at a later time. Suppose a company delivers goods or services in one accounting period but receives payment in a later period, Revenue is recognized in the period during which the goods or services are provided. Similarly, expenses are accounted for when they are incurred, irrespective of the payment date. When a company receives a utility bill in December but settles it in January, the expense is recorded in December to align with the period the utility service was consumed.

Generally Accepted Accounting Principles (GAAP):

The principles which have substantial authoritative support become the part of the Generally Accepted Accounting Principles (GAAP). These principles act as general decision rules for accounting techniques, helping ensure consistency. GAAP includes fundamental principles such as the going concern assumption, consistency, and accrual basis, which collectively provide a framework for financial reporting.

The principles that form the foundation of GAAP are described bellow-

1. **Accounting Entity Principle**: This principle establishes that a business is a separate entity distinct from its owner. The owner's personal transactions are excluded from the financial records of the entity.
2. **Money Measurement Principle**: Qualitative aspects are not included.
3. **Accounting Period Principle**: Financial statements are generated for defined time frames, such as quarterly or annually, to deliver up-to-date financial information. This helps in determining financial performance and position periodically.
4. **Full Disclosure Principle**: All necessary information should be included in financial statements, making them clear and comprehensive to prevent misinterpretation by stakeholders.
5. **Prudence Principle (Conservatism)**: This principle advises caution, meaning that expenses and liabilities must be documented when probable; however, revenues are recognized only when they are certain.
6. **Historical Cost Principle**: Assets are recorded based on the cost at the time of acquisition, which can make financial statements less reflective of current market values
7. **Duel Aspect**: The Dual Aspect Concept is a core principle in accounting, emphasizing that each financial transaction impacts two accounts in equal and opposite ways. This principle underpins the double-entry bookkeeping system, where every debit entry has a corresponding credit entry. As per this concept: Assets = Liabilities + Equity.
8. **Matching Concept:** During the accounting year revenue earned should be matched with the expenses incurred. This way, the income statement accurately shows how much profit a company made during a specific time**.**

2.3: ACCOUNTING CONVENTIONS

1. **Conservatism:** The conservatism convention is an approach which guides financial reporting with caution, especially when facing uncertainty. This principle states that **potential losses should be recognized as soon as they are reasonably anticipated**, whereas gains should only be recorded when they are realized. This practice helps to prevent overstatement of a company's financial position and protects users of financial statements from an overly optimistic view of financial performance.
2. **Consistency:** According to consistency convention a company should apply the same accounting principles and methods consistently across accounting periods. Once a company adopts an accounting method, it should continue to use that method in subsequent periods unless there is a valid reason for change facilitating analysis and trend evaluation. Suppose a business uses the straight-line method of depreciation for fixed assets, it should apply this method in each accounting period.
3. **Materiality:** The convention of Materiality states that only items or information that is important of users should be reflected in the financial statements. Insignificant amounts or immaterial items may be omitted if their impact is less. For example an expenditure on low-cost office supplies, which may be used over time, might be expensed immediately rather than recorded as an asset, as it does not significantly affect financial outcomes.
4. **Full Disclosure**: As per this convention all information favorable and unfavorable should be disclosed in the financial to understand company's financial position. This includes any significant transactions, events or conditions that could impact the financial well-being of the business which allows users to make informed judgments and decisions.

2.4 DOUBLE ENTRY SYSTEM OF BOOK KEEPING:

This approach is based on the concept of duality or the dual aspect principle, which means that each transaction has two equal and opposite effects, one recorded as a debit and the other as a credit. Every debit has equal amount of credit. For instance, if a business buys goods worth Rs. 1,000 in cash, the Cash account is decreased (credited) by Rs. 1,000, and the Purchases account is increased (debited) by the same amount. Each ledger account has both a debit and a credit side. When transactions occur, they are recorded in the appropriate accounts in the ledger following the double-entry principle. This system aids in preparing a trial balance, which summarizes all account balances from the ledger.

Example 1: Mr Ram sold Goods for ` 1,000 to Mr Syam on credit. In this case the dual aspects of this transaction for Mr X and Mr Y are as follows-

Dual Aspects of Mr Ram	Dual Aspects of Mr Syam
1. Receipt of Cash Rs.1000 2. Forgoing of goods of Rs.1000	1. Payment of Cash Rs.1000 2. Receipt of goods of

	Rs.1000

1.3.1: Advantages of Double Entry System:

The advantages of Double entry system are discussed bellow-

1. **Ensures Accuracy**: The double-entry system helps maintain accuracy in accounting records. Recording each transaction as both a debit and a credit enables businesses to create a trial balance, ensuring that the sum of debits matches the sum of credits. This process aids in identifying discrepancies in financial records.

2. **Facilitates Financial Statement Preparation**: The double-entry system structures financial data to facilitate the creation of essential financial statements, such as the balance sheet, income statement, and cash flow statement. These reports provide an accurate representation of the business's financial condition.

3. **Detects and Prevents Errors**: The system helps to identify discrepancies.
4. **Supports Management Decision-Making**: By organizing accurate and detailed records, the double-entry system provides valuable financial information that management can use for analyzing performance, planning, and decision-making.

5. **Universally Recognized**: The double-entry system aligns with generally accepted accounting principles (GAAP) and is widely used globally. Its standardized approach enhances the credibility and reliability of financial records, making it easier for businesses to comply with regulatory requirements.

2.5 ACCOUNTING EQUATION:

An accounting equation is a declaration of equality between the sources and the resources.
They are listed in a document called the balance sheet which shows the financial health of company. Assets are the resources of a company and liabilities are the sums of money that the business owes to third parties. The owner of a company always prefers the former to the latter.

Resources=Sources of Finances

Resources refer to the assets tangible and intangible or tangible items such as land and buildings, plant and machinery, furniture, investments, stock, debtors, bank balances, and cash balances. Intangible assets include patents, trademarks, and copyright.

Sources of Finances mainly includes equity and debt.

Capital refers to the amount of investment contributed by the owner of a company.

Liabilities refer to the company's payment obligations to the outsiders.

The Accounting equation may be written as follows-

Total Assets= Total Equities

Or

Assets=Internal Equities + External Equities

Or

Assets= Capita + Liabilities

Capital= Assets – Liabilities

The bellow table provides a summary of the impact of various transactions on company's financial elements including assets, liabilities and capital.

Table No.1: Impact of Transactions on Financial Elements: Assets, Liabilities, and Capital

Transaction	Effect on Assets	Effect on Liabilities	Effect on Capital
Investment of capital into the business	Increase	—	Increase
Loan Taken	Increase in Cash	Increase in Lenders	—
Purchase of Goods for Cash	Increase in Goods & Decrease in Cash	—	—
Credit Purchase of Goods	Increase in Goods	Increase in Creditors	—
Sale of Goods for Cash	Increase in Cash & Decrease in Goods	—	Increase due to Profit
Sale of Goods on Credit	Increase in Debtors & Decrease in Goods	—	Increase due to Profit
Goods Returned by Customer	Decrease in Debtors & Increase in Goods	—	Decrease due to Decrease in Profit
Goods Returned to Supplier	Decrease in Goods	Decrease in Creditors	—
Collection from Debtors	Increase in Cash & Decrease in	—	—

	Debtors		
Payment to Creditors	Decrease in Cash	Decrease in Creditors	—
Receipt of an Income	Increase in Cash	—	Increase due to Income
Payment of an Expense	Decrease in Cash	—	Decrease due to Expense
Depreciation Charged	Decrease in Fixed Asset	—	Decrease due to Depreciation

2.5.1 From the following information analyze the effect of transactions on Assets, liabilities and capital-

Started business with cash – Rs 5,000
Purchased goods on credit – Rs 400
Purchased goods for cash – Rs 100
Purchased furniture – Rs 50
Withdrew for personal use – Rs 70
Paid rent – Rs 20
Received interest – Rs 10
Sold goods costing Rs 50 on credit for Rs 70
Paid to creditors – Rs 40
Paid for salaries – Rs 20
Further capital invested – Rs 1,000
Borrowed from P – Rs 1,000

Table No.1: Effect of transaction on Assets, liabilities and Capital

Transaction No.	Description	Assets (Rs)	Liabilities (Rs)	Capital (Rs)
1	Business Started with cash Rs 5,000	+5,000		+5,000
2	Purchased goods on credit Rs 400	+400	+400	
3	Purchased goods for cash Rs 100	-100		
4	Purchased furniture Rs 50	+50		
5	Withdrew for	-70		-70

	personal use Rs 70			
6	Paid rent Rs 20	-20		-20
7	Received interest Rs 10	+10		+10
8	Sold goods costing Rs 50 on credit for Rs 70	+70 - 50		+20
9	Paid to creditors Rs 40	-40	-40	
10	Paid for salaries Rs 20	-20		-20
11	Further capital invested Rs 1,000	+1,000		+1,000
12	Borrowed from Ram Rs 1,000	+1,000	+1,000	
Total		7280	1360	5920

2.6 SUMMERY:

In this unit has covered all the essential accounting principles, conventions, and the accounting equation, which form the core of reliable and consistent financial reporting. Key accounting principles include the accrual principle, recognizing revenues and expenses when earned or incurred; the consistency principle, which ensures methods are used consistently across periods; and the conservatism principle, which advises cautious asset or income reporting. Accounting conventions like materiality, full disclosure, and prudence further guide the preparation of meaningful financial statements. These principles and conventions work together within the framework of the accounting equation-Assets = Liabilities + Equity which underlies the double-entry system. The balance this equation ensures that every financial transaction maintains of a company's financial position, reflecting how assets are financed by liabilities and equity. Together, these foundational concepts enable accurate financial analysis and clear communication of a company's economic health.

2.6 SELF ASSESSMENT QUESTIONS:

1-Mark Questions

1. **What does GAAP stand for?**
   a) General Accounting and Auditing Principles
   b) Generally Accepted Accounting Principles

c) Government Approved Accounting Policies
d) General Agreement on Accounting Practices

2. **Which of the following is not an accounting principle?**
a) Revenue Recognition Principle
b) Cost Principle
c) Matching Principle
d) Marketing Principle

3. **Accounting conventions primarily focus on:**
a) Maintaining profitability
b) Ensuring uniformity and consistency in practices
c) Preparing budgets
d) Tracking tax compliance

4. **The double-entry system of bookkeeping means:**
a) Every transaction affects two accounts
b) Recording all transactions twice for accuracy
c) Preparing two sets of financial statements
d) Recording revenue and expenses only

5. **The accounting equation is:**
a) Revenue = Expenses + Profit
b) Assets = Liabilities + Equity
c) Assets = Revenue - Expenses
d) Liabilities = Assets + Equity

6. **Which accounting convention emphasizes recording transactions based on evidence rather than assumptions?**
a) Conservatism
b) Consistency
c) Materiality
d) Objectivity

7. **The principle that requires matching expenses with related revenues is known as the:**
a) Cost Principle
b) Matching Principle
c) Revenue Recognition Principle
d) Full Disclosure Principle

8. **Which convention advises that financial statements should present a cautious view to avoid overstatement of assets or income?**
a) Materiality
b) Conservatism
c) Consistency
d) Full Disclosure

5-Mark Questions:

1. Discuss briefly the basic accounting concepts and fundamental accounting assumptions.
2. What are the accounting concepts and conventions? Name them and explain any three accounting concepts in detail.
3. Explain GAAP.
4. Use the accounting equation to demonstrate how each transaction impacts his assets, liabilities, and capital.

   Purchased goods on credit Rs 8,000.

   Purchased a plant for cash Rs 2,000.

   Sold goods costing Rs 1,000 for Rs 2,000 in cash.

   Sold goods on credit to Mahendra costing Rs 800 for Rs 1,500.

   Withdrawn Rs 500 for personal use.

   Salaries paid Rs 300.

   Received cash from Rakesh Rs 700.

2.7: REFERENCE

1. Tulsian, P. C. (2002). *Financial accounting*. Pearson.
2. Rao, M. E. (2006). *Accounting for managers*. New Age International Private Limited.
3. Gupta, A. (2016). *Financial Accounting for Management Analytical perspective*. Pearson.

UNIT 3: ACCOUNTING STANDARDS: IND AS AND IFRS

OBJECTIVES:

After studying this unit, you should be able to

1. Meaning and Objectives of Accounting Standard
2. Advantages and Significance of Accounting Standards
3. Development of Accounting Standards in India (ASB).
4. International Financial Reporting Standards (IFRS)
5. Historical background of International Financial Reporting Standards (IFRS), Foundation of IFRS

6. International Accounting Standard Board (IASB) and List of International Accounting Standards

STRUCTURE:

3.1: INTRODUCTION

In order to bring uniformity in diverse accounting policies and practices The Institute of Chartered Accountants of India, recognizing the need to formulate accounting standards also constituted the Accounting Standards Board on 21st April, 1977. Accounting Standards provide a uniform framework of rules and guidelines to ensure consistency, transparency, and comparability in financial statements. The unit begins by introducing the concept and objectives of Accounting Standards, highlighting their significance in fostering reliable and understandable financial information for stakeholders.

3.2 ACCOUNTING STANDARDS

The Institute of Chartered Accountants of India (ICAI) established the Accounting Standards Board (ASB) with the aim of ensuring uniformity in accounting terminology, approach and the preparation and presentation of financial statements. The primary function of the ASB was to formulate accounting standards, which would then be approved by the Council of the ICAI. In the process of creating these standards, the ASB gave due consideration to International Accounting Standards (IAS) and sought to integrate them to the extent possible. Additionally, the ASB took into account the relevant laws, customs, business practices, and the prevailing business environment in India, ensuring that the standards were both globally aligned and locally applicable.

3.2.1 Objectives Accounting Standards:

Accounting standards provide a common framework to enhance uniformity in financial statements. It makes easier for users to compare information across different entities and periods. Accounting standards provides norms to ensure that financial statements are accurate and fairly presented.

3.2.2 Significance of Accounting Standards:

1. As accounting standards provides common framework for preparation and presentation of financial statements, it allows stakeholders to make informed comparisons across companies, industries, and time periods.
2. Accounting standards help organizations disclose relevant information, fostering transparency and accountability.
3. Standardization reduces the gap between internal management knowledge and external user information which increase level of trust in financial reporting.

3.2.3 Advantages of Establishing Accounting Standards

1. **Reduction in Variations**: Accounting standards help minimize or eliminate inconsistencies in the treatment of accounting items, which can reduce confusion and improve reliability in financial reporting.
2. **Disclosure beyond Legal Requirements**: In some cases, accounting standards require disclosures that go beyond statutory obligations, ensuring that important information is transparent for stakeholders.
3. **Facilitates Comparability**: With standardized accounting practices, it becomes easier to verify information across different companies**.**

3.2.4 Accounting Standards Board in India

1. **Accounting Standards Board (ASB) Formation:** The Institute of Chartered Accountants of India (ICAI) established **Accounting Standards Board (ASB)** to create accounting standards to harmonize diverse accounting practices and foster consistency across financial statements. ICAI provided the institutional framework to guide the ASB in its function of developing, reviewing, and implementing standards in India.
2. **Scope and Function of ASB:**

   a. Accounting Standards will be designed to align with relevant laws, customs, and business practices in India. However, if an Accounting Standard conflicts with a law, the law will take precedence, and financial statements must be prepared according to that law.

b. Accounting Standards cannot override local regulations that govern how financial statements are prepared. The ICAI will decide what disclosures need to be made in the financial statements and auditor's report.

c. Accounting Standards only apply to material items in financial statements. The ICAI will specify which businesses the standards apply to, when they take effect, and any limitations.

3. **Steps involved for issuing Accounting Standards**

Step 1- The process begins with identifying areas where accounting standards are needed.

Step 2-The ICAI prepares an exposure draft, which is a preliminary draft accounting standard and review by professionals and stakeholders in the industry.

Step 3-The draft is circulated to various stakeholders such as accountants, auditors, and financial experts for feedback. Their suggestions and concerns are reviewed carefully by the ICAI.

Step 4- After incorporating relevant suggestions the ICAI finalizes the accounting standard. This version is formally prepared, ensuring that it aligns with legal and business requirements.

Step 5- The last step is to submit final draft of the proposed standard to the council of the institute.

Lists of the Accounting Standards (AS) issued by **the ICAI-**

Table No. 2: Accounting Standards

AS No.	Title
AS-1	Disclosure of Accounting Policies
AS-2	Valuation of Inventories
AS-3	Cash Flow Statements
AS-4	Contingencies and Events Occurring after the Balance Sheet Date

AS-5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS-6	Depreciation Accounting
AS-7	Construction Contracts
AS-8	Accounting for Research and Development (withdrawn)
AS-9	Revenue Recognition
AS-10	Accounting for Fixed Assets
AS-11	The Effects of Changes in Foreign Exchange Rates
AS-12	Accounting for Government Grants
AS-13	Accounting for Investments
AS-14	Accounting for Amalgamations
AS-15	Employee Benefits
AS-16	Borrowing Costs
AS-17	Segment Reporting
AS-18	Related Party Disclosures
AS-19	Leases
AS-20	Earnings Per Share
AS-21	Consolidated Financial Statements
AS-22	Accounting for Taxes on Income
AS-23	Accounting for Investments in Associates in Consolidated Financial Statements
AS-24	Discontinuing Operations
AS-25	Interim Financial Reporting

AS-26	Intangible Assets
AS-27	Financial Reporting of Interest in Joint Ventures
AS-28	Impairment of Assets
AS-29	Provisions, Contingent Liabilities and Contingent Assets
AS-30	Financial Instruments: Recognition and Measurement
AS-31	Financial Instruments: Presentation
AS-32	Financial Instruments: Disclosures

3.3 INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS):

32 The International Financial Reporting Standards (IFRS) were created by the International Accounting Standards Board (IASB).The aim of IFRS is to make financial statements comparable across international boundaries. IFRS is essential for investors and other stakeholders involved in multinational businesses.

3.3.1 Need for harmonization

Harmonization in accounting practice is needed minimize the variation in accounting standards used by different countries also to harmonization aims across nations which makes financial statements more consistent, comparable, and transparent globally. This uniformity benefits multinational companies, investors, and stakeholders by allowing them to understand and analyze financial data easily, without needing to adjust for different national standards.

3.3.2 What is Convergence?

Convergence in accounting refers to the process of harmonizing various 45 national accounting standards with International Financial Reporting Standards (IFRS) to create a unified, globally accepted set of accounting principles. This requires standard-setting bodies worldwide to agree upon a single, high-quality framework for accounting standards. There are two ways to achieve convergence-

1. Either adopting 10 International Financial Reporting Standards (IFRS) or
2. Adopt IFRS to formulate the country's own accounting standards

3.3.3 Historical Background of IFRS

The historical background of IFRS (International Financial Reporting Standards) begins with the establishment of the International Accounting Standards Committee (IASC) in 1973, which aimed to develop global accounting standards. IASC issued International Accounting Standards (IAS) to promote consistency in financial reporting. In 2001, the International Accounting Standards Board (IASB) replaced IASC, which assumed responsibility for setting standards and introduced IFRS to replace IAS. This evolution reflects the growing demand for unified standards to enhance comparability and reliability in financial statements globally.

3.3.4 International Financial Reporting Standard Foundation:

(IFRS) Foundation is an independent, not-for-profit organization responsible for overseeing the development and adoption of IFRS. Its main goal is to establish high-quality, transparent, and globally accepted financial reporting standards.

The principal objectives of the IFRS Foundation are stated bellow-

1. Developing a single set of high-quality, understandable, and enforceable global accounting standards.
2. Promoting the use and rigorous application of these standards.
3. Taking account of the financial reporting needs of emerging economies and small- and medium-sized entities (SMEs).

3.4 What is International Accounting Standard Board (IASB)?

The IASB operates under the IFRS Foundation an independent, not-for-profit organization which mainly responsible for development and publication of IFRSs. They oversee the work of the IASB and support the IFRS Interpretations Committee, which provides authoritative guidance on applying IFRS standards. The IASB coordinate with all the stake holders around the world including investors, regulators, business leader, the setter of accounting standards etc.

Importance of formulation of IASB

1. This is universally recognized and common international accounting standard.
2. No manipulation over the over a best solution to accounting problem
3. No national standard setter is in a position to set accounting standard that can gain acceptance around the world.

3.4.1 List of international accounting standards issued by IASC

Table No.1: International Accounting Standards

IAS No.	Title
IAS 1	Presentation of Financial Statements

IAS 2	Inventories
IAS 7	Cash Flows Statement
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events After the Reporting Period
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
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 27	Separate Financial Statements
IAS 28	Investments in Associates and Joint Ventures
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities, and

	Contingent Assets
IAS 38	Intangible Assets
IAS 40	Investment Property
IAS 41	Agriculture

3.5 SUMMARY:

Accounting standards are guidelines that help companies prepare financial statements in a clear, consistent, and comparable way. These standards make it easier for investors, regulators, and other stakeholders to understand and trust financial information. The Accounting Standards Board (ASB) under the Institute of Chartered Accountants of India (ICAI) creates standards that fit local business needs while also aligning with international practices in India. Globally, (IFRS), established by the International Accounting Standards Board (IASB), offer a unified set of guidelines for companies globally. IFRS was introduced to remove differences in financial reporting across countries, which helps promote global investment and economic cooperation. The IASB, which replaced the older International Accounting Standards Committee, regularly updates these standards to keep up with changes in business and finance. Together, these standards cover key areas like valuing assets, recognizing revenue, and managing financial instruments, helping create a more transparent and connected financial world.

3.6 CHECK YOUR PROGRESS:

1-Mark Questions

1. **What is the primary objective of Accounting Standards?**
   a) To increase profitability
   b) To ensure uniformity and transparency in financial reporting
   c) To promote tax compliance
   d) To facilitate internal decision-making
2. **The primary goal of IFRS is to:**
   a) Promote tax harmonization across nations
   b) Standardize financial reporting globally
   c) Replace national accounting standards
   d) Increase economic growth
3. **Harmonization in accounting refers to:**
   a) Creating identical accounting systems worldwide
   c) Eliminating differences in tax regulations
   d) Promoting uniformity in managerial decisions

4. What is the meaning of "convergence" in relation to IFRS?

   a) Full replacement of local standards with IFRS
   b) Adoption of an identical financial system worldwide
   c) Gradual alignment of local accounting standards with IFRS
   d) Development of a new global financial standard

5. **Which body is responsible for overseeing the development of IFRS?**
   a) International Monetary Fund (IMF)
   b) IFRS Foundation
   c) World Bank
   d) United Nations

5-Mark Questions:

1. What is the primary purpose of accounting standards?
2. Define the role of the Accounting Standards Board (ASB) in India.
3. Explain how accounting standards improve the comparability of financial statements.
4. Explain the importance of the International Accounting Standards Board (IASB) in the context of global accounting.
5. Imagine a company operating internationally. How would following IFRS benefit its investors?
6. Discuss the impact of IASB standards on international economic cooperation.

3.7 REFERENCES:

1. Tulsian, P. C. (2002). *Financial accounting*. Pearson.
2. Rao, M. E. (2006). *Accounting for managers*. New Age International Private Limited.
3. Gupta, A. (2016). *Financial Accounting for Management Analytical perspective*. Pearson.

MODULE 2: JOURNALIZING, POSTING, BALANCING AND PREPARATION OF TRAIL BALANCE

UNIT 4: ACCOUNTING PROCEDUDERS- ANALYSIS OF TRANACATIONS: Meaning and Classification of Account, Format of Account, Meaning of Debit and Credit, Classification of Accounts- Traditional Approach and Modern Approach, Rules for Debit and Credit

UNIT 5- JOURNAL AND LEDGER AND ITS PREPARATION: Concept of Journal, Types of Journal Entries, Concept of Ledger, Balancing of an Account, Procedure for Balancing of an Account

UNIT 6: UNDERSTANDING AND PREPARING THE TRIAL BALANCE: Meaning of Trial Balance, Features and objectives in drawing up a trial balance, Preparation of Trial balance, Rectification of trial balance, Rectification of Errors That Do Not Affect the Trial Balance, Rectification of Errors Affecting the Trial Balance

UNIT 4: ACCOUNTING PROCEDUDERS- ANALYSIS OF TRANACATIONS

OBJECTIVES:

After studying this unit, you should be able to:

1. Traditional and Modern classification of Account.
2. Analyzing of transactions as per traditional and modern approach.
3. Understand the fundamental rules for debit and credit in various transactions.

Structure:

6.9 Introduction
6.10 Meaning and Classification of Account
6.10.1 Format of Account
6.10.2 Meaning of Debit and Credit
6.10.3 Classification of Accounts- Traditional Approach and Modern Approach
6.11 Rules for Debit and Credit
6.12 Summery
6.13 Check Your Progress
6.14 Reference

4.1 INTRODUCTION

This unit introduces the fundamental concepts of accounting, focusing on the meaning, classification, and rules associated with accounts. It begins with an exploration of what an account is, including the standard format used to record transactions. The unit further delves into the concepts of debit and credit, explaining their significance and application in accounting.. The unit concludes with the essential rules for debit and credit, which form the foundation for accurately recording financial transactions in the accounting system.

4.2 MEANING AND CLASSIFICATION OF ACCOUNT

An account is a consolidated record of all transactions of a similar type associated with a specific individual, asset, income item, or expense item. In business, it's essential to categorize and organize all transactions of a similar kind or with the same party under appropriate categories.For all the transitions happen with Ram will be recorded under the heading of Ram Account.

4.2.1: Format of Account:

In general an account is prepared in T shape having two side left hand side and right hand side. The format of an account is given bellow

Cash Account

Date	Particulars	JF	Amount (Rs)	Date	Particulars	JF	Amount (Rs)

In accounting, each account is divided into two sides. The left side is called the 'debit side,' and is marked with 'Dr.' at the top corner. The right side is the 'credit side,' denoted by 'Cr.' at the top corner. The name of the account is placed at the center at the top, with the term "Account" or its abbreviation "A/c" added to it. For example, Building A/c, Furniture A/c, Salary A/c, Cash A/c

4.2.2: Meaning of Debit and Credit

The terms Debit and Credit are fundamental in accounting. These terms serve as directional indicators, signaling which side of the account the amount will be recorded on. A debit refers to entering a value on the left side of the account, while a credit refers to entering a value on the right side. This practice of debiting on the left and crediting on the right is a standard convention in accounting, similar to how people drive on the left side of the road in certain countries.

Definition of Debit:

To **debit** an account means to record a transaction on the left side of the account, this is called the debit side (Dr.). The word "debit" comes from the Latin term **'Debitum',** meaning what is due.

Definition of Credit:

To **credit** an account means to record a transaction on the right side, known as the credit side (Cr.). The word "credit" is derived from the Latin term **'Credere'**, meaning "trust" or belief.

3.2.3 Classification of Accounts:

There are two methods for classifying. They are-

1. Traditional Approach
2. Modern Approach

Traditional Approach

This approach classifies accounts into three main types:

1. **Personal Accounts**: These represent accounts related to individuals, organizations or entities. For example- Individuals- Mr X's Account, organization- State Bank of India Account. Personal Account are further classified into following three accounts-

    a. **Accounts of Natural Persons**: These accounts record transactions involving individual people. For instance, accounts for individuals like Ram, Jadu, Suresh, Jayanta, Raju, etc.

    b. **Accounts of Artificial Persons**: These accounts represent transactions related to entities such as firms, companies, institutions, associations, or organizations. Examples include accounts like Gauhati Commerce College A/c, J. B. College A/c, Army School Narangi, M/s. Baruah Brothers A/c, Assam Tea Company A/c, Oil India Ltd. A/c, State Bank of India A/c, N. F. Railway A/c, and Gauhati Club A/c.

    c. **Representative Personal Accounts**: These are accounts that stand for a specific individual or a group of individuals, even though the actual person or group might not be directly mentioned in the account name. For example- outstanding Salary A/c, Prepaid Salary A/c

2. **Real Accounts**: These include accounts related to tangible or intangible assets, such as Land or Goodwill.
3. **Nominal Accounts**: These relate to income, expenses, gains, and losses, reflecting operational activities. For example Purchase Account, Sale Account.

Example 1: The following accounts are classified as per traditional approach-

i. Land- Real Account
ii. Building-Real Account
iii. Investment- Real Account
iv. Discount allowed-Real Account
v. Machinery-Real Account
vi. Goodwill- Real Account
vii. Cash in hand- Real Account
viii. Property- Real Account

ix. Trademark- Real Account
x. Carriage Outwards- Nominal Account
xi. Interest Paid- Nominal Account
xii. Loan to Ram- Personal Account
xiii. Capital- Personal Account
xiv. Purchase- Nominal Account
xv. Sales-Nominal Account
xvi. Loan from Madhu- Personal Account
xvii. Bank loan- Personal Account

Modern Approach:

This approach classify the following accounts-

1. Assets Accounts**:** This account cover tangible and intangible assets like land and building, cash and Patents.
2. Liabilities Accounts**:** Represent amounts owed by the enterprise to outside parties, such as trade creditors, bank overdraft and short term loan.
3. Capital Accounts: Relate to the owner's equity in the business for example capital account, drawings account.
4. Revenue Accounts**:** This account reflect income from sales or other business activities. For example sales, discount received, interest received.
5. Expenses Accounts**:** This account include all the costs incurred in generating revenue, like Purchases and Salaries.

Example 2: The following accounts are classified as per modern approach-

i. Land- Asset Account
ii. Building- Asset Account
iii. Investment- Asset Account
iv. Furniture- Asset Account
v. Goodwill- Asset Account
vi. Cash in hand- Asset Account
vii. Debtors- Asset Account
viii. Creditors- Liability Account
ix. Loan to Ram- Asset Account
x. Loan from Hari- Liability Account
xi. Capital- Liability Account
xii. Purchase- Expense Account
xiii. Sales- Revenue Account
xiv. Return inward- Revenue Account
xv. Discount allowed-Expense Account
xvi. Discount Received- Revenue Account
xvii. Interest paid- Expense Account
xviii. Interest Received- Revenue Account

xix. Rent paid in advance- Asset Account
xx. Depreciation- Expense Account
xxi. Outstanding Salary- Liability Account

4.3 DEBIT AND CREDIT RULES

Debit refers to recording an amount of transaction on the left side of an account and credit refers to recording an amount of transaction on the right side of an account. In accounting Dr Stands for Debit and Cr stands for Credit.

Table No.1: Rules for Debit and Credit

Category	Rule for Debit	Rule for Credit
Traditional Approach		
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 incomes and gains
Modern Approach		
Asset Accounts	Debit the increase	Credit the decrease
Liability Accounts	Debit the decrease	Credit the increase
Capital Accounts	Debit the decrease	Credit the increase
Revenue Accounts	Debit the decrease	Credit the increase
Expense Accounts	Debit the increase	Credit the decrease

Example 3-

From following information classify the accounts heads also state the accounts heads affected as traditional and modern approach.

1. Pulkit started business with Rs. 30,000
2. Loan taken from Pramode, Rs. 10,000
3. Purchased Machinery for Rs. 50,000 in cash from Prakash Stores.
4. Purchased goods for cash Rs. 12,000
5. Purchased goods for Rs. 5,000 from Madhab.
6. Sold goods for cash to Jadab Rs. 7,000
7. Sold goods to Sanjay Rs. 6,000 on credit.
8. Received cash from Sanjay Rs. 3,000
9. Paid cash to Madhab Rs. 9,000
10. Deposited cash into Bank Rs. 7,000
11. Cash withdrawn for personal use Rs. 2000
12. Withdrawn from Bank for office use Rs. 25,000.

13. Withdrawn from Bank for domestic purpose Rs. 3,000
14. Purchase of Machinery for Rs. 70,000 from M/s. AB Ltd.
15. Taken goods worth Rs. 1,000 for personal use

Table 2: Analysis of transactions as per Traditional approach

Transaction No.	Accounts Affected	Class of Account	Debit Amount (Rs.)	Credit Amount (Rs.)	Reason
1	Cash, Capital	Real, Personal	30000	30000	Cash comes in, Capital is given
2	Cash, Loan from Pramode	Real, Personal	10000	10000	Cash comes in, Loan is given
3	Machinery, Cash	Real, Real	50000	50000	Machinery comes in, Cash goes out
4	Purchases, Cash	Nominal, Real	12000	12000	Purchase expense increases, Cash goes out
5	Purchases, Madhab	Nominal, Personal	5000	5000	Purchase expense increases, Madhab is the giver
6	Cash, Jadab	Real, Personal	7000	7000	Cash comes in, Goods are given
7	Sanjay, Sales	Personal, Nominal	6000	6000	Goods are given on credit, Sale income increases
8	Cash, Sanjay	Real, Personal	3000	3000	Cash comes in, Sanjay pays
9	Madhab,	Personal,	9000	9000	Cash goes out,

	Cash	Real			Paid to Madhab
10	Bank, Cash	Real, Real	7000	7000	Cash goes to Bank
11	Drawings, Cash	Nominal, Real	2000	2000	Cash goes out for personal use
12	Bank, Cash	Real, Real	25000	25000	Cash goes to Bank for office use
13	Drawings, Bank	Nominal, Real	3000	3000	Cash goes out for domestic purpose
14	Machinery, Bank	Real, Real	70000	70000	Machinery comes in, Bank goes out
15	Drawings, Purchases	Nominal, Nominal	1000	1000	Goods taken for personal use, Expense increases

Table 3: Analysis of transactions as per Modern approach

Transaction No.	Accounts Affected	Class of Account	Debit Amount (Rs.)	Credit Amount (Rs.)	Reason
1	Cash, Capital	Asset, Capital	30,000	 30,000	Increased Increased
2	Cash Loan from Promod	Asset Liability	10,000	 10,000	Increased Increased
3	Machinery Cash	Asset Asset	50,000	 50,000	Increased Decreased

4	Purchase Cash	Expense Asset	12,000	 12,000	Increased Decreased
5	Purchase Madhab	Expense Liability	5,000	 5,000	Increased Increased
6	Cash Sales	Asset Revenue	7,000	 7,000	Increased Increased
7	Sanjay Sales	Asset Revenue	6,000	 6,000	Increased Increased
8	Cash Sanjay	Asset Asset	3,000	 3,000	Increased Decreased
9	Madhab Cash	Liability Cash	9,000	 9,000	Decreased Decreased
10	Bank Cash	Asset Asset	7,000	 7,000	Increased Decreased
11	Drawings Cash	Capital Asset	2,000	 2,000	Decreased Decreased
12	Cash Bank	Asset Asset	25,000	 25,000	Increased Decreased
13	Drawings Bank	Capital Asset	3,000	 3,000	Decreased Decreased
14	Machinery M/S AB ltd	Asset Liability	70,000	 70,000	Increased Increased
15	Drawings Purchase	Capital Expense	1,000	 1,000	Decreased Decreased

Example 4: From the following information analyze the transactions as per traditional and Modern approach-

1. Ram started his business with cash of Rs.10,000
2. Borrowed from Ram Rs.5,000
3. Purchased furniture of Rs.20,000
4. Sold goods for cash Rs.15,000
5. Sold goods to Mohan on credit Rs.25,000
6. Paid Rent Rs.10,000

Table No.4: Analysis of transactions as per traditional approach

Transactions	Types of Account involved	Nature of Account	Debit and credit rules	Debited/Credited
1	Cash A/C	Real Account	Cash is coming in	Debit
	Capital A/C	Personal Account	Ram is the giver	Credit
2	Cash A/C	Real Account	Cash is coming in	Debit
	Loan from Ram A/c	Personal Account	Ram is the giver	Credit
3	Furniture A/c	Real Account	Furniture is coming in	Debit
	Cash A/C	Real Account	Cash is going out	credit
4	Cash A/c	Real Account	Cash is coming in	Debit
	Sales A/C	Nominal Account	A sale is revenue.	Credit
5	Mohan's Account	Personal Account	Mohan is the Receiver	Debit
	Sales A/c	Nominal Account	A sale is revenue.	Credit
6	Rent A/C	Nominal Account	Rent is an expenses	Debit
	Cash A/C	Real Account	Cash is going out	credit

Table No.5: Analysis of transactions as per Modern approach

Transactions	Types of Account involved	Nature of Account	Debit and credit rules	Debited/Credited
1	Cash A/C	Asset	Increased	Debit
	Capital A/C	Capital	Increased	Credit
2	Cash A/C	Asset	Increased	Debit
	Loan from Ram A/c	Liability	Increased	Credit
3	Furniture A/c	Asset	Increased	Debit
	Cash A/C	Asset	Decreased	Credit
4	Cash A/c	Asset	Increased	Debit
	Sales A/C	Revenue	Increased	Credit
5	Mohan's Account	Asset	Increased	Debit
	Sales A/c	Revenue	Increased	Credit
6	Rent A/C	Expenses	Increased	Debit
	Cash A/C	Asset	Decreased	Credit

4.4 SUMMERY

This unit introduces the fundamental concept of accounts, explaining their meaning and purpose in the financial recording process. The format of an account is described as a structured ledger divided into two sides debit (left) and credit (right).The terms "debit" and "credit" are clarified as directional indicators signifying amounts recorded on either side. Accounts are classified under two approaches: the *Traditional Approach,* which categorizes them as personal, real, or nominal accounts, and the *Modern Approach*, which organizes them into assets, liabilities, equity, revenue, and expenses. Lastly, the unit outlines the rules for debit and credit, which differ based on the chosen classification approach, providing a systematic framework for accurate and consistent bookkeeping.

4.5 CHECK YOUR PROGRESS:

1- Mark multiple Choice Questions

1. What is the basis of the traditional classification of accounts?

a) Type of transaction

b) Nature of the account (Personal, Real, and Nominal)

c) Function of the account

d) Accounting standards

2. Under the modern approach, which type of account is used to record equity?

a) Asset account

b) Liability account

c) Capital account

d) Revenue account

3. **Which of the following accounts is classified as a nominal account?**

   a) Furniture

   b) Bank Loan

   c) Rent

   d) Capital

4. **What is the modern rule for debiting an expense account?**

   a) Debit the account when expenses are paid

   b) Debit the account when expenses increase

   c) Debit the account when expenses decrease

   d) Debit the account only when a liability exists

5. **In the traditional approach, which rule applies to personal accounts?**

   a) Debit what comes in, credit what goes out

   b) Debit the receiver, credit the giver

   c) Debit all expenses, credit all incomes

   d) Debit increases, credit decreases

5-Mark Questions:

1. List the three categories of Traditional Approach.
2. Identify the five classifications of Modern Approach.
3. Classify the following accounts as per traditional and modern approach-
   Carriage outward Account, Capital Account, Purchase Account, Furniture Account, Loan to Ram Account, Travelling expenses Account, Salaries Account, Interest paid Account, Cash account
4. Analyze the following transactions by applying rule of Debit and Credit-
   a. Started business with cash Rs.1,00000
   b. Purchased goods for Cash Rs.25,000
   c. Sold goods to Ram Rs.8,000
   d. Purchased furniture Rs.4,000
   e. Rent paid Rs.1,000
   f. Paid salary Rs.45,000
   g. Purchased goods from Hari Rs.7000

4.6 REFERENCE

1. Tulsian, P. C. (2002). *Financial accounting*. Pearson.
2. Rao, M. E. (2006). *Accounting for managers*. New Age International Private Limited.
3. Gupta, A. (2016). *Financial Accounting for Management Analytical perspective*. Pearson.

UNIT 5- JOURNAL AND LEDGER AND ITS PREPARATION

Objectives:

After studying this unit, you should be able to:

1. Meaning and format of Journal and Ledger.
2. Difference between Journal and Ledger.
3. Recording Transactions in the Journal
4. Posting of transactions from Journal to Ledger.
5. Balancing of Accounts.

Structure:

1.1 Introduction

1.2 Concept of Journal

5.2.1 Format of a Journal

5.2.2 Features of a Journal

5.2.3 Steps involved in journalizing

5.3 Types of Journal Entries

5.4 Concept of Ledger

5.4.1 Format of a Ledger

5.4.2 Features of Ledger

5.4.3 Meaning of Posting and Procedure

5.4.4 Compounded Entry in Journal

5.4.5 Difference between Journal and Ledger

5.5 Balancing of an Account

5.5.1 Procedure for Balancing of an Account

5.6 Summery

5.7 Check Your Progress

5.8 Reference

5.1 INTRODUCTION

This unit focuses on the foundational concepts of recording and organizing financial transactions through **Journals** and **Ledgers**, essential components of the accounting process. It begins with the concept, format, and features of a journal, detailing the steps involved in journalizing and the different types of journal entries, including compounded entries. The unit then transitions to the **Ledger**, which acts as the principal book of accounts, explaining its format, features, and the process.Additionally, the unit highlights the differences between a journal and a ledger and delves into the procedure for balancing ledger accounts. By mastering these concepts, learners will gain a comprehensive understanding of recording, classifying, and summarizing financial data systematically.

5.2 CONCEPT OF JOURNAL:

Each transaction is recorded with details of debit and credit accounts along with a narration or brief explanation of the transaction. As the transactions are recorded for the first time.

Recording a transaction in the journal is the process of Journalizing. Entering transactions in the journal is called journal entry. In this process transactions are first analyzed to identify which accounts must be debited and credited then transactions are entered in the journal with proper narrations.

5.2.1: Format of a Journal

The bellow table represents the format of a Journal-

Table No.1: Format of Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
2024-11-09	Bank Account Dr. To Cash Account (Narration: Cash deposited in bank)	001 002	10,000	10,000

In this table-

1. **Date**: Transaction date is recorded in this column. All the transactions are entered in chronological order.
2. **Particulars**: This column includes the details of accounts affected. The title of the account being debited is listed first stated by **"Dr."** (Bank Account Dr in the above table).The credited account is indented below starting with **"To." L.F. (Ledger Folio)**: This column is used to note the ledger page number.
3. **Debit amount column:** This column recorded the amount to be debited
4. **Credit amount column**: This column recorded the amount to be credited

5.2.2: Features of a Journal

The features of journal are discussed bellow-

1. Journal is a book of original entry where transactions are first recorded.
2. In journal transactions are recorded considering Double entry system of book keeping as transactions are recorded in two fold debit and credit.
3. chronologically transaction are recorded in journal means Sequence of dates
4. Transactions are recorded on daily basis.
5. Every transaction is recorded by giving a concise description.
6. Journal is known as Book of Primary entry as transactions are first recorded in journal then transferred to ledger.

5.2.3: Steps involved in journalizing:

Steps involved in the process of Journalizing-

1. **Identify Accounts Involved**: Figure out which accounts are affected by the transaction.
2. **Classify Account Types**: Determine what type each account is (example-asset, liability, income, or expense).
3. **Apply Debit or Credit Rules**: Which account will be debited and which will be credited it is decided based on account types.
4. **Enter the Date**: Write the transaction date.
5. **Record the Debit Entry**: Write the name of the account to be debited first write "Dr." next to it, and write the value in the Debit column.
6. **Record the Credit Entry**: On the following line, write "To" followed by the account to be credited, and then enter the amount in the Credit field.
7. **Add a Narration**: In brackets, briefly explain the reason for the transaction (example-Goods purchased for cash).
8. **Draw a Line**: Add a line below to separate this entry from the next one.

5.3: TYPES OF JOURNAL ENTRIES

There are two kinds of entries documented in the Journal.

a) Simple Journal Entry

In simple journal entry a transaction affects only one aspect/account in debit and another aspect/account in credit. All the transactions which are presented in Table No.2 and Table No.3 are the example of simple journal entry.

b) Compounded Journal Entry

In this journal entry debit side can reflect more than one account similarly credit side can also reflect more than one account at the same time. The following two transaction shows compounded journal entry in a journal.

5th November, 24 Received Rs.3,900 from Ramesh and allowed him discount Rs.100

6th November, 24 Paid Rs.950 to Sanjoy and discount allowed by him Rs.50

In the books of……

Table No.2: Journal

Date	Particulars	L F	Dr.(Amount)	Cr.(Credit)
5th Nov.24	Cash A/c Dr Discount allowed A/c Dr To Ramesh (Being amount received from Ramesh and discount allowed)		3,900 100	 4,000
6th Nov.24	Sanjoy Dr To Cash A/c To Discount Received A/c (Being amount paid to Sanjoy and received discount)		1,000	 950 50

Illustration 1: Journalize the following transactions in the books Mr. Ram

2024 (November)	Particulars	Amount (`)
1.	Mr Ram started his business with cash	50,000
2.	Purchased goods	5,000
3.	Purchased goods for cash	10,000
4.	Purchased goods from Mr. Sun for cash	15,000
5.	Sold goods	6,000
6.	Sold goods for cash	12,000
7.	Sold goods to Mr. Sky for cash	18,000
8.	Purchased goods from Mr. Moon	10,000
9.	Purchased goods from Mr. Star on credit	20,000
10.	Sold goods to Mr. Sea	12,500
11.	Sold goods to Mr. Ocean on credit	25,000
12.	Mr. Sea returned goods	2,500
13.	Returned goods to Mr. Moon	2,000
14.	Received from Mr. Sea	9,900

15.	Allowed him discount	100
16.	Paid Mr. Moon	7,880
17.	Discount allowed by him	120
18.	Withdrew for personal use	1,000
19.	Withdrew goods for personal use (Cost: `500, Selling Price: `600)	
20.	Paid salary to Mr. Sevakram, an employee	500
21.	Paid rent to Mr. Estate, landlord	500

Table No.3: Ram's Books of Account

Journal

Date	Particulars	L.F.	Dr. (Rs)	Cr. (Rs`)
1.	Cash A/c Dr. To Capital A/c (Being the capital brought in byMr Ram)		50,000	 50,000
2.	Purchases A/c Dr. To Cash A/c (Being goods purchased)		5,000	 5,000
3.	Purchases A/c Dr. To Cash A/c (goods purchased for cash)		10,000	 10,000
4.	Purchases A/c Dr. To Cash A/c (Being goods purchased from Mr. Sun for cash)		15,000	 15,000
5.	Cash A/c Dr. To Sales A/c (Being goods sold)		6,000	 6,000
6.	Cash A/c Dr. To Sales A/c (Being goods sold for cash)		12,000	 12,000
7.	Cash A/c Dr. To Sales A/c (Being goods sold to Mr. Sky for cash)		18,000	 18,000
8.	Purchases A/c Dr.		10,000	

	To Mr. Moon A/c (Being goods purchased from Mr. Moon)			10,000
9.	Purchases A/c Dr. To Mr. Star A/c (Being goods purchased on credit)		20,000	20,000
10.	Mr. Sea A/c Dr. To Sales A/c (Being goods sold to Mr. Sea)		12,500	12,500
11.	Mr. Ocean A/c Dr. To Sales A/c (Being goods sold on credit)		25,000	25,000
12.	Sales Returns A/c Dr. To Mr. Sea A/c (Being goods returned by Mr. Sea)		2,500	2,500
13.	Mr. Moon A/c Dr. To Purchases Returns A/c (Being goods returned to Mr. Moon)		2,000	2,000
14.	Cash A/c Dr. Discount Allowed A/c Dr. To Mr. Sea A/c (Being amount received and discount allowed)		9,900 100	10,000
15.	Mr. Moon A/c Dr. To Cash A/c To Discount Received A/c (Being amount paid and discount received)		8,000	7,880 120
16.	Drawings A/c Dr. To Cash A/c (Being amount withdrawn for personal use)		1,000	1,000
17.	Drawings A/c Dr. To Purchases A/c (Being goods withdrawn for personal use at cost)		500	500
18.	Salary A/c Dr.		500	

	To Cash A/c (Being salary paid)			500
19.	Rent A/c Dr. To Cash A/c (Being rent paid)		500	500

Illustration 2: Journalize the following transactions

1. Paid into bank ` 11,000 for opening a current account
2. Withdrew for private expenses ` 1,000
3. Withdrew from bank ` 3,000
4. Withdrew from bank for private use ` 1,500
5. Placed on Fixed Deposit A/c at Bank by transfer from current account ` 5,000

Table No.4: Journal

Date	Particulars	Dr. (Rs`)	Cr. (Rs`)
1	Bank A/c Dr. To Cash A/c (Being cash deposited into the bank)	11,000	11,000
2	Drawings A/c Dr. To Cash A/c (Being cash withdrawn for private use)	1,000	1,000
3	Cash A/c Dr. To Bank A/c (cash withdrawn from bank)	3,000	3,000
4	Drawings A/c Dr. To Bank A/c (Being cash withdrawn from bank for private use)	1,500	1,500
5	Fixed Deposit A/c Dr. To Bank A/c (Being transfer from current to fixed deposit account)	5,000	5,000

5.4: CONCEPT OF LEDGER

The ledger is a primary book in accounting that holds all accounts related to assets, liabilities, capital, revenue, and expenses. It serves as the Book of Final Entry, meaning it records the final Endpoint of all transactions initially documented in the journal. The ledger provides a permanent record.

5.4.1: Format of Ledger Account

The format a ledger Is presented in the following table:

Dr……………Name of the Account……………………….Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount

5.4.2 Features of Ledger

1. Ledger provides clear details of money a trader is liable to pay to the creditors.

2. By preparing Purchase and Sale account during a specific period the actual amount of purchase and sales can be known from the ledger.

3. The amount of Revenue earned from different sources also the expenses incurred under different heads during a specific period can be known from ledger.

4.Investment in various types of Assets such as land and building, furniture, Machinery, cash and bank balance and the liabilities can be identified from ledger.

5.4.3 Meaning of Posting and Procedure

Posting is the process of transferring transactions from the journal into the appropriate ledger account. Posting can be done on a daily, weekly, or monthly basis, depending on the business's specific needs and preferences. By transferring entries from the journal to the ledger, the company gains a clearer view of how each transaction affects individual accounts.

5.4.4 Procedure of Posting from Journal

In the journal, this transaction would be recorded as:

Date	Particulars	LF	Debit	Credit
11th November,2024	Rent A/C…………………Dr To Cash A/c (Being rent paid)		1000	 1000

In this above transaction Rent account is debited with Rs.1000 and Cash Account is credited with 1000.

Steps to Post to Ledger Accounts:

Step 1: The accounts affected are the Rent Account and Cash Accounts.

Step 2: Check the ledger to see if there are accounts for "Rent" and "Cash". If not need to create separately.

Step 3: Post to Rent Account (Debit Side):

Date: 11th November, 2024

Particulars: Cash (the opposite account involved)

Ledger Folio: Enter the journal page or reference number

Debit: Rs 1000

Credit: Leave this blank, as this account is debited

Step 4: Post to Cash Account (Credit Side)

Date: 11th November, 2024

Particulars: Rent

Ledger Folio: Enter the journal page or reference number

Debit: (leave blank)

Credit: Rs.1000

Step 5: Last, you would calculate the balance by taking the difference between the Debit and Credit columns for each ledger account.

5.4.5: Compounded Entry in Ledger

A compound ledger entry is defined as an entry that consolidates multiple accounts involved in a single transaction, enabling the posting of debits and credits across multiple accounts with one entry.

The bellow example shows the compounded entry in Ledger-

Illustration 1- On 11th November, 2024 Paid Rs.490 to Ram in full settlement of his Rs.500 account

Journal Entry

Date	Particulars	LF	Debit	Credit

11th Nov.24	Ram A/c……………………..Dr To Cash A/c………………...Cr To Discount Received A/c….Cr		500	 490 10

Ledger
Ram Account

Date	Particulars	LF	Debit	Credit
11th Nov.24	To Cash A/c		500	

Cash Account

Date	Particulars	LF	Debit	Credit
11th Nov.24	To Ram A/c			500

Discount Received Account

Date	Particulars	LF	Debit	Credit
11th Nov.24	To Ram A/c			10

5.4.6 Difference between Journal and Ledger

The following shows the difference between Journal and Ledger-

Sl. No	Basis	Journal	Ledger
1.	Nature	Journal is a book of primary entry.	Ledger is a book of final entry.
2.	Basis of Recording	In journal, transactions are recorded on the basis of voucher.	Transactions are recorded from the journal.
3.	Manner of Recording	Transactions are recorded in order of happening (date-wise).	Transactions are recorded on the basis of 'account heads'.
4.	Narration	Every entry in the journal is followed by a narration.	Posting in the Ledger is not followed by any narration.
5.	form of Information	Provides information in scattered form.	Provides information in a summarized and classified form.

5.5 BALANCING OF AN ACCOUNT

Balancing an account refers to the process of determining the net difference between the debit and credit sides after totaling both columns. In simpler terms, it involves writing the difference between both sides match (i.e., their grand totals become equal). Balancing is typically done at regular intervals, such as weekly, monthly, quarterly, semi-annually, or annually.

In computerized systems, the balance is usually updated and displayed after each transaction, whereas, in manual systems, it needs to be calculated. The balance provides a snapshot of the account's position at a specific point in time.

5.5.1 Procedure for balancing of an Account

The following steps are to be followed while balancing a ledger Account

1. First calculate the total amount on both sides column of the account on a rough sheet of paper.
2. Calculate the difference between the two totals, which is known as balance.
3. When the debit side total is greater, the difference is entered on the credit side, with "By Balance c/d" written in the particulars column. Conversely, if the credit side total is higher, in debit side the difference is written with "To Balance c/d"
4. Once the difference has been entered on the appropriate side, both sides of the account are totaled. The totals will be the same. A thin line is drawn above the totals, and two parallel lines are drawn beneath them.
5. After balancing, amount is brought forward (brought down). If there is a debit balance, it is entered on the debit side with "To Balance b/d" in the particulars column. credit balance, is written on the credit side with "By Balance b/d" in the particulars column.
6. If the "Balance b/d" appears on the debit side, it means the account has a debit balance. If it appears on the credit side, the account has a credit balance.

Illustration 2: Prepare Ram’s Capital Account based on the following details:

January 1, 2024: Commenced business with cash of Rs. 40,000

March 31, 2024: Net loss as per Profit & Loss Account of Rs. 16,000

March 31, 2024: Drawings amounted to Rs. 3,000

Ram’s Capital Account

Date	Particulars	J F	Amount(Rs)	Date	Particulars	J F	Amount (Rs)
2024 Marc	To Profit and Loss A/C (Net		16,000	2024 Jan 1	By Cash A/c		40,000

h 31	Loss)						
March 31	To Cash A/c		3,000				
March 31	To Balance C/d		21,000				
			40,000	2024			40,000
				April 1	By Balance B/d		21,000

5.6**: SUMMARY:**

This unit provides a comprehensive understanding of the foundational accounting tools: the journal and the ledger, along with the process of balancing accounts. It begins with the meaning of a journal, its format, and its distinctive features, followed by a detailed explanation of the steps involved in journalizing and the various types of journal entries. The concept of the ledger is then introduced, highlighting its format, features, and the crucial process of posting transactions from the journal to the ledger. The procedure of posting, along with an explanation of compounded journal entries.Finally, the balancing of an account is covered, outlining the systematic approach to ensure the equality of debit and credit totals, which includes calculating the balance, entering it appropriately, and maintaining accurate account records. This unit equips learners with the skills and knowledge required to maintain and interpret financial records effectively.

5.7: CHECK YOUR PROGRESS

1-Mark Questions Multiple Choice Questions

1. **What is the primary purpose of a journal in accounting?**
   a) To summarize financial transactions
   b) To record financial transactions in chronological order
   c) To prepare trial balances
   d) To calculate profits
2. **Which of the following is a key feature of a journal?**
   a) It records only cash transactions
   b) It contains classified accounts
   c) It balances all accounts automatically
3. **What is the correct order of steps involved in journalizing?**
   a) Record the amount, classify the account, and write the narration
   b) Identify the accounts, record debit and credit, write the narration
   c) Prepare a ledger, identify the accounts, record the amount
   d) Record the narration, classify the transaction, balance the account
4. **What is the main purpose of a ledger in accounting?**

a) To analyze journal entries
b) To classify and summarize transactions by account
c) To prepare final accounts
d) To ensure accuracy of transactions

5. **What is posting in accounting?**
a) Recording transactions in the journal
b) Transferring entries from the journal to the ledger
c) Preparing the trial balance
d) Finalizing financial statements

6. **Which of the following is not a feature of a ledger?**
a) It summarizes financial transactions by account
b) It contains both debit and credit entries
c) It is the book of original entry
d) It helps in balancing accounts

7. **What is meant by balancing an account?**
a) Ensuring accurately recorded transactions
b) Posting all entries to the ledger
c) Preparing a trial balance

5-Mark Questions

1. What is the purpose of a ledger in accounting?
2. Describe the importance of balancing an account in accounting.
3. Demonstrate the posting of a transaction from the journal to the ledger
4. From the following journal entries, identify errors in posting to the ledger:
Jan 1: Purchased machinery for Rs. 50,000 (Cash A/c debited).
Jan 5: Paid rent of Rs. 5,000 (Rent A/c credited instead of debited).

5. Prepare a complete set of journal entries, ledger postings, and account balancing for the following transactions:

Jan 1: Started business with cash Rs. 1,00,000.

Jan 5: Bought furniture for Rs. 20,000.

Jan 10: Sold goods worth Rs. 50,000 (received in cash).

Jan 15: Paid rent of Rs. 5,000.

5.8: REFERENCES:

1. Tulsian, P. C. (2002). *Financial accounting*. Pearson.
2. Rao, M. E. (2006). *Accounting for managers*. New Age International Private Limited.

3. Gupta, A. (2016). *Financial Accounting for Management Analytical perspective*. Pearson.

UNIT 6: UNDERSTANDING AND PREPARING THE TRIAL BALANCE

OBJECTIVES:

After studying this unit, you should be able to:

1. Understand the meaning, features and objectives of Trial balance.
2. Fundamental rules for preparation of Trail balance.
3. Methods of preparation of Trial balance.
4. Understand different errors in Trial balance
5. Rectification of different errors in Trial balance

STRUCTURE:

6.1 Introduction
6.2 Meaning of Trial Balance, Features and objectives in drawing up a trial balance
6.3 Preparation of Trial balance
6.3.1 Format of a Trial Balance
6.4 Errors in trial balance
6.4.1 Types of Errors
6.5 Rectification of trial balance
6.5.1 Rectification of Errors That Do Not Affect the Trial Balance
6.5.2 Rectification of Errors Affecting the Trial Balance
6.6 Summery
6.7 Check Your Progress
6.8 Reference

6.1 INTRODUCTION

This unit delves into the concept and significance of the Trial Balance, a key component in the accounting process used to ensure the accuracy of recorded financial transactions. It begins by defining the trial balance, highlighting its features, and outlining the objectives of preparing it, such as verifying the equality of debits and credits. The unit then explains the steps involved in the preparation of a trial balance, along with its standard format. It also examines common errors that may arise in the trial balance, categorizing them into types and explaining how they can occur. Lastly, the unit addresses the rectification of errors, distinguishing between those that do not affect the trial balance and those that do, and providing methods to correct them effectively. This unit equips learners with a comprehensive understanding of the trial balance and its role in maintaining the integrity of financial records.

6.2 MEANING OF TRIAL BALANCE

The term "trial" refers to a preliminary check or test. It implies that the trial balance is a test of the accuracy of the bookkeeping entries. A trial balance is defined as a statement that lists total amounts of debit and credit items across all ledger accounts, along with cash and bank balances.

6.2.1 Features of a Trial balance:

The features of a Trial balance are discussed bellow-

1. The Trial balance is separate format statement which neither prepared in journal form nor in ledger form.
2. Preparation of Trial balance does not follow the principle of Double entry system of book keeping.
3. In a regular interval a trial balance is prepared such as weekly, monthly, quarterly, half yearly and yearly basis.

6.2.2 Objectives of preparing a trial balance

It serves three main purposes-

1. **Arithmetical Accuracy**: Ensures that total debits and credits recorded in ledger accounts are equal.
2. **Error Detection**: Identifies any errors if the debits and credits do not balance.
3. **Preparation of Financial Statements**: It serves as a foundational tool for compiling financial statements. By ensuring correctly balanced all ledger accounts , trial balance simplifies the transfer process of income, expenses, liabilities, capital, and assets to these statements.

6.3 PREPARATION OF TRIAL BALANCE

1. **Complete Ledger Posting**: In terms of debit and credit must ensure all transactions are recorded and balanced in each ledger account. Preparation of periodic trial balance monthly, quarter and half yearly is advisable.
2. **Methods**: There are two methods to prepare the trial balance:

   a) **Balance Method**: List the balances of each ledger account showing whether they are debit or credit balances.
   b) **Total Amount Method**: Instead of balances, list the overall amount of debit and credit separately.

The **Balance Method** is the standard and preferred method for preparing a trial balance. It is also widely used in accounting practice. This method incorporates only the ending debit or credit balances of each account rather than the total debits and credits. It streamlines the preparation process and simplifies the transition to financial statements. This method also provides a straightforward way to confirm the correctness of entries as any imbalance can quickly indicate a posting error in the ledger.

3. **Listing and Summing**: All accounts are listed under the respective debit or credit columns, ensuring the totals match.

6.3.1: Format of a Trial Balance as per Balance Method

TRIAL BALANCE…….(NAME OF THE ENTERPRISE)

As on Date…

SL. No	Name of the Account	LF	Debit (Rs)	Credit(Rs)
1.	Purchase A/c		xxxx	
2.	Sales A/c			Xxxx
3.	Purchase Return			xxxx
4.	Sales Return		Xxxx	
5.	Cash A/c		Xxxx	
6.	Bank A/c		xxxx	
7.	Capital A/s			xxxx
8.	Salaries A/c		xxxx	
Total			xxxx	xxxx

Illustration 1:

From the following information pass the journal entries, prepare ledger account and trial Balance-

Date(2024)	Particulars	Amount (Rs.)
01-Jan	Hari started business with cash	30,000
03-Jan	Hari opened a current account in the bank	18,000
04-Jan	Machinery purchased	3,000
05-Jan	Furniture purchased and payment made by cheque	1,800
07-Jan	Purchased goods on credit from Balen	5,000
10-Jan	Paid to Balen in full settlement	4,900
12-Jan	Withdrawal of Goods personal use	800
17-Jan	Sold goods to Haren	6,500
19-Jan	Amount received from Haren	2,000
31-Jan	Salaries paid	900
31-Jan	Rent paid by cheque	1,000
31-Jan	Commission received	400

Solution-

Date (2024)	Particulars	LF	Debit(Rs)	Credit(Rs)
Jan 1	Cash A/c Dr To Capital A/c (Being business started with cash by Hari)		30,000	 30,000
Jan 3	Bank A/c Dr To Cash A/c (Being amount paid into Bank)		18,000	 18,000
Jan 4	Machinery A/c Dr To Cash A/c (Being purchase of machinery)		3,000	 3,000
Jan 5	Furniture A/c Dr To Bank A/c (Being furniture purchased and payment made by cheque		1,800	 1,800
Jan 7	Purchase A/c Dr To Balen A/c (Being goods purchase from Balen)		5,000	 5,000
Jan 10	Balen A/c Dr To Cash A/c To Discount Received A/C (Being amount paid to Balen and		5,000	 4,900 100

	discount received)			
Jan 12	Drawings A/c Dr To Purchase A/c		800	 800
Jan 17	Haren Dr To Sales A/s (Being goods sold to Haren)		6,500	 6,500
Jan 19	Cash A/c Dr To Haren A/c (Being the amount received from Haren)		2,000	 2,000
Jan 31	Salary A/c Dr To Cash A/c (Being salary paid in cash		900	 900
Jan 31	Rent A/c Dr To Bank A/c		1,000	 1,000
Jan 31	Cash A/c Dr To Commission Received (Being commission received)		400	 400

Ledger Account

Cash Account

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date	Particulars	J F	Amount Rs
Jan 1 Jan 19 Jan 31	To Capital A/c To Haren To Commission A/c		30,000 2,000 400	Jan 3 Jan 4 Jan 10 Jan 31 Jan 31	By Bank A/c By Machinery A/c By Balen By salaries A/c By Balance c/d		18,000 3,000 4,900 900 5,600
			32,400				32,400
Feb 1	To Balance b/d		5,600				

Capital A/c

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs

Jan 31	To Balance c/d		30,000	Jan 1	By Cash A/c		30,000
			30,000				30,000
					By Balance b/d		30,000

Bank A/c

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs
				Jan 5	By Furniture		1,800
Jan 3	To Cash A/c		18,000	Jan 31	By Rent		1,000
				Jan 31	By Balance b/d		15,200
			18,000				18,000
Feb 1	To Balance c/d		15,200				

Machinery A/C

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs
Jan 4	To Cash A/c		3,000				
				Jan 31	By Balance b/d		3,000
			3,000				3,000
Feb 1	To Balance c/d		3,000				

Purchase A/c

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs

Jan 7 Feb 1	To Balen To Balence b/d		5,000 5,000 4,200	Jan 12 Jan 31	By Drawings A/c By Balance c/d		800 4,200 5,000

Balen A/c

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs
Jan 10	To Cash A/c To Discount Received		4,900 100 5,000	Jan 7 Jan 31	By Purchase A/c		5,000 5,000

Discount Received A/c

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs
Jan 31	To Balance c/d		100 100	Jan 10 Jan 31 Feb 1	By Balen By Balance b/d		100 100 100

Drawings A/c

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs

Jan 12	To Purchase A/c		800	Jan 31	By Balance c/d		800
			800				800
Feb 1	To balance b/d		800				

Haren

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs
Jan 17	To Sales A/c		6,500	Jan 19	By Cash A/c		2,000
				Jan 31	By Balance c/d		4,500
			6,500				6,500
Feb 1	To balance b/d		4,500				

Sales A/c

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs
Jan 31	To balance c/d		6,500	Jan 19	By Haren		6,500
				Jan 31			
			6,500				6,500
	To balance b/d			Feb 1	By balance b/d		6,500

Salaries A/c

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs

Jan 31	To cash A/c		900	Jan 19	By balance c/d		9,00
			900	Jan 31			900
Feb 1	To balance b/d		900	Feb 1			

Rent A/c

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs
Jan 31	To Bank A/c		1,000				
			1,000	Jan 31	By balance c/d		1,000
							1,000
Feb 1	To balance b/d		1,000				

Furniture A/c

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs
Jan 5	To Bank A/c		1,800				
			1,800	Jan 31	By balance c/d		1,800
							1,800
Feb 1	To balance b/d		1,800				

Communication Received A/c

Dr Cr

Date 2024	Particulars	J F	Amount Rs	Date 2024	Particulars	J F	Amount Rs

Jan 5	To balance c/d		400 400	Jan 31	By cash		400 400
Feb 1	To balance b/d		1,800	Feb 1	By balance b/d		400

Trial Balance (Balance Method)

As on January 31, 2024

Particulars	LF	Debit (Rs)	Credit (Rs)
Cash A/c		5.600	-
Capital A/c		-	30,000
Bank A/c		15,200	-
Purchase A/c		4,200	-
Discount Received A/c		-	100
Machinery A/c		3,000	-
Haren A/c		4,500	-
Salaries A/c		900	-
Sales		-	6,500
Rent A/c		1,000	-
Furniture A/c		1,800	-
Commission Received A/c		-	400
Drawings A/c		800	-
		37,000	37,000

6.4 ERRORS IN TRIAL BALANCE

The sum of the debit balances equals the sum of the credit balances, indicating that entries in the ledger have been accurately recorded according to the double-entry accounting system. Even if the trial balance totals are equal, some errors may still be present. These errors don't affect the trial balance, as they maintain the equality of debits and credits, but they can still lead to incorrect financial information.

6.4.1Types of Errors

Different categories of error are discussed bellow-

1. **Error of Omission:** This error occurs when a transaction is completely excluded from the records i.e. Journal or not posted in the ledger account. For example a cash sale of Rs.500 is made but is not written in cash or sales account. Since neither a debit nor a credit entry is made, the trial balance still balances.
   under this error another errors are there-
   i. **Complete omission:**
      In this error both the aspect of a transaction is not recorded in the books of account. When a transaction is not recorded in the original book of entry, the same transaction is also not posted in the ledger account hence a complete error of omission occur in this situation.
   ii. **Partial omission:**
      In this error a transaction is recorded in the journal considering both the aspect but one of the aspect transactions is not posted in the ledger account. It means that only one aspect of the transaction is posted in the ledger. This partial omission may affect either debit or credit aspect of transaction. For example purchase of furniture from M/S XYZ Furniture house has been recorded in the journal. From the journal posting of transaction has been made in the Furniture Account but not in M/S XYX Furniture house.

2. **Error of Commission:**

   Errors of commission occur due to intentional or unintentional mistakes made by the individual maintaining the books of accounts. These errors often result from inadequate accounting knowledge, ignorance, or carelessness. Examples of such errors include:

   a. Recording a transaction that violates basic accounting principles.
   b. Entering an incorrect amount in the ledger account from the subsidiary book.
   c. Posting entries on the wrong side of an account.
   d. Errors in totaling or casting subsidiary books.
   e. Mistakes in totaling or casting ledger accounts.
   f. Errors in balancing ledger accounts.
   g. Posting an item twice in the ledger account from the subsidiary book.
   h. Recording an entry under the wrong account head.

6.5 RECTIFICATION OF ERROR

Rectification of errors refers to the process of correcting mistakes made during the preparation of accounting records. It is important not to corrected by overwriting or erasing, as this compromises the credibility of the accounting records and may create suspicion of concealment.

6.5.1 Rectification of Errors That Do Not Affect the Trial Balance

These errors occur simultaneously in two or more accounts, ensuring that the total debits and credits remain equal. As a result, the trial balance continues to agree despite the errors. Such mistakes are also referred to as two-sided errors. To correct them, a journal entry is passed, appropriately debiting and crediting the affected accounts.

This category includes the following types of errors:

1. Failing to record a transaction in the book of original entry.
2. Recording a transaction incorrectly in the book of original entry.
3. Posting an entry to the wrong account.
4. Errors related to principles.

Rectification Process for Two-Sided Errors
to rectify two-sided errors, the following steps is followed:

1. Reverse the effect of the incorrect debit or credit to cancel its impact.
2. Apply the correct debit or credit to restore accuracy.

6.5.2 Rectification of Errors Affecting the Trial Balance

Errors that affect only one account and disrupt the agreement of the trial balance are referred to as one-sided errors. For example, if ₹4,000 paid to Barun is correctly recorded in the Cash Book but not posted to Barun's account, the error exists solely in Barun's account and is thus a one-sided error.

Common Instances of One-Sided Errors:

1. When a subsidiary book is undercast (under-totaled) or overcast (over-totaled).
2. When a posting is omitted in one of the accounts involved in the transaction.
3. When a posting is made on the wrong side of an account.
4. When an incorrect amount is posted in one of the accounts involved.

6.6 SUMMERY

This unit provides a comprehensive understanding of the Trial Balance, a vital tool in financial accounting. It begins by highlighting the features of a trial balance, emphasizing its role as a summary of ledger balances. The objectives of preparing a trial balance are explored, focusing on ensuring the accuracy of ledger entries and detecting potential discrepancies. The preparation process is detailed, including the standard format used for compiling a trial balance. The unit then addresses errors in trial balance, categorizing them into different types, and explains their potential impact. Finally, it discusses differentiating between errors that do not affect the trial balance and those that do, providing methods to correct each. Overall, the unit equips learners with the knowledge and skills to prepare, identify errors in, and rectify a trial balance effectively.

6.7 KNOW YOUR PROGRESS

1-Marks multiple Choice Questions

1. **What is the primary purpose of preparing a trial balance?**
   a) To calculate profit or loss
   b) To record journal entries
   c) To classify transactions into accounts
2. **Which of the following is an error that does not affect the trial balance?**
   a) Omission of a transaction
   b) Incorrect posting of debit and credit balances
   c) Recording the wrong amount in the ledger
   d) Transposing amounts in the trial balance
3. **What type of error occurs when a transaction is entered in the wrong account of the correct classification?**
   a) Error of omission
   b) Error of principle
   c) Error of commission
   d) Compensating error
4. **Which step is involved in the rectification of errors affecting the trial balance?**
   a) Journal entry to the ledger Reposting
   b) In Trail Balance Correcting incorrect totals
5. c) Adjusting balances through a suspense account
   d) Rewriting the original trial balance
6. **Which of the following errors affects the trial balance?**
   a) Double recording of a transaction in the journal
   b) Posting a debit entry to the wrong account without affecting the total
   c) Incorrect totaling of a ledger account balance
   d) Omitting a transaction entirely

5-Mark Questions:

1. List the features of a trial balance.
2. Name the types of errors that can occur in a trial balance.
3. Explain the objectives of preparing a trial balance.
4. Enter the following transactions in various subsidiary books of Mr. Debang Gandhi and post them to Ledger and prepare a Trial Balance as on 30th April, 2024
   April 1, 2024 Cash in hand, Rs. 12,000, Cash at Bank Rs. 26,000 and Capital Account Rs. 38,000

April 2, 24 Bought goods for cash of Rs. 6,000

April 4, 24 Purchased goods from Ram & Co. for Rs. 6,000 less 10% trade discount

April 7, 24 Sold goods to Sonu & Co. for Rs. 10,000 less 20% trade discount

April 9, 24 Withdrew Rs. 1,000 from bank for private use.

April 12, 24 Sold goods to Binaca for Rs. 7,000.

April 15, 24 Rs. 5,300 paid to Ram & Co. in full settlement of their account.

April 18, 24 Goods worth Rs 600 returned by Binaca.

April 20, 24 Received Rs. 4,000 from Binaca.

April 21, Purchased goods from Sankar & Co. for Rs. 9,000.

April 23, 24 Rs. 6,000 paid to Sankar & Co. by cheque; discount allowed by them Rs. 200.

April 24, 24 Purchased furniture for Rs. 4,000 from Ashoka Furniture House on credit.

April 26, 24 Paid into bank Rs. 3,000

April 29, 24 Goods worth Rs. 500 returned to Sankar & Co.

April 30, 24 Goods worth Rs. 600 taken by the proprietor for his personal use.

April 30, 2024 Paid Rs. 800 for advertisement by cheque.

April 30, 24 Paid salaries to staff Rs. 3,400

April 30, 24 Cash sales Rs. 24,700

April, 30, 24 Paid into bank Rs. 17,000

April 30, 24 Bought 1000 shares in Reliance Co. at Rs. 12 per share.

April 30, 24 Received Rs. 6,900 from Sonu & Co., discount allowed Rs. 100.

6.8 REFERENCES:

1. Tulsian, P. C. (2002). *Financial accounting*. Pearson.
2. Rao, M. E. (2006). *Accounting for managers*. New Age International Private Limited.
3. Gupta, A. (2016). *Financial Accounting for Management Analytical perspective*. Pearson.

UNIT 7: SUBSIDIARY BOOKS- PREPARATION OF CASH BOOK

Objectives:

After studying this unit, you should be able to understand:

1. Meaning and importance of Cash Book
2. Advantages of Cash Book.
3. Different types of Cash Book
4. Preparation of different types of Cash Book.

Structure:

7.1 Introduction

7.2 Cash Book

- 7.2.1Importance of Cash Book
- 7.2.2Features of Cash Book
- 7.2.3Advantages of Cash Book

7.3 Cash Book: A Journal or a Ledger?

7.4 Types of Cash Book and Preparation

7.5 Summery

7.6 Check your Progress

7.7 Reference

MODULE 3: CASH BOOK AND DEPRECIATION

UNIT 7: SUBSIDIARY BOOKS- PREPARATION OF CASH BOOK: Cash Book, Importance of Cash Book, Features of Cash Book, Advantages of Cash Book, Cash Book: A Journal or a Ledger?, Types of Cash Book and Preparation

UNIT 8: BANK RECONCILIATION STATEMENT: Meaning of Bank Reconciliation Statement, Features of Bank Reconciliation Statement, Reasons for discrepancies between the cash book and pass book balances, Procedure for Preparation Bank Reconciliation Statement

UNIT 9- DEPRECIATION AND PROVISIONS: Meaning of Depreciation and Depreciation Accounting, Causes of Depreciation, Methods of allocating Depreciation, Reducing Installment Method/Diminishing Balance Method/Written Down Value Method, Provisions Meaning of Reserve Objectives of creating Reserves, Types of Reserves

UNIT 7: SUBSIDIARY BOOKS- PREPARATION OF CASH BOOK

7.1 INTRODUCTION

This unit delves into the essential financial tool of the *Cash Book*, highlighting its importance in maintaining accurate and systematic records of cash transactions for businesses and organizations. It begins by exploring the significance and key features of the Cash Book, emphasizing its role in streamlining financial management. The advantages of using a Cash

Book are discussed, followed by a debate on whether it functions more as a journal or a ledger. The unit also provides a comprehensive overview of the different types of Cash Books, their preparation, and practical applications. A summary encapsulates the key insights, and an engaging "Check Your Progress" section ensures understanding and retention of the concepts. This structured approach offers a clear understanding of the Cash Book's purpose and utility in accounting.

7.2 MEANING CASH BOOK

A **cash book** is used by businesses to record all cash receipts and payments within a specific period. Transactions are entered chronologically in the debit or credit columns by an accountant as they occur. The cash book serves a dual purpose, functioning both as a **book of original entry** (journal) and as a **book of final entry** (ledger). It tracks all cash transactions and is considered a part of the ledger. The cash book typically includes two accounts: the **Cash Account** and the **Bank Account**. As an **Asset account** or **Real account**, the cash book records increases in cash or bank balances on the debit side and decreases on the credit side. The balance of a cash book always remains on the debit side.

7.2.1 Importance of Cash Book

The **Cash Book** is a vital subsidiary book for every business as it records all cash transactions. Its importance can be understood through the following points:

- **a. Helps in cash management**: The Cash Book is essential for businesses of all sizes because managing cash effectively is crucial. It provides details of daily, weekly, and monthly cash receipts and payments, along with the cash balance. This information helps businesses plan and utilize their cash efficiently.
- **b. Shows the true cash position**: The Cash Book reflects the actual cash transactions of the business. The cash balance in the book must always match the physical cash in hand, ensuring accurate records.
- **c. Prevents fraud and embezzlement**: Maintaining a Cash Book reduces the risk of fraud by keeping track of daily cash activities. Without it, the business may not know its cash position, increasing the chances of manipulation by staff.
- **d. Provides documentary evidence**: The Cash Book acts as proof of the available cash balance. It allows regular comparisons between the recorded and actual cash, helping identify and fix any discrepancies.

7.2.2 Features of Cash Book

The **Cash Book** has several key features that make it essential for recording cash transactions:

1. It records only cash transactions.
2. It serves a dual purpose, functioning as both a book of original entry (journal) and a book of final entry (ledger).

3. Cash transactions are recorded immediately as they occur, making it a book of original entry. The cash aspect of each transaction is also finalized in the Cash Book, giving it the role of a book of final entry.
4. Since the Cash Book acts as a ledger for cash, there is no need to open a separate Cash Account in the ledger.
5. Only one aspect of each cash transaction is posted to the ledger.
6. The Cash Book has two sides: the debit side on the left for cash receipts and the credit side on the right for cash payments.
7. The difference between the total of the debit and credit sides shows the cash in hand.
8. Accountants can verify the cash book balance by comparing it with the actual cash in the cash box.
9. The Cash Book always has a debit balance, as cash cannot have a negative balance.
10. Unlike other accounts, the Cash Book is balanced daily to ensure accurate cash tracking.

7.2.3 Advantages of Cash Book

Cash transactions occur frequently, and most credit transactions eventually settle in cash. Recording cash transactions in the Journal and then posting them to a Cash Account in the ledger can be a time-consuming and costly process. To simplify this, businesses maintain a separate book called the Cash Book, which is both efficient and economical. In addition to saving time and cost, the Cash Book offers the following benefits:

1. It provides a clear record of daily cash receipts and cash payments.
2. The cash balance in hand can be determined at any time by checking the Cash Book.
3. Errors in the Cash Book can be easily identified and corrected during cash verification.
4. Any misappropriation of funds can be detected when verifying cash.
5. As cash is verified daily, the Cash Book remains accurate and up-to-date.

7.3 CASH BOOK: A JOURNAL OR A LEDGER?

From the above discussion, it is clear that the **Cash Book** functions as a substitute for the **Cash Account**. As a result, there is no need to maintain a separate Cash Account in the ledger, as the Cash Book fulfills its purpose. The entries recorded in the Cash Book represent one side of the **Double Entry System**, while the corresponding entries are posted to the relevant accounts in the ledger.

L.C. Cropper remarked "Every entry in the Cash Book makes one half of a double entry; the other half of the double entry appears on the opposite side of some account in the Ledger."From this angle, 'Cash Book is a Ledger'.

Similarities between Cash Book and Ledger:

1. The format of the Cash Book is similar to that of the ledger.

2. Just like the ledger, the terms "To" and "By" are used in the Cash Book.
3. There is no need for separate Cash and Bank Accounts in the ledger, as the Cash Book serves this purpose.
4. Both the cash and bank columns of the Cash Book are balanced periodically, similar to how ledger accounts are balanced.

However, all cash transactions are initially recorded in the Cash Book in chronological order and later posted to the relevant ledger accounts. From this perspective, the Cash Book functions as a Journal. Therefore, the Cash Book can be considered a combination of both the Journal and the Ledger.

According to Spicer & Pegler, "the Cash Book is actually a ledger account, but owing to the large number of entries made therein, it is kept in a separate book, called a Cash Book, which is used also as a book of prime entry."

Similarities between Cash Book and Journal:

1. Cash transactions are recorded in the Cash Book at the time they occur, just like in the Journal.
2. Transactions in the Cash Book are recorded in chronological order (date-wise), similar to the Journal.
3. The Cash Book includes a ledger folio column, just as the Journal does.
4. Narrations are provided for each entry in the Cash Book, just like in the Journal.

Specimen of Simple Cash Book

Date	Particulars	V. No	LF	Amount	Date	Particulars	V. No	LF	Amount

Explanation of the Columns in the Cash Book:

Date: This column records the date of the transaction. The year is written in the first line, followed by the month and the actual date on the second line.

Particulars: Here, the name of the opposite account (representing the second aspect of the cash transaction) is written along with a brief description or narration of the transaction.

L.F. (Ledger Folio): This column shows the page number of the Ledger where the corresponding accounts has been opened. It helps in quickly locating the relevant account in the Ledger. In the Cash Book, "L.F." is used, while in the Ledger, "J.F." (Journal Folio) is used as the reference. This distinction is made because cash transactions are not initially recorded in the Journal.

Amount: For cash receipts, the amount is written on the left hand side, while cash payments are recorded on the right hand side.

V. No. (Voucher Number): This column records the voucher number for each receipt and payment. The voucher number is important for tracking each transaction. Typically, each voucher has a unique serial number, which is entered in this column (V. No).

The following table shows the difference between Cash book and Cash Account

Sl. No	Cash Book	Cash Account
1.	Transactions are directly recorded.	In Ledger where postings are made from the journal.
2.	Serves the purpose of both a journal and a ledger.	Serves only as a ledger account.
3.	Narration is required for each transaction.	Narration is not required.
4.	Contains a column for Ledger Folio (L.F.).	Contains a column for Journal Folio (J.F.)

7.4 **TYPESOFCASHBOOK**:

Different types of Cash book are discussed bellow-

1.One-Column Cash Book

2.Two-Column Cash Book:

a. With Cash and Discount column

b. With Cash and Bank column

c. With Bank and Discount column

3.Three Columnar Cash Book

4.Petty cash Book

1. One Column Cash Book

The One-Column Cash Book is the simplest type of Cash Book, used in businesses where most transactions involve cash payments and receipts, and no cash discounts are given or received. If there are any discount or cheque transactions, The format of a One-Column Cash Book resembles that of a standard cash account.

Illustration 1: From the following information prepare a single column Cash book-

April, 2024	Amount (Rs)
April 1 Cash in hand	6,500
April 3 Purchased goods for cash	685
April 4 Paid to Rishi	95
April 6 Deposited into bank	4,000
April 6 office stationary paid	465
April 15 Sold goods for cash	2,500
April 22 Salary paid	400
April 30 Paid into bank	2,500

Solution: **In the books of….**

Date	Receipts	L.F	Amount	Date	Receipts	L.F	Amount
2024 April 1	To balance b/d		6,500	2014 April,3	By Purchases a/c		685
April,15	To Sales a/c		2,500	April,4	By Rishi		95
				April,6	By Bank a/c		4,000
				April,6	By stationary		465
				April,22	By Salary a/c		400
				April,30	By Banka/c		2,500
				April,30	By Balance c/d		**855**
			9,000				**9,000**

2. Two Column Cash Book

The Two-Column Cash Book includes two columns on each side: one for cash and another for discounts. When payments involve cash discounts, it is convenient to record both the cash and the discount in the same place. One-Column Cash Book has an extra column on each side for recording discounts. Since discounts are nominal accounts, **discount allowed** (a loss) is recorded on the debit side, while **discount received** (a gain) is recorded on the credit side.

Illustration No 2: Fromm the following information prepares a Double column Cash Book-

Date (2024)	Amount (Rs)
September.1 Balance in hand	2,500
September.5 Purchased furniture for cash	750
September.7 Received from XYZ ltd	980
September.7 Discount allowed	20
September 10 Paid to Bihari	290
Discount received	10
September 27, Paid Salary	50
September 28,Paid rent	380

Solution: **In the books of….**

Cash Book with Discount and Cash Columns

Date	Receipts	L.F	Discount	Cash	Date	Receipts	L.F	Discount	Cash
2024 September1	To balance b/d			2,500	2024 September,5	By Purchases a/c			750
September7	To XYZ ltd		20	750					
					September, 10	By Bihari		10	290
					September. 27	By Salary			50
					September, 28	By Rent			380
					September, 30	By Balance c/d			1,780
			20	**3,250**				**10**	**3,250**

3. Three-Column Cash Book

In modern business; it is common to conduct frequent transactions through a bank. Most businesses maintain a current account at the bank, allowing for regular deposits and withdrawals. Since bank transactions are often more frequent than cash transactions, it is practical and convenient to include an additional column in the Cash Book on each side to **record deposits made to the bank** and **payments made from the bank.**

Illustration 3: From the following information prepare a triple column Cash book-

2024

March 1 Cash in hand 3,000

Balance at Bank 36,000

March 5 Cash Sales 10,000

Discount 200

March 8 Deposited into Bank 9,000

March 9 Rent paid by cheque 3,000

March 18 Paid by cheque to Mr Das Rs 6,900 in full settlement of a claim for Rs 7,000

March 28 Salaries paid Rs.4,000

Solution: **In the books of….**

Date	Particulars	LF	Discount	Cash	Bank	Date	Particulars	LF	Discount	Cash	Bank
2024						2024					
March 1	To Balance b/d			3,000	36,000	Mar 8	By Bank A/c	C		9,000	
Mar 5	To Sales A/C		200	10,000		Mar 9	By Rent A/c				3,000
Mar8	To Cash A/c	C			9,000	Mar18	By Mr Das				6,900
Mar 14	To Mr Dutta				8,000				100		2,000
Mar 22	To Bank A/c	C		2,000		Mar22	By Cash A/c	C			1,100
						Mar 22	By Drawings A/c				

						Mar 28	By Salary A/c			4,000	40,000
						Mar 31	By balance c/d			2,000	
			200	15,000	53,000				100	15,000	53,000
2024 April 1	To balance b/d			2,000	40,000						

4. Petty Cash Book

The term "petty" refers to small amounts. In every business, there are regular payments for minor expenses, such as carriage, postage, telegrams, and similar items. Since these payments involve small amounts, they are not typically made by cheque..

The petty cash book is a record of small expenses organized by date. It is often maintained as a physical ledger rather than a digital record, making it part of a manual accounting system.

1. **Debit Entries**: this record the cash received by the petty cash clerk, usually as a lump sum provided occasionally.
2. **Credit Entries**: These record small cash payments made for various purposes, such as meals, office supplies, postage, or stamps.

When the petty cash balance gets low due to frequent small payments, the petty cash clerk requests additional funds from the main cashier. This new amount is recorded as a debit entry. Along with this, the petty cash clerk submits a copy of the petty cash book to the accountant or cashier, who prepares a journal entry summarizing how the petty cash was spent.

The petty cash book acts as an important control tool to ensure accountability for petty cash expenses. It requires the petty cash clerk to document all cash inflows and outflows formally. To maintain its effectiveness, an internal auditor should periodically review the petty cash book and compare the recorded balance with the actual cash available. Any discrepancies can indicate the need for further training or investigation.

Although the petty cash book remains a helpful tool for managing small expenses, its use is declining as more businesses switch to company credit cards for such transactions.

Advantages of Petty Cash Book

1. The petty cash book provides a straightforward method for recording minor expenses.
2. It is easy and simple to prepare.
3. It saves the chief cashier's valuable time and effort by delegating the handling of small expenses to a petty cash clerk.
4. It ensures a clear distinction between entries in the main cash book and the petty cash book, based on the nature of the transactions.
5. Posting transactions from the petty cash book to the ledger is quick and convenient.

Systems of Petty Cash Book

Petty cash can be managed using two different systems for providing funds to the petty cashier:

1. **Ordinary System of Petty Cash**
2. **Imprest System of Petty Cash**

Specimen of Petty Cash Book

Amount Received (Rs)	C.B.F.	Date	Particulars	V.No.	L.F.	Amount Paid (Rs)
XX X XX X		Opening Date	To Balance b/d To cash /Bank By variou s Expenses			XX X XX X XX X
XXX		Closing Date	By Balance c/d			XXX
XXX		Next Opening Date	By Balance b/d			

7.5 SUMMERY

The cash book serves a dual purpose, acting as both a book of original entry and a final ledger. It plays the role of both a journal and a ledger by systematically recording all cash transactions of the business. The cash book always reflects a debit balance, as it cannot show a credit balance. It is an essential tool for tracking daily cash receipts and payments.The cash book records cash received on the debit side under the amount column, while cash payments are recorded on the credit side in the same column. Transactions are dated in two lines within the cash book. Various types of cash books exist, including the single-column cash book, two-column cash book, three-column cash book, and petty cash book. A petty cash book is used to document small, routine expenditures in chronological order. When cheques received from customers are deposited on the same day, they are entered in the bank column of the cash book. However, if cheques are deposited on a later date, it is treated as a money deposit, requiring a contra entry. Additionally, a cash discount refers to a reduction in the amount owed, provided to encourage timely payment of debts.

7.6 CHECK YOUR PROGRESS

1-Mark multiple choice Questions:

1. **Which of the following is a feature of a Cash Book?**
   a) It only records credit transactions
   b) It acts as both a journal and a ledger
   c) It tracks inventory levels
   d) It replaces financial statements
2. **The Cash Book primarily records transactions related to:**
   a) Goods sold on credit
   b) Cash and bank
   c) Fixed assets
   d) Outstanding liabilities
3. **How does a Cash Book benefit an organization?**
   a) Helps maintain inventory records
   b) Reduces the need for financial reconciliation
   c) Ensures transparency in cash transactions
   d) Tracks long-term liabilities
4. **Why is the Cash Book considered both a journal and a ledger?**
   a) Because it records non-monetary transactions
   b) It records and posts cash transactions simultaneously
   c) It is used exclusively for credit entries
   d) It generates profit and loss statements
5. **A triple-column Cash Book includes columns for:**
   a) Cash, inventory, and liabilities
   b) Cash, bank, and discounts
   c) Cash, receivables, and bank
   d) Bank, discounts, and payables

5-Mark Questions:

1. Why the cash book is considered a dual-purpose accounting record?
2. Name the four types of cash books commonly used in accounting.
3. List any three reasons why a cash book is considered important in accounting.
4. Explain why the cash book is called a "book of original and final entry."
5. What is Contra Entry? Name the types of transaction for which contra entries passed?
6. Prepare a Double column cash book from the following transactions of M/S R Roy

   March, 2024

   March 1 Cash in hand Rs 8,000

   March 6 Cash purchase Rs.4,000

   March 10 Wages paid Rs 80

   March 11 Cash Sales Rs12,000

   March 12 Cash received from Suraj Rs 3,960 and allowed him discount Rs 40

   March 19 Cash paid to Mohan Rs 4,940 and discount received Rs 60

   March 27 Cash paid to Rajesh Rs 800

   March 28 Purchased goods for Cash Rs 4,140

7. From the following information you are asked to prepare a cash book with Cash, Bank, and Discount columns and to balance the Cash Book on 15.1.20024

Jan. 1 He commenced business with Rs. 5000 of which Rs. 2000 were borrowed from Mahesh.

Jan. 3. Deposited into bank Rs. 4,700

Jan. 6. Purchased goods worth Rs. 2000 from Ganesh and paid for them by cheque.

Jan. 8 Received Rs. 475 from Shekhar in settlement of his account for Rs. 500

Jan 10 Purchased from Das and Co. one table for office use and paid in cash Rs. 300.

Jan 12 Paid in cash life Insurance premium of Rs. 300 on the life of Mrs.Paul.

Jan 14 Paid Nanda Kumar by Cheque Rs. 650 in full settlement of his bill for Rs. 700.

Jan 15 Draw by Cheque for office use Rs. 1000.

7.7 REFERENCES:

1. Tulsian, P. C. (2002). *Financial accounting*. Pearson.
2. Rao, M. E. (2006). *Accounting for managers*. New Age International Private Limited.
3. Gupta, A. (2016). *Financial Accounting for Management Analytical perspective*. Pearson.

UNIT 8: BANK RECONCILIATION STATEMENT

Objectives:

After studying this unit, you should be able to:

1. Understand the meaning and importance of preparing a Bank Reconciliation Statement (BRS).
2. Recognize the reasons for differences between the bank balance recorded in the Cash Book and the Passbook.
3. Learn the steps to prepare a Bank Reconciliation Statement.
4. Calculate the correct bank balance as per the Cash Book.

Structure:

8.1 INTRODUCTION

This unit delves into the concept and significance of the **Bank Reconciliation Statement (BRS)**, a critical tool which ensure alignment between a company's cash book and its bank statement. It begins by exploring the meaning, key features, and importance of the BRS in identifying and resolving discrepancies, thus maintaining accurate financial records. A clear distinction is drawn between the bank statement and the BRS, emphasizing their distinct purposes. The unit also examines common reasons for mismatches between the cash book and passbook balances, along with essential considerations for preparing a BRS effectively. To provide practical understanding, it includes a specimen format and outlines the step-by-step procedure for its preparation, ensuring learners can confidently apply these concepts in real-world scenarios.

8.2 MEANING OF BANK RECONCILIATION STATEMENT:

It is commonly observed that the bank balance recorded in the firm's cash book does not match the balance shown in the bank statement. To address this, the reasons for the difference must first be determined. These differences are then documented in a statement called the **Bank Reconciliation Statement (BRS)**, which is used to reconcile or match the two balances.

To prepare a BRS, the bank balances as per the cash book and the bank statement for a specific date are required, along with the details of transactions in both records. When the balances differ, the entries in the cash book and bank statement are compared to identify the reasons for the variation. The differences, along with their amounts, are then reflected in the BRS to achieve reconciliation.

8.2.1 Features of Bank Reconciliation Statement:

- **a.** A Bank Reconciliation Statement is not treated as an account.
- **b.** It is usually created on a separate sheet of paper.
- **c.** It can be prepared at regular intervals, such as weekly, monthly, semi-annually, or annually.
- **d.** The primary purpose is to check the accuracy of the transactions recorded in the Cash Book and the Pass Book.
- **e.** It is prepared even when the balances in the Cash Book and Pass Book match, as there may still be compensating errors.
- **f.** Typically, businesses operating a current account with a bank prepare this statement.

8.2.2 Need and Importance of a Bank Reconciliation Statement

1. Detecting errors in Cash and Pass Books

The Bank Reconciliation Statement compares the entries in the Cash Book with those in the Pass Book. This comparison helps pinpoint entries that were either incorrectly recorded or omitted in either book.

2. **Highlighting Delays in Cheque Clearance**

By comparing the Cash Book and the Pass Book (or the bank statement), the statement reveals discrepancies in the timing of cheque deposits and their clearance. If delays are significant, the causes can be investigated, and corrective actions can be taken.

3. **Verifying the Accuracy of the Cash Book**

Regular reconciliation assures management that the Cash Book is being maintained accurately. Any discrepancies in the entries can be quickly identified and corrected.

4. **Preventing Fraud and Misappropriation**

Comparing balances frequently, whether daily, weekly, monthly, or annually makes it challenging for employees to engage in misappropriation of funds.

5. **Establishing a Moral Deterrent**

Preparing a Bank Reconciliation Statement serves as a control mechanism, reducing opportunities for dishonesty. It helps ensure the integrity of transactions involving cheques, drafts, or other dealings with the bank.

6. **Assisting in updating the Cash Book**

The reconciliation process makes it easier to prepare an updated Cash Book by accounting for entries recorded in the Pass Book but missing from the Cash Book. These include bank charges, interest debits or credits, and direct payments by the bank. Such adjustments ensure the Cash Book reflects accurate financial information.

8.2.3 Bank statement and bank reconciliation statement difference

The bellow shows the difference between Bank Statement and Bank Reconciliation Statement-

Sl. No	Bank Statement	Bank Reconciliation Statement
Who Prepares	Prepared by the bank.	Prepared by the customer (account holder).
Objective	Provides details of all transactions during a specific period.	Reconciles the bank balance in the Cash Book with that in the Bank Statement.
Timing	Generated periodically by the bank.	Prepared on a specific date by the customer.
Necessity	Mandatory document provided by the bank.	Optional and prepared as needed by the account holder.
Contents	Lists all deposits, withdrawals, and the resulting balance.	Includes discrepancies and their adjustments.

8.3 REASONS FOR DISCREPANCIES BETWEEN THE CASH BOOK AND PASS BOOK BALANCES

1. **Timing Differences in Recording Transactions**: Sometimes, the transactions in the cash book and bank passbook don't match because they are recorded at different times. There are a few reasons for this.

a. **Cheques Issued but Not Yet Cashed**:

In the Cash Book: When the business issues a cheque to someone, it immediately records the payment in the cash book, which reduces the cash balance.

In the Bank Passbook: The bank only reduces the business's balance when the cheque is actually presented and paid. If the recipient does not deposit the cheque right away, there will be a delay in the bank's records.

Result: This delay in presenting the cheque causes a difference between the cash book and the bank passbook balances.

b. Cheques Deposited but Not Yet Collected by the Bank:

In the Cash Book: When the business receives a cheque from a customer, it immediately records it in the cash book, increasing the bank balance.

In the Bank Passbook: The bank only credits the business's account when the cheque is cleared, which can take time. If the cheque is from a different location or bank, it may take even longer.

Result: Until the cheque is cleared by the bank, the bank passbook will show a lower balance compared to the cash book.

c. Direct Debits by the Bank on Behalf of the Customer
Occasionally, the bank may deduct amounts from the account for various services without informing the firm in advance. The firm only becomes aware of these deductions when the bank statement is received. Examples of such deductions include charges for cheque collections, incidental fees, interest on overdrafts, and fees for bounced or stopped cheques. As a result, the balance shown in the passbook will be lower than the balance in the cash book.

d. Direct Deposits made into the Bank Account

Sometimes, customers may directly deposit money into the firm's bank account. However, the firm may not be informed of these deposits until it receives the bank statement. In such cases, the bank records the deposits in the firm's account, but the firm does not record them in the cash book. As a result, the balance in the bank passbook will be higher than the balance in the firm's cash book.

e. Interest and Dividends collected by the Bank

When the bank collects interest or dividends on behalf of the customer, these amounts are immediately credited to the customer's account. However, the firm only becomes aware of these transactions when it receives the bank statement and records them in the cash book. Until then, there will be a difference between the balances shown in the cash book and the passbook.

f. **Direct Payments Made by the Bank on Behalf of the Customer**
Sometimes, customers give standing instructions to the bank to make regular payments, such as for telephone bills, insurance premiums, rent, or taxes. The bank makes these payments directly from the customer's account. Since the firm may not be aware of these payments until receiving the bank statement, the balance in the bank passbook will be lower than the balance shown in the cash book.

g. Dishonored cheques or Bills

If a cheque deposited by the firm or a bill of exchange discounted by the bank is dishonoured on its due date, the bank will debit the firm's account. Since the firm may not know about this immediately, it will not record this in the cash book until the bank statement is received. As a result, the balance in the passbook will be lower than that in the cash book.

2**. Differences caused by Errors**

Discrepancies between the two balances may sometimes occur due to mistakes made either by the bank or in the business's Cash Book. Such errors result in a mismatch between the balance shown in the Cash Book and the one reflected in the bank statement.

a. Errors committed in recording transaction by the firm

Errors made by the firm in recording transactions, such as omitting or incorrectly entering details of issued or deposited cheques, as well as errors in totaling, can lead to discrepancies between the balances in the Cash Book and the Pass Book.

b. Errors committed in recording transactions by the bank

Mistakes made by the bank in recording transactions, such as omitting or inaccurately posting details of deposited cheques or errors in totaling, can also result in discrepancies between the Pass Book and Cash Book balances.

8.3.1 Important to be considered while preparing Bank Reconciliation Statement

The following steps should be undertaken while preparing Bank Reconciliation Statement-

1. **Debit Balance as per Cash Book** also referred to as the bank balance as per the Cash Book.
2. **Credit Balance as per Cash Book**, also known as the bank overdraft as per the Cash Book.
3. **Debit Balance as per Pass Book**, which indicates the bank overdraft as per the Pass Book.

4. **Credit Balance as per Pass Book**, signifying the bank balances as per the Pass Book.

It should be noted that:

1. If the statement begins with the balance as per the Cash Book, the resulting balance will be that of the Pass Book
2. If the statement begins with the balance as per the Pass Book, the resulting balance will be that of the Cash Book.

8.3.2 Specimen format of a Bank Reconciliation Statement

Bank Reconciliation Statement

As on……

Item/Particulars	**Amount**	
	Plus Items (Rs.)	Minus Items (Rs.)
Dr. Balance as per Cash Book		
Add:		
(i) Cheques issued but not yet presented for payment		
(ii) Interest credited by the bank but not recorded in the Cash Book		
(iii) Amount directly deposited by customers into the bank account		
(iv) Interest and dividends collected by the bank on the trader's investments		
(v) Cheques deposited but omitted to be entered in the Cash Book		
(vi) Any wrong credit given by the bank in the Pass Book		
Less:		
(i) Cheques deposited but not yet credited by the bank		

(ii) Cheques deposited but dishonored by the bank		
(iii) Direct payments made by the bank according to customer instruction		
(iv) Bank charges and commissions levied by the bank		
(v) Cheques issued but omitted from the Cash Book		
(vi) Any wrong debit given by the bank in the Pass Book		
Cr. Balance as per Pass Book		

8.4 PROCEDURE FOR PREPARATION BANK RECONCILIATION STATEMENT

Step 1: Compare the debit entries in the Cash Book with the credit entries (deposits) in the Pass Book. Mark the matching items in both books with a tick and identify any unmatched entries, as these are potential causes of discrepancies.

Step 2: Compare the credit entries in the Cash Book with the debit entries (withdrawals) in the Pass Book. Tick off the matching items in both books and note any unmatched entries, which will serve as reasons for the differences.

Step 3: Start with the balance as per the Cash Book. Add items that increase the balance in the Pass Book and subtract those that reduce it alternatively, begin with the Pass Book balance, adding items that increase the Cash Book balance and deducting those that decrease it

Table 1: Format of bank reconciliation statement when the bank Balance as per cash book is taken as a starting point

Bank Reconciliation Statement

As at . . . (here enter the date on which the statement is being prepared) . . .

Particulars	Add (+)	Less (-)
A. Balance as per Cash Book		
(i) Favorable (Debit Balance)		
(ii) Overdraft (Unfavorable, Credit Balance)		
B. Add: Items increasing balance in Pass Book		

(i) Cheques deposited in the bank but not recorded in the Cash Book	✓	
(ii) Cheques issued but not yet presented for payment	✓	
(iii) Interest credited in Pass Book only	✓	
(iv) Bills receivable collected directly by the bank	✓	
(v) Direct payments by customers into the bank, not recorded in Cash Book	✓	
(vi) Cheques issued but returned due to technical reasons	✓	
(vii) Wrong credit given by the bank in Pass Book	✓	
C. Less: Items reducing balance in Pass Book		
(i) Cheques received but not sent to the bank for collection		✓
(ii) Cheques deposited but not yet cleared by the bank		✓
(iii) Bank charges or interest on overdraft debited in Pass Book only		✓
(iv) Insurance premium paid by the bank as per standing instructions		✓
(v) Cheques deposited, returned dishonored (recorded in Pass Book only)		✓
(vi) Discounted bills dishonored, not recorded in Cash Book		✓
(vii) Wrong debit given by the bank in Pass Book		✓
D. Balance as per Pass Book (If Total of Plus Items > Total of Minus Items) or Overdraft as per Pass Book (If Total of Plus Items < Total of Minus Items)		

Table 2: Format of bank reconciliation statement when the bank Balance as per Pass book is taken as a starting point

Bank Reconciliation Statement

As at . . . (here enter the date on which the statement is being prepared) . . .

Particulars	Add (+)	Less (-)
A. Bank Balance as per Pass Book		

(i) Favorable (Credit Balance)		
(ii) Overdraft (Unfavorable, Debit Balance)		
B. Less: Items reducing balance in Cash Book		
(i) Cheques deposited into the bank but not recorded in Cash Book		✓
(ii) Cheques issued but not yet presented for payment		✓
(iii) Interest credited in Pass Book only		✓
C. Add: Items increasing balance in Cash Book		
(i) Cheques received but not sent to the bank for collection	✓	
(ii) Direct payments by a customer into the bank, not recorded in Cash Book	✓	
(iii) Cheques issued but returned due to technical reasons	✓	
(iv) A wrong debit given by the bank in Pass Book	✓	
D. Balance as per Cash Book		
(If Total of Add Items > Total of Less Items, Favorable Balance) or		
(If Total of Add Items < Total of Less Items, Overdraft Balance)		

Illustration 1: Fromm the following information as on 31st March, 2024 prepare a Bank Reconciliation Statement-

1. Cheque deposited but not yet collected by bank 1,500
2. Cheques issued but not yet presented for payment 2,500
3. Bank charges debited in Pass Book only 200
4. Interest allowed in Pass Book only 100
5. Insurance Premium paid directly by bank understanding advice 500
6. Bills receivables directly collected by bank 2,000
7. A wrong debit given by bank in Pass Book 3,800
8. A wrong credit given by bank in Pass Book 400
9. Direct payment by a customer into the bank but not recorded in Cash Book 700

Prepare a Bank Reconciliation Statement as at 31st March in each of the following alternative cases:

Case I If the debit balance as per Cash Book was 200

Case II If the credit balance as per Pass Book was 200

Case III If an overdraft as per Cash Book was 200

Case IV If an overdraft as per Pass Book was 200

Solution:

Bank Reconciliation Statement as at 31st March [Case I]

Particulars	Plus Items (Rs)	Minus Items (Rs)
A Balance as per Cash Book	200	
B. Add: Transactions having the effect of higher balance as per Pass Book		
1. Cheques issued but not yet presented	2,500	
2. Interest allowed in pass book only	100	
3. Bills receivable directly collected by bank	2000	
4. A wrong credit given by bank in Pass Book	400	
5. Direct payment by a customer into bank but not recorded in Cash Book	700	
C. Less: Transactions having the effect of lower balance as per Pass Book		
1. Cheque deposited but not yet collected by bank		1500
2. Bank charges debited in pass book only		200
3. Insurance premium paid directly by bank understanding advice		500
4. A wrong debit given by Bank in Pass Book		3800
	5,900	**6,000** **100**

Case-II Bank Reconciliation Statement as at 31st March

Particulars	Plus Items (Rs)	Minus Items (Rs)
A Balance as per Pass Book	200	
B. **Less**: Transactions having the effect of higher balance as per Pass Book		
1. Cheques issued but not yet presented		2,500
2. Interest allowed in pass book only		100
3. Bills receivable directly collected by bank		2000
4. A wrong credit given by bank in Pass Book		400
5. Direct payment by a customer into bank but not recorded in Cash Book		700
C. **ADD**: Transactions having the effect of lower balance as per Pass Book		
1. Cheque deposited but not yet collected by bank	1500	
2. Bank charges debited in pass book only	200	
3. Insurance premium paid directly by bank understanding advice	500	
4. A wrong debit given by Bank in Pass Book	3800	
	6,200	**5,700**
D. Debit balance as per Cash Book	**500**	

Case-III Bank Reconciliation Statement as at 31st March

Particulars	Plus Items (Rs)	Minus Items (Rs)
A Overdraft as per Cash Book		200
B. **Add**: Transactions having the effect of higher balance as per Pass		

Book		
1. Cheques issued but not yet presented	2,500	
2. Interest allowed in pass book only	100	
3. Bills receivable directly collected by bank	2000	
4. A wrong credit given by bank in Pass Book	400	
5. Direct payment by a customer into bank but not recorded in Cash Book	700	
C. **Less**: Transactions having the effect of lower balance as per Pass Book		
1. Cheque deposited but not yet collected by bank		1500
2. Bank charges debited in pass book only		200
3. Insurance premium paid directly by bank understanding advice		500
4. A wrong debit given by Bank in Pass Book		3800
	5,700	**6,200**
D. Overdraft as per Pass Book		**500**

Case-IV Bank Reconciliation Statement as at 31st March

Particulars	Plus Items (Rs)	Minus Items (Rs)

A Overdraft as per Cash Book		200
B. **Less**: Transactions having the effect of higher balance as per Pass Book		
1. Cheques issued but not yet presented		2,500
2. Interest allowed in pass book only		100
3. Bills receivable directly collected by bank		2000
4. A wrong credit given by bank in Pass Book		400
5. Direct payment by a customer into bank but not recorded in Cash Book		700
C. **Add**: Transactions having the effect of lower balance as per Pass Book		
5. Cheque deposited but not yet collected by bank	1500	
6. Bank charges debited in pass book only	200	
7. Insurance premium paid directly by bank understanding advice	500	
8. A wrong debit given by Bank in Pass Book	3800	
	6,000	**5,900**
D. Overdraft as per Cash Book	**100**	

8.5 SUMMERY

The Bank Reconciliation Statement (BRS) is a simple financial tool used to match the balance in a business's cash book with the balance in the bank's passbook. Sometimes, these balances do not match due to timing differences, such as checks issued but not yet cleared, deposits not yet credited, bank charges, or recording errors. The BRS helps identify and explain these differences, ensuring both records are accurate.

The BRS is important because it keeps financial records correct, helps detect errors or fraud, and provides updated information for better decision-making. Unlike a bank statement, which shows all transactions from the bank's side, the BRS is prepared by the business to explain why the two balances differ.

To prepare a BRS, start with the closing balance of either the cash book or passbook. Adjust this balance by adding or subtracting items like uncleared checks, uncredited deposits, and bank charges. Once all adjustments are made, the final balance should match the other record. The BRS is an easy and effective way for businesses to keep their financial accounts in order and avoid misunderstandings with the bank.

8.6 CHECK YOUR PROGRESS

1-Mark multiple Choice Questions

1. **What is the primary purpose of a Bank Reconciliation Statement (BRS)?**
   a) To record all bank transactions
   b) To reconcile discrepancies between the cash book and the bank statement
   c) To calculate the bank balance at the end of the year
   d) To record cash payments only
   Answer: b) To reconcile discrepancies between the cash book and the bank statement
2. **What is the difference between a bank statement and a Bank Reconciliation Statement?**
   a) The bank statement records the company's cash inflow and outflow; the BRS reconciles balances.
   b) The bank statement is prepared by the company; the BRS is prepared by the bank.
   c) The bank statement and the BRS serve the same purpose.
   d) The bank statement records discrepancies; the BRS eliminates them.
   Answer: a) The bank statement records the company's cash inflow and outflow; the BRS reconciles balances.
3. **Which of the following could be a reason for discrepancies between the cash book and passbook balances?**
   a) Errors in recording transactions
   b) Outstanding checks or deposits
   c) Bank charges or interest not recorded in the cash book
   d) All of the above
   Answer: d) All of the above
4. **Which of the following is a key consideration when preparing a Bank Reconciliation Statement?**
   a) Ignore bank charges and interest adjustments
   b) Start with the closing balance of the previous financial year

c) Match all entries between the cash book and the bank statement
d) Record only deposits in the reconciliation statement

Answer: c) Match all entries between the cash book and the bank statement

5. What is included in the specimen format of a Bank Reconciliation Statement?

a) A list of fixed assets and liabilities
b) Adjustments for outstanding checks and deposits
c) The profit and loss statement
d) A breakdown of monthly expenses

Answer: b) Adjustments for outstanding checks and deposits

5-markQuestions

1. What is a Bank Reconciliation Statement (BRS)?
2. List the key features of a BRS.
3. How does a bank statement differ from a Bank Reconciliation Statement?
4. Identify potential errors in the cash book if the BRS does not reconcile with the passbook balance.
5. From the following particulars, prepare a Bank Reconciliation Statement as on 31st March.

a. Bank Balance as per Cash Book is 10,000

b. A Cheque for 1,000 deposited but not recorded in the Cash Book. (Note: Bank has collected and credited this cheque.)

c. A Cash deposit of 200 was recorded in the Cash Book as if there is no Bank Column therein.

d. A Cheque issued for 250 was recorded as 205 in the Cash Column. (Note: Bank has made the payment of this cheque.)

e. The debit balance of 1,500 as on the previous day was brought forward as a credit balance.

f. The payment side of the Cash Book (Bank column) was under cast by 100.

g. A cash discount allowed of 112 was recorded as 121 in the Bank Column.

h. A cheque of 500 received from a debtor was recorded in the Cash Book but not deposited in the Bank for collection.

i. One outgoing cheque of 300 was recorded twice in the Cash Book.

8.7 REFERENCE:

1. Tulsian, P. C. (2002). *Financial accounting*. Pearson.

2. Rao, M. E. (2006). *Accounting for managers*. New Age International Private Limited.

3. Gupta, A. (2016). *Financial Accounting for Management Analytical perspective*. Pearson.

UNIT 9- DEPRECIATION AND PROVISIONS

Objectives:

After studying this unit, you should be able to understand-

1. Meaning of Depreciation
2. Causes of Depreciation
3. Need and importance for charging Depreciation.
4. Factors Affecting the Amount of Depreciation
5. Meaning of Depreciation Accounting
6. Methods of Charging Depreciation
7. Methods of Recording Depreciation
8. Meaning and Objectives of Provision
9. Meaning, Objectives and Types of Reserves

Structure:

9.1 INTRODUCTION

This unit provides a comprehensive understanding of **Depreciation Accounting** and the creation of provisions and reserves, which are essential elements of financial management and reporting. It begins with an introduction to depreciation, exploring its causes, the need for charging depreciation, and the factors that influence its determination. The unit highlights various methods of recording and allocating depreciation, including the Straight-Line Method and the Reducing Installment/Diminishing Balance Method, along with their respective advantages. Further, it delves into provisions, discussing their characteristics, purpose, and the nature of balances in provision and reserve accounts. Lastly, the unit covers the meaning, objectives, and types of reserves, emphasizing their role in financial planning and stability, ensuring learners gain a thorough grasp of these critical accounting concepts.

9.2 MEANING OF DEPRECIATION AND DEPRECIATION ACCOUNTING

Depreciation refers to the reduction in the value of a fixed asset over time. This decrease happens due to factors like wear and tear, out datedness (obsolescence), the passage of time, or a permanent drop in its market value. The word "depreciation" comes from the Latin term *Depretum*, where *de* means "decline" and *pretum* means "price," signifying a decline in value.

Businesses rely on fixed assets for their operations, such as buildings, machinery, furniture, vehicles, and office equipment like computers and photocopiers. These assets have a limited lifespan, after which they lose their utility. Over time, the value and usefulness of these assets decrease due to regular usage, the effects of time, and technological advancements. This reduction in value is called depreciation.

In accounting, depreciation is the method used to distribute the cost of a fixed asset across its useful life. The net cost of a fixed asset is calculated by subtracting its scrap or residual value (the estimated value at the end of its life) from its purchase price.

According to **the Institute of Chartered Accountants in England and Wales**, 'Depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent on the amount of profit earned'

9.2.1 Causes of Depreciation

The value of an asset decreases over time due to several reasons. These include:

1. **Constant Use**: Regular use of an asset causes wear and tear, reducing its value. For example, using a machine in a factory over time makes it less valuable. If the machine is sold, it won’t fetch the same price as its original purchase price because of its use.

2. **Passage of Time (Effluxion)**: Many assets lose value as time passes, even if they are not used. Natural factors like weather, rain, and wind contribute to this decline. For instance, if a business buys a machine, motor vehicle, or furniture and tries to sell it after a few years without using it, the resale value will still be lower than the purchase price simply because time has elapsed.
3. **Expiration of Legal Rights**: Some assets come with legal usage rights for a fixed period, like leases, patents, or mining rights. For example, if a business leases land for 20 years by paying ₹4,00,000, the value of the lease reduces by ₹20,000 every year. After 20 years, the lease expires, and the land returns to its original owner, making the entire initial payment non-recoverable.
4. **Obsolescence**: Advances in technology and the invention of new products can make existing assets outdated. For example, older versions of computers become obsolete as newer versions are developed. Businesses in competitive markets must upgrade to newer technologies to remain efficient and cost-effective, even if the old equipment is still usable.
5. **Accidents**: Unexpected events like accidents, floods, earthquakes, or fires can damage or destroy assets, leading to a sudden loss in their value. For instance, a machine might be damaged in a fire, or a vehicle could be wrecked in an accident, requiring a reduction in their recorded value.
6. **Depletion**: Some assets, such as mines, oil wells, or natural resources, decrease in quantity over time due to continuous extraction. This gradual reduction in quantity results in a decline in their value, which is accounted for as depreciation.

9.2.2 Need and Importance of Charging Depreciation:

Depreciation on fixed assets is necessary for several reasons. These include:

1. **To Determine True Profit or Loss**: Accurate profits can only be calculated if all expenses related to generating revenue are accounted for. Since assets help in earning revenue, their depreciation must be recorded in the Profit & Loss Account. Without including depreciation, the business's true profit or loss cannot be determined.
2. **To Show a True and Fair Financial Position**: If depreciation is not recorded, the value of assets in the Balance Sheet will appear higher than their actual worth. This misrepresentation prevents the Balance Sheet from showing the business's true financial position. Therefore, depreciation ensures the financial statements reflect the correct value of assets.
3. **To Accurately Calculate Production Costs**: Depreciation is an expense and must be included when calculating the cost of production. The selling price of goods is based on production costs, so if depreciation is not considered, the selling price may be set too low, reducing profits.

4. **To Create Funds for Asset Replacement**: Depreciation is a non-cash expense, meaning it is recorded in the Profit & Loss Account but does not involve an actual cash outflow. The saved cash from depreciation can be retained in the business and used to replace assets once they reach the end of their useful life.
5. **To Reduce Income Tax Liability**: Depreciation is treated as an allowable expense under income tax laws. Recording depreciation lowers the net profit, which in turn reduces the taxable income and the tax payable by the business.
6. **Other Objectives**: If depreciation is not accounted for, the profits shown may be higher than the actual profits. This can lead to:

   a. Employees demanding higher wages or bonuses.

   b. Extravagant spending by the business.

   c. Increased competition, as new businesses might enter the market, thinking the business is more profitable than it really is.

9.2.3 Factors to Consider When Determining Depreciation

Although the exact amount of depreciation for a specific period cannot be calculated, certain factors are taken into account to estimate it:

1. **Cost of the Asset**: The cost of a fixed asset includes the purchase price and all expenses required to make the asset ready for use. These expenses may include freight charges, transit insurance, and installation costs.
   Example: If a machine is bought for ₹80,000, and an additional ₹6,000 is spent on packing, ₹3,000 on freight, and ₹1,000 on installation, the total cost of the machine will be ₹90,000 (₹80,000 + ₹6,000 + ₹3,000 + ₹1,000).
2. **Estimated Useful Life of the Asset**: The useful life is the period during which an asset can effectively contribute to business operations. It is usually expressed in years. If a machine is expected to last 15 years but might become obsolete in 10 years due to newer technology, its useful life is considered 10 years for depreciation purposes.
3. **Estimated Scrap Value**: Scrap value refers to the expected amount the asset can be sold for at the end of its useful life. Also known as residual or breakup value, it is subtracted from the asset's cost to determine the total depreciation.
   Example: If a machine is purchased for ₹70,000, with ₹3,000 spent on freight and ₹2,000 on installation, and its scrap value is estimated at ₹5,000 after 10 years, the total depreciation amount will be ₹70,000 (₹70,000 + ₹3,000 + ₹2,000 - ₹5,000).

9.2.4 Meaning of Depreciation Accounting

Depreciation accounting refers to the systematic method of spreading the cost of a fixed asset over its estimated useful life. This process allocates the expense to different accounting periods during the asset's life. Depreciation is recorded as an expense against revenue and does not create funds for replacing the asset. Instead, it recognizes the cost of the asset as an expense over time.

Accounting Standard on Depreciation Accounting

The **Accounting Standard (AS-6)**, issued by the Institute of Chartered Accountants of India (ICAI), provides guidelines for depreciation accounting. According to AS-6:

Depreciation measures the reduction in value of a depreciable asset due to factors such as use, the passage of time, or technological and market changes. It is allocated in a way that a fair portion of the asset's depreciable value is charged to each accounting period during its useful life. Depreciation also includes **amortization** for assets with a fixed useful life.

Exceptions to AS-6

AS-6 does not apply to certain assets where special considerations are required. These include:

1. Regenerative natural resources such as forests and plantations.
2. Wasting assets, including costs related to the exploration and extraction of minerals, oil, natural gas, and other non-renewable resources.
3. Research and development expenses.
4. Goodwill.
5. Livestock.

Additionally, AS-6 does not apply to land unless the land has a limited useful life for the business.

9.2.5 Methods of Recording Depreciation

The two methods of Recording Depreciation are as follows-

1. By Charging to Asset Account
2. By creating provision for depreciation/Accumulated Depreciation Account

Recording of Depreciation By Charging to Asset Account

1. In this Depreciation is directly credited to respective Asset Account
2. At its Book Value respective Asset Account appears
3. The Journal entries which are passed under this method is given bellow

Table No.1: Journal Entries

Sl. No	Transaction	Journal Entry	Narration

1.	To record Purchase of Asset	Asset A/c Dr. To Cash/Bank A/c	(Being the Asset purchased)
2.	To provide Depreciation	Depreciation A/c Dr. To Asset A/c	(Being the Depreciation provided)
3.	To Close Depreciation Account	Profit & Loss A/c Dr. To Depreciation A/c	(Being the transfer of Depreciation A/c to P&L A/c)
4.	To record Sale of Asset	Cash/Bank A/c Dr. To Asset A/c	(Being the Asset sold)
5.	To record Profit/Loss on Sale (In Case of Profit)	Asset A/c Dr. To Profit & Loss A/c	(Being the transfer of Profit on Sale)
6.	To record Profit/Loss on Sale (In Case of Loss)	Profit & Loss A/c Dr. To Asset A/c	(Being the transfer of Loss on Sale)

9.3 METHODS OF ALLOCATING DEPRECIATION

There are different ways to allocate depreciation over an asset's useful life. The two most commonly used methods in businesses and industries are the **Straight-Line Method (SLM)** and the **Written-Down Value Method (WDV).**

9.3.1 Meaning of Straight-Line Method (SLM) of Depreciation

Under the Straight-Line Method, a fixed amount of depreciation is charged each year. This is calculated as a fixed percentage of the original cost of the asset and is spread evenly over its expected useful life.

Steps to Calculate the Rate of Depreciation under SLM

1. **Determine the Total Cost of the Asset**: Add the purchase price of the asset to any expenses incurred to make it ready for use.

2. **Calculate the Amount of Depreciation**: Subtract the residual (scrap) value from the original cost of the asset and divide the result by the asset's expected useful life.

Amount of Depreciation $= \frac{\textit{Original Cost} - \textit{Residual Value}}{\textbf{Expected Useful life of the Asset}}$

3. Find the Rate of Depreciation: Divide the annual depreciation amount by the original cost of the asset and multiply by 100 to get the percentage.

Rate of Depreciation = $\frac{\textbf{\textit{Amount of Depreciation}}}{\textbf{Original Cost}}$ X 100

9.3.2 Advantages and Disadvantages of the Straight-Line Method

Advantages

1. It is simple and easy to understand.
2. Calculating the depreciation amount and rate is straightforward.
3. By the end of the asset's useful life, its book value either reaches zero or matches its residual (scrap) value.

Disadvantages

1. Over time, repair costs increase as the asset gets older, but depreciation stays the same. This makes the total expense (depreciation plus repairs) higher in later years compared to earlier years.
2. This method does not consider the interest lost on the money spent to buy the asset.
3. It does not save money for replacing the asset when its useful life is over.

Illustration 1: On 1st Jan 2013, Tulsian Ltd. purchased a second-hand machine for 80,000 and spent 20,000 on its cartage, repairs and installation. The residual value at the end of its expected useful life of 4 years is estimated at 68.000 Calculate the amount of depreciation according to Straight Line Method for the first year ending on 31st March, 2013

Solution:

Step 1: Total Cost of Asset = Purchase Price Expenses to be capitalized 80,000+20,000-1,00,000

Step 2: Amount of Depreciation per year

$$\frac{\text{Total Cost of Assets} - \text{Estimated Residual value}}{\text{Expected useful life}}$$

$$\frac{1{,}00000 - 68{,}000}{4}$$

= 8,000 Per year

Illustration 2: Calculation of profit/loss on sale of asset

X Ltd. purchased a second-hand machine for 5,00,000 and spent 1,00,000 on its repairs. Depreciation is to be provided 10% p.a. according to Straight Line Method. This machine is sold for 4,50,000. Accounting year is financial year. Calculate the profit or loss on sale of machine in each of the following alternative cases:

Case (a) If date of purchase is 1.4.2015 and date of sale is 31.3.2018.

Case (b) If date of purchase is 1.4.2015 and date of sale is 30.9.2017

Case (c) If date of purchase is 1.7.2015 and date of sale is 31.3.2018

Case (d) If date of purchase is 1.7.2015 and date of sale is 30.9.2017

Solution:

Particulars	Case (a)	Case (b)	Case (c)	Case (d)
A. Total Cost of Asset (Rs.5,00000+1,00000	6,00000	6,00000	6,00000	6,00000
B. Less: Depreciation from date of purchase to date of sale	6,00000x $\frac{10}{100}$ x$\frac{36}{12}$= 1,80,000	6,00000x $\frac{10}{100}$ x$\frac{30}{12}$= 1,50,000	6,00000x $\frac{10}{100}$ x$\frac{33}{12}$= 1,65,000	6,00000x $\frac{10}{100}$ x$\frac{27}{12}$= 1,35,000
C. Book Value as on date of sale [A–B]	4,20,000	4,50,000	4,35,000	4,65,000
D. Less: Sale Proceeds	4,50,000	4,50,000	4,50,000	4,50,000
E. Loss on Sale/Profit on Sale	(30,000)	--	(15,000)	15,000

Illustration No 3: From the following information prepare Journal, Machinery A/c and Depreciation Account for the first three years assuming that accounts are closed on 31st March every year. On 1st April 2015, Tulsian Ltd. purchased a second-hand machine for 2 80,000 and spent 20,000 on its cartage, repairs and installation. The residual value at the end of its expected useful life of 4 years is estimated at 40,000. On 30th Sept. 2016, repairs & renewals amounted to ₹ 2,000, On 30th Sept. 2017. This machine is sold for 50,000. Depreciation is to be provided according to Straight Line Method.

Solution: **Journal of Tulsian ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)

01.04.2015	Machinery A/c Dr. To Bank A/c (Being the machinery purchased)		80,000	80,000
01.04.2015	Machinery A/c Dr. To Bank A/c (Being the cartage & installation charges paid)		20,000	20,000
31.03.2016	Depreciation A/c Dr. To Machinery A/c (Being the depreciation provided)		15,000	15,000
31.03.2016	Profit & Loss A/c Dr. To Depreciation A/c (Being the transfer of Depreciation A/c to P&L A/c)		15,000	15,000
31.03.2016	Repairs & Renewals A/c Dr. To Cash A/c (Being the payment made for repairs & renewals)		2,000	2,000
31.03.2017	Depreciation A/c Dr. To Machinery A/c (Being the depreciation provided)		15,000	15,000
31.03.2017	Profit & Loss A/c Dr. To Depreciation A/c (Being the transfer of Depreciation A/c to P&L A/c)		15,000	15,000
30.09.2017	Depreciation A/c Dr. To Machinery A/c		7,500	7,500
30.09.2017	Bank A/c Dr To Machinery A/c (Being the machinery Sold)		50,000	50,000
30.09.2017	Profit & Loss A/c Dr. To Machinery A/c (Being the transfer of loss on sale of machinery		12,500	12,500
31.03.2018	Profit & Loss A/c Dr. To Depreciation A/c (Being the transfer of Depreciation A/c to P&L A/c)		7,500	7,500

MACHINERY ACCOUNT

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs)
1.04.15	To Bank A/c To Bank A/c	80,000 20,000	31.3.16	By Depreciation A/c 1,00000x 15/100x 12/12 By Balance b/d	15,000 85,000
		1,00000			1,00000
1.04.15	To Balance b/d	85,000	31.3.17	By Depreciation A/c 1,00000x 15/100x 12/12 By balance c/d	15,000 70,000
		85,000			85,000
1.04.15	To balance b/d	70,000	30.9.18	By Depreciation A/c 1,00000x 15/100x 6/12 By Bank A/c (Sale) By P/L A/C (Loss)	7,500 50,000 12,500
		70,000			70,000

Depreciation Account

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs)
31.3.15 31.3.16 30.9.17	To Machinery A/c To Machinery A/c To Machinery A/c	15,000 15,000 7,500	31.3.16 31.3.17 31,3,18	By Profit and Loss A/c By Profit and Loss A/c By Profit and Loss A/c	15,000 15,000 7,500

Calculation of the Rate of Depreciation

Step 1: Calculation of Total Cost of Asset 80,000-20,000 ₹ 1,00.000

Step 2: Calculation of Amount of Depreciation per year

$$\frac{\text{Total Cost of Assets} - \text{Estimated Residual value}}{\text{Expected useful life}}$$

$$\frac{1,00000 - 40,000}{4}$$

= 15,000

Step 3: Calculation of Rate of Depreciation under SLM

$\frac{\text{Amount of Depreciation}}{\text{Total Cost of assets}}$x 100

= 15,000/100000X 100

= 15%

Calculation of Profit/Loss on Sale of Machine

Particulars	Amount (Rs)
A. Total Cost (80,000 + 20,000)	1,00000
B. Less Depreciation from date of Purchase to date of Sale 1,00000 x 15/100 x 30/12	37,500
C. Book Value as on date of Sale A-B	62,500
D. Less Sale Proceeds	50,000
E. Loss on Sale of Assets C-D	12,500

9.4 REDUCING INSTALLMENT METHOD (DIMINISHING BALANCE METHOD/ WRITTEN DOWN VALUE METHOD)

The Reducing Installment Method, also called the Diminishing Balance Method, is a way of calculating depreciation where a fixed percentage is applied to the asset's remaining value after depreciation has been deducted each year. The value of the asset decreases annually until it reaches its scrap value.

For example:

- If an asset's initial cost is ₹20,000 and the depreciation rate is 10%, the value at the end of the 1st year will be ₹18,000 (₹20,000 - 10% of ₹20,000).
- At the end of the 2nd year, the value will reduce further to ₹16,200 (₹18,000 - 10% of ₹18,000).

In this method, depreciation is calculated on the asset's balance at the start of each year:

- For the 1st year, depreciation is ₹2,000.
- For the 2nd year, depreciation is ₹1,800.

As the asset's value decreases every year, the depreciation amount also reduces, but the rate remains the same. This method is also known as the **Written down Value Method** or the **Reducing Balance Method.**

9.4.1 Advantages of the Reducing Installment Method

1. **Simple Calculation:** Calculating depreciation is straightforward. If new assets are purchased, they can be grouped easily for depreciation purposes.
2. **Balanced Charges on Profit & Loss Account:** Depreciation is higher in the earlier years when repair costs are low. As the asset ages, repair costs increase while depreciation decreases, keeping the total expense relatively stable over time.
3. **Lower Pressure in Later Years:** Since depreciation is higher in the initial years, when the asset is more efficient, this method reduces the financial burden in the later years when the asset's efficiency declines.
4. **Asset Value is never reduced to Zero:** This method ensures that the asset always retains some value, no matter how small, until it is disposed of.
5. **Accepted by Tax Authorities:** This method is allowed under income tax laws, making it a preferred choice for businesses.

Demerits of the Diminishing Balance Method

1. **Asset Value Cannot Reach Zero**: This method does not reduce the value of an asset to zero, even if the asset is no longer useful. A small balance will always remain in the asset account.
2. **No Interest Consideration**: Similar to the straight-line method, this method does not account for the interest lost on the amount invested in the asset.
3. **Difficulty in Setting the Depreciation Rate**: It can be challenging to decide the depreciation rate. If the rate is too low, the asset might become obsolete before it is written down to its scrap value. To avoid this, the rate is often set higher, which can still take a long time to reduce the asset's value sufficiently.
4. **Original Cost and Depreciation Details Not Clear**: This method does not show the original cost of assets in the Balance Sheet. When assets are grouped together, it may be hard to identify specific assets. Additionally, small residual balances might remain in the Balance Sheet even after an asset has been disposed of.

Illustration 1: On 1st January 2006, a merchant purchased machinery for Rs. 78,000 and spent Rs. 2,000 on carriage and installation charges. On 1st July 2007, he purchased another machine costing Rs. 30,000. The rate of depreciation charged on machinery was 10% per annum on diminishing balance method. Accounts are closed on 31st December each year. Show the Machinery Account and Depreciation Account up to 31st December, 2009 by charging depreciation to assets account.

Solution:

(a) Calculation of Cost of the machine bought on 1st January, 2006 Rs.

Purchase Price	78,000
Add: Carriage and Installation charges	2,000

(b) Calculation of Depreciation on 1st Machine:

Cost of the Machine	80,000
Depreciation for 2006 @ 10% on 80,000 p.a	8,000
Written down value on 1.1.2007	**72,000**
Less: Depreciation for 2007 @ 10% p.a on Rs. 72,000	7.200
Written down value on 1.1.08	64,800
Less: Depreciation for 2008 @ 10% p.a. on Rs. 64,800	6,480
Written down value on 1.1.09	58,320
Less: Depreciation for 2009 @ 10% p.a. on Rs. 58,320	5,832
Written down value on 1.1.10	52,488

(c) Calculation of Depreciation on 2nd Machine:

Cost of the 2nd machine bought on 1st July, 2007	Rs. 30,000
Less: Depreciation for 6 months @ 10% p.a. on Rs. 30,000 for 2007	1,500
Written down value on 1.1.08	28,500
Less: Depreciation for 2008 @ 10% p.a. on Rs. 28,500	2,850
Written down value on 1.1.09	25,650
Less: Depreciation for 2009 @ 10% p.a. on Rs. 25,650	2,565

Written down Value on 1.1.10 23,085

Machinery Account

Date	Particulars	JF	Amount (Rs)	Date	Particulars	JF	Amount (Rs)
2006				2006			
Jan1	To bank A/c		78,000	Dec.31	By Depreciation A/c		8,000
Jan 1	To Bank A/c		2,000				
				Dec 31	By balance c/d		72,000
			80,000				**80,000**
2007				2007	By		
Jan 1	To balance b/d		72,000	Dec 31	depreciation A/c (Rs 7,200 +1,500)		8700
	To Bank A/c						
July 1			30,000	Dec 31	By balance c/d		93.300
			1,02,000				**1,02,000**
2008	To balance b/d						
Jan 1			93,300	2008	By		
				Dec 31	depreciation A/c (Rs 6480 +2850)		9,330
				Dec 31	By balance c/d		83,970
	To balance b/d		**93,300**				**93,300**
2009	Rs (58,320			2009	By		
Jan 1	+25,650		83,970	Dec 31	depreciation A/c (Rs 5832 +2565)		8,397
					By balance c/d		75,573
2010							
Jan 1			**83,970**				**83,970**
	To Balance b/d Rs(52,488+23085)		75,573				

Depreciation Account

Date	Particulars	JF	Amount (Rs)	Date	Particulars	JF	Amount (Rs)
2006 Dec.31	To Machinery A/c		8,000	2006 Dec 31	By P/L A/c (transferred)		8,000
2007 Dec.31	To Machinery A/C		8,700	2007 Dec.31	By P/L A/c (transferred		8,700
2008 Dec.31	To Machinery A/C		9,330	2008 Dec 31	By P/L A/c (transferred		9,330
2009 Dec 31	To Machinery A/C		8,397	2009 Dec31	By P/L A/c (transferred		8,397

9.5 PROVISIONS

When running a business, it is essential to be prepared for both predictable and unpredictable situations. To avoid using capital as profit and ensure financial stability, businesses must make provisions and create reserves from their profits while preparing final accounts. Although the terms **provisions** and **reserves** may seem similar, they are quite different. Here's a simple explanation of **provisions**:

A **provision** is money set aside to cover potential expenses or liabilities whose exact amount is not yet known. It is recorded as an expense in the **Profit and Loss Account** so the company's profit is calculated accurately. This ensures that the company can handle known or anticipated costs, even if it doesn't make a profit.

Examples of Provisions:

Here are common examples of provisions made by businesses:

1. Provision for Income Tax
2. Provision for Sales Tax
3. Provision for disputed claims (e.g., pending court cases)
4. Provision for Depreciation
5. Provision for Repairs and Renewals
6. Provision for Doubtful Debts (expected bad debts)
7. Provision for Discounts to Debtors

There is difference between Liability and Provision. If the exact amount of a liability is known (e.g., unpaid salaries or wages), it is treated as a liability. If the amount is uncertain or an estimate, it is treated as a provision.

9.5.1 Characteristics/Features of Provisions

1. **Purpose of Provision:**

   A provision is made to handle a specific liability that is already known.

2. **Uncertainty in Amount:**

   While the liability is certain, its exact amount cannot be determined. For example, it is clear that some customers may not pay their dues (bad debts), but the exact amount of such losses cannot be predicted.

3. **Impact on Profits:**

   Provisions are treated as expenses and are deducted from profits. This means creating a provision reduces the profit or increases the loss for the year it is made. Later, when the actual loss happens, it is adjusted against the provision. As a result, the profit of the year when the loss occurs is not significantly impacted.

4. **Creation in All Scenarios:**
   A provision is created even if the business incurs a loss during the year.

9.5.2 Importance/Need/Purpose of Creating Provisions

1. To Determine Accurate Profit:

To calculate the real profit of a business, all expenses related to that year whether paid or not—must be accounted for in the **Profit and Loss Account**. Provisions are created for expenses or liabilities that cannot be precisely estimated. For example, since the exact amount of bad debts is uncertain, a provision for doubtful debts is necessary.

2 To Show the True Financial Position:

Provisions ensure that the **Balance Sheet** reflects a fair and accurate financial position by accounting for all expected losses and expenses.

3 To Prepare for Future Losses:

Provisions help set aside funds for future losses that are likely to occur. Examples include provisions for bad debts, taxes, repairs, or damages from pending legal cases.

4 **To Distribute Expenses Fairly Over Time:**

Provisions allow for a balanced allocation of expenses over multiple years. For instance, the cost of repairs and renewals over an asset's lifetime can vary, with lower costs in early years and higher costs later. By creating a **Provision for Repairs**, the expense is spread evenly across the years, ensuring that the **Profit and Loss Account** of each year bears an equal share of the repair costs.

9.5.3 Nature of Balances in Provision and Reserve Accounts

Generally, **Provision** and **Reserve Accounts** have a **credit balance**. The only exception is the **Reserve for Discount on Creditors Account**, which shows a **debit balance**.

How Provisions Are Shown in the Balance Sheet

1. Provisions for Liabilities and Charges:

   Provisions made for liabilities or expenses (e.g., Provision for Income Tax **or** Provision for Repairs and Renewals**)** are displayed on the liability side of the Balance Sheet**.**

2. Provisions for Specific Purposes:

   Provisions created for specific purposes, such as anticipated losses or contingencies (e.g., Provision for Doubtful Debts **or** Provision for Discount on Debtors**),** are shown as a deduction from Sundry Debtors on the assets side of the Balance Sheet.

9.6 MEANING AND OBJECTIVES CREATING OF RESERVE

A **Reserve** is money set aside from profits or other surpluses to prepare for future uncertainties or unknown losses. It represents a portion of profits retained in the business instead of being distributed to the owners or shareholders. Reserves are created by **appropriating profits**, meaning they are recorded after calculating the net profit.

Objectives of Creating Reserves

1. **To Strengthen Financial Stability:**

Reserves help improve the financial position of the business, ensuring it can handle uncertainties effectively.

2. **To Fund Modernization or Expansion**

Reserves provide money for upgrading existing facilities or purchasing new ones for growth and development.

3. **To Maintain Consistent Dividends:**

Reserves are used to ensure a steady dividend payout, even during years when profits are lower.

4. **To Fulfill Legal Requirements**

Certain reserves, like the **Debenture Redemption Reserve or Capital Redemption Reserve**, are created to comply with laws under the **Companies Act, 1956**, or tax rules like the **Income Tax Act, 1961** (e.g., Development Allowance Reserve, Foreign Project Allowance Reserve).

5. **To Handle Unexpected Losses**

Reserves act as a safeguard to cover abnormal or unforeseen losses that may arise.

9.6.1 Types of Reserves

Reserves are broadly classified into two categories: **Revenue Reserves** and **Capital Reserves.**

1. **Revenue Reserves**

These reserves are created from profits that can be distributed as dividends. They are further divided into two types:

a.General Reserves:

General reserves are not created for any specific purpose. They act as a financial cushion for unforeseen events. Examples include:

i. General Reserve

ii. Contingency Reserve

b. Specific Reserves:

Specific reserves are created for a particular purpose. Examples include:

i. Dividend Equalization Reserve
ii. Debenture Redemption Reserve

iii. Investment Fluctuation Reserve
iv. Workmen Compensation Reserve

2. Capital Reserves

Capital reserves are created from profits that are not generated through regular business operations. These are not available for dividend distribution. Examples of sources for capital reserves include:

a. Profits made before the business was incorporated
b. Premium received from issuing shares or debentures
c. Profits from the reissue of forfeited shares
d. Gains from the redemption of debentures
e. Profits from selling fixed assets
f. Surplus from revaluing fixed assets
g. Profits from selling the whole or part of the business

9.7 SUMMERY

This unit thoroughly explains the concepts of depreciation, provisions, and reserves, which are crucial for understanding financial accounting practices. It begins by defining depreciation as the reduction in the value of an asset over time due to wear and tear, usage, or obsolescence. The causes of depreciation are explored, emphasizing physical deterioration, legal limitations, or technical advancements. The unit highlights the need and importance of charging depreciation, such as reflecting the true value of assets, matching expenses with revenues, and complying with accounting standards.

The discussion extends to the factors to consider when determining depreciation, such as the asset's original cost, expected life, residual value, and usage patterns. It also introduces depreciation accounting, explaining how depreciation is systematically recorded in financial statements. Two methods of recording depreciation are covered, focusing on how it can be charged directly to the asset account or otherwise. The unit then examines the methods of allocating depreciation, with a detailed focus on two widely used techniques. The Straight-Line Method (SLM) is explained as a way to allocate an equal amount of depreciation over the useful life of the asset. Steps for calculating the depreciation rate under SLM are outlined, along with its advantages, such as simplicity, and disadvantages, such as not considering the asset's diminishing efficiency. The Reducing Balance Method (also known as Diminishing Balance or Written down Value Method) is discussed; where depreciation decreases over time as it is based on the asset's reducing book value. Its advantages, such as better reflection of asset usage, and disadvantages, like complexity in calculation, are detailed.

The unit also introduces the concept of provisions, explaining them as amounts set aside to cover anticipated expenses or losses. The features of provisions and their importance in ensuring accurate financial reporting are discussed. The nature of provisions as liabilities and their accounting treatment are explained, helping learners understand how they impact financial statements. The distinction between provisions and reserves is made clear, with the meaning and objectives of reserves elaborated. Reserves, created from profits, serve purposes such as strengthening financial stability or funding future growth. The types of reserves are also briefly introduced.

9.8 CHECK YOUR PROGRESS

1 Mark Multiple Choice Questions:

1. **What is the primary purpose of charging depreciation in accounting?**
   a) To increase the value of fixed assets
   b) To allocate the cost of an asset over its useful life
   c) To determine the profit of the business
   d) To record expenses incurred on maintenance
   Answer: b) To allocate the cost of an asset over its useful life
2. **Which of the following is NOT a cause of depreciation?**
   a) Wear and tear
   b) Obsolescence
   c) Market demand fluctuations
   d) Effluxion of time
   Answer: c) Market demand fluctuations
3. **What factor is considered when determining depreciation?**
   a) Initial cost of the asset
   b) Estimated useful life of the asset
   c) Residual or scrap value of the asset
   d) All of the above
   Answer: d) All of the above
4. **Which depreciation method allocates an equal amount of depreciation each year?**
   a) Straight Line Method
   b) Reducing Balance Method
   c) Sum of Years Digits Method
   d) Revaluation Method
   Answer: a) Straight Line Method
5. **What is an advantage of the Straight Line Method?**
   a) Simplicity and ease of calculation
   b) Higher depreciation in initial years
   c) Tax benefits are maximized

d) Depreciation is based on usage
Answer: a) Simplicity and ease of calculation

6. **Which depreciation method results in higher depreciation in the earlier years of an asset's life?**
a) Straight Line Method
b) Reducing Balance Method
c) Production Units Method
d) Inventory Method
Answer: b) Reducing Balance Method

7. **What is the primary objective of creating provisions in accounting?**
a) To show higher profits
b) To prepare for future liabilities or expenses
c) To allocate resources for expansion
d) To reduce tax liabilities
Answer: b) To prepare for future liabilities or expenses

8. **Which of the following is a characteristic of provisions?**
a) Created for known liabilities with uncertain amounts
b) Created only when profits are high
c) Recorded on the debit side of the Profit & Loss Account
d) Used for distributing dividends
Answer: a) Created for known liabilities with uncertain amount

9. **Reserves are primarily created to:**
a) Cover future losses or uncertainties
b) Allocate funds for specific purposes like asset replacement
c) Strengthen the financial position of a business
d) All of the above
Answer: d) All of the above

10. **Which of the following is a type of reserve?**
a) General Reserve
b) Specific Reserve
c) Capital Reserve
d) All of the above
Answer: d) All of the above

5-Mark Questions:

1. What is the meaning of depreciation?
2. List the factors affecting the calculation of depreciation.
3. Differentiate between the Straight-Line Method and the Reducing Balance Method of depreciation.
4. What is the importance of making provisions for depreciation?

5. Why it is necessary to provide for depreciation? Explain the effect of depreciation on Profit and loss account and Balance sheet.
6. On 1st April, 2006 ABC Company purchased a Machine for Rs. 60,000 and spent Rs. 2,000 on its carriage and Rs. 3,000 on its erection. On the date of purchase, it was estimated that the effective life of the machine will be 10 years and after 10 years its scrap value will be Rs. 5,000. Show Machine Account and Depreciation Account for the first four years by charging depreciation to Asset Account. Assume that books of accounts are closed on 31st March each year.

9.9 REFERENCE:

1. Tulsian, P. C. (2002). *Financial accounting*. Pearson.

2. Rao, M. E. (2006). *Accounting for managers*. New Age International Private Limited.

3. Gupta, A. (2016). *Financial Accounting for Management Analytical perspective*. Pearson.

MODULE 4: COMPANY FINAL ACCOUNTS

UNIT 10 BASICS OF FINANCIAL STATEMENT: Meaning and objectives of financial statements, Nature of financial statements, Types of financial statements, Balance Sheet, Statement of changes in owner's Equity, Statement of changes in financial position

UNIT 11 FINANCIAL STATEMENT OF A COMPANY: Schedule III of the Companies Act, 2013, Form of Preparing a Statement of Profit and Loss, Vertical Form of Summarized Balance Sheet with Major Headings

UNIT 12 FINANCIAL STATEMENT ANALYSES: Meaning of Ratio Analysis, Classification of Ratio Analysis on the basis of Financial Statements, Classification of Ratios based on users requirements, Common Size Statement, Comparative Analysis

UNIT 10 BASICS OF FINANCIAL STATEMENT

Objectives:

After studying this unit, you should be able to understand:

1. Financial statements and their role in decision-making.
2. How financial statements serve as key sources of information for:
    a. Assessing profitability.
    b. Evaluating the financial position of a business.
    c. Supporting informed decision-making processes.
3. The general guidelines for preparing financial statements.
4. Recognize the importance of financial statements for various stakeholders, including: Investors, Creditors, Owners, The general public.

Structure:

10.1 INTRODUCTION

This unit focuses on **financial statements**; a crucial component of financial reporting that provides a structured representation of a company's financial performance and position. It begins with an overview of the meaning, objectives, and nature of financial statements, emphasizing their role in decision-making for stakeholders. The unit explores the different types of financial statements, including the **Balance Sheet**, which reflects the financial position of a business; the **Income Statement (Profit and Loss Account)**, which highlights profitability; the **Statement of Changes in Owner's Equity**, showing variations in equity over a period; and the **Statement of Changes in Financial Position**, which details cash flows and changes in financial structure. These concepts offer learners a solid foundation in understanding and analyzing key financial documents essential for effective management and investment decisions.

10.2 MEANING AND OBJECTIVES OF FINANCIAL STATEMENT

Accounting is the process of identifying, measuring, and sharing financial information to help people make informed decisions. It involves recording, organizing, and summarizing business transactions. The result of these transactions is financial statements, like the balance sheet (showing the financial position) and the profit and loss account (showing income and expenses).

These financial statements summarize the business's performance and help assess its profitability and financial position. They are used for decision-making by managers and others interested in the business, such as investors, creditors, customers, suppliers, banks, employees, potential investors, the government, and the public.

How these statements are analyzed and interpreted depends on the type and quality of the information they provide.

Financial statements show the financial position of a business. These statements are prepared by the business to provide important financial information. The term "financial statements" usually refers to two key documents:

1. **The Balance Sheet** (or Position Statement), which shows the financial position of the business.
2. **The Profit and Loss Account** (or Income Statement), which shows the income and expenses of the business.

These statements serve two main purposes:

1. **To communicate with stakeholders**, such as shareholders, creditors, banks, financial institutions, analysts, investors, and the government, about the financial health of the business.
2. **To analyze the performance and operations** of the business, helping in planning for the future.

American Institute of Certified Public Accounts "Financial statements are prepared for the purpose of presenting a periodical review or report by the management and deal with the status of the investment in the business and the results achieved during the period under review."

Objectives of Financial Statements

Financial statements provide essential information that helps assess a business's profitability and financial position. They are the primary tools used by businesses to communicate their financial status to owners, creditors, and the public. The main goal of financial statements is to support decision-making.

According to the Accounting Principles Board of America, the key objectives of financial statements are:

1. To provide accurate financial information about changes in the economic resources and obligations of a business.
2. To offer additional relevant details about these changes.
3. To deliver reliable data on changes in the net resources and obligations resulting from business activities.
4. To supply financial information that helps evaluate the business's earning potential.
5. To disclose, as much as possible, other useful information related to financial statements to meet the needs of users.

10.2.1 Nature of Financial Statements

Financial statements are based on recorded facts that can be expressed in monetary terms. These statements summarize the financial data of a business and are usually prepared for a specific accounting period. The following points explain their nature:

1. **Recorded Facts**:

Financial statements are prepared using data from accounting records, which are based on actual costs (historical costs). These records include figures for items such as cash, bank balances, bills receivable, debtors, and fixed assets, as recorded in the books of accounts.

2. **Accounting Conventions**:

While preparing financial statements, specific accounting conventions are followed. For instance:

a. Inventory is valued at either cost or market price, whichever is lower.
b. Assets are valued at cost minus depreciation for balance sheet purposes.
c. Small items like pencils or postage stamps are treated based on the convention of materiality.

3. **Assumptions(Postulates)**:
Certain assumptions guide the preparation of financial statements:

a. The business is treated as a **going concern**, meaning it is expected to operate indefinitely. If liquidation is intended, assets would need to be valued differently.
b. It is assumed that the **value of money remains constant** over time, even though its purchasing power may change significantly. Therefore, assets purchased at different times are recorded at their original cost.

4. **Personal Judgments**:

Despite following standard accounting conventions, the accountant's judgment plays a crucial role in preparing financial statements. For example:

a. When valuing inventory, the accountant decides on the cost calculation method (e.g., FIFO, LIFO, average cost, or standard cost).
b. Such decisions involve applying professional judgment to ensure accuracy and consistency.

10.3 TYPES OF FINANCIAL STATEMENTS

Financial statements mainly consist of two key reports:

1. **Balance Sheet (Position Statement)**
2. **Income Statement (Profit and Loss Account)**

However, according to Generally Accepted Accounting Principles (GAAP), a complete set of financial statements should also include:

1. A **Balance Sheet**
2. An **Income Statement**
3. A **Statement of Changes in Owner's Equity**
4. A **Statement of Changes in Financial Position**

10.3.1 Balance Sheet

The balance sheet is an important financial statement that provides a snapshot of a business's financial position at a specific point in time. It shows:

Assets: What the business owns or uses.

Liabilities: What the business owes to others (creditors, banks, etc.).

Owner's Equity: The claims of the business owners.

Horizontal form of balance sheet

Balance sheet of…..

As on…….

Liabilities	Amount	Assets	Amount
Share capital		All fixed assets	
Reserve and surplus		Less : depreciation	
Debentures		Investment	
Current liabilities		All current assets	
Provisions		Loans and advances	
		Miscellaneous expenditure	

Vertical form of Balance sheet

	Schedul eNo.	Figures as at the end of current financial year(Rs)	Figures as at the end of previous financialyear (Rs)
I Sources of funds 1 Shareholders funds (a) Capital (b) Reserves and surpluses 2. loans funds (a) Secured loans (b) Unsecured loansTotal : II Application of funds 1 fixed assets (a) Gross block (b) Less: depreciation (c) Net block (d) Capital work in progress 2. investments 3.current assets, loans and advances (a) inventories (b) sundry debtors (c) cash and bank balances (d) other current assets (e) loans and advances Less: current liabilities andprovisions Net current assets			

4(a) Miscellaneous expenditure to the extent not written off or			

Description of Key Balance Sheet Items

1. Share Capital**:**

Share capital is listed as the first item on the liabilities side of the balance sheet. It includes the authorized and issued capital, showing the number of shares issued and their respective value. The number of shares applied for by the public is also mentioned, along with the type of capital, such as preference share capital and equity share capital. If the capital is issued in a form other than cash, the amount of such capital is also noted.

2. Reserves and Surplus:

This section includes reserves created from undistributed profits. These reserves are classified as:

Capital Reserves: These are not available for distribution as profits.

Revenue Reserves: Created from profits, they can be used for distribution. Specific types of reserves included are:

a. Capital reserves
b. Capital redemption reserve
c. Share premium account
d. Other reserves
e. Surplus

3. **Secured Loans**

This category includes loans for which the business has provided security, such as debentures. It also includes loans from banks and subsidiary companies that are backed by assets.

4. **Unsecured Loans**:

Unsecured loans are those that are not backed by any security. These include loans from subsidiary companies, deposits, and loans from other sources. Short-term loans are those that are due within one year. Loans from directors, managers, and others are separately listed under different sub-headings.

5. **Current Liabilities and Provisions**:

Current Liabilities: These include items such as acceptances, sundry creditors, advance payments, unexpired discounts, unclaimed dividends, and other short-term liabilities.

Provisions: These are amounts set aside for future liabilities, such as taxation, proposed dividends, contingencies, provident fund schemes, and other provisions.

Assets Side

Fixed Assets:

1. Fixed assets are long-term assets purchased for use in the business, not for resale. These assets help in increasing the business's production capacity and are meant to be used for a long period. Fixed assets include items like goodwill, land, buildings, leaseholds, and plant and machinery, and are shown separately on the balance sheet.
2. **Investments**:

Investments are listed by their nature and valuation method. These include investments in government or trust securities, shares, debentures, bonds, and immovable properties, each listed separately in the balance sheet.

3. **Current Assets**:

Current assets are assets that move through various stages of production, distribution, and payment until they are converted into cash or cash equivalents, which can then be used to pay debts.

4. **Miscellaneous Expenditure**:

This includes deferred expenditure, which refers to expenses that are not fully accounted for in the current year's profit and loss statement. These expenses are spread over multiple years, with the remaining balance shown on the balance sheet.

10.3.2 Income Statement (Profit and Loss Account)

The income statement, also known as the profit and loss account, is prepared to evaluate the financial performance of a business. It shows the revenue earned and the expenses incurred to generate that revenue. If the revenue is higher than the expenses, it results in a profit. If the expenses exceed the revenue, a loss is shown.

The income statement is prepared for a specific period, usually one year. For example, if the statement is prepared for the year ending December 31st, 1999, it will include all revenues and expenses for that year, regardless of when the actual payments or receipts occurred.

The format of the income statement depends on the type of business. For example, a trading business will prepare a **trading account** to calculate the gross profit, and a **profit and loss account** to determine the net profit.

In sole proprietorships and partnerships, there are no set formats for the income statement, although it is recommended to prepare one. For Joint Stock Companies, however, preparing an income statement is mandatory.

Manufacturing Account

For the year ending…..

Particulars	Amount (Rs)	Particulars	Amount (Rs)

To opening stock Raw Materials Partly manufactured goods To purchases of raw materials To carriage inwards To manufacturing wagesTo factory rent To deprecation on Factory building Machinery To repairs to plant		By cost of finished goods transferred to trading account By closing stock Raw material Partly manufactured goods	

Trading and Profit and Loss Account

For the year ending….

Particulars	Amount (Rs)	Particulars	Amount (Rs)

To opening stock To purchases To gross profit c/d To gross loss b/d To salaries To office rent To advertising To carriage outwards To discount allowed To depreciation on Office building, furniture To net profit transferred to capitalaccount		By sales By closing stock By finished goods By gross loss c/d By gross profit /d By discount received By net loss transferred to capitalaccount	

10.3.3 Statement of Changes in Owner's Equity (or Retained Earnings)

Owner's equity refers to the value or claims that the business owners (shareholders) have on the firm's assets. It includes two main parts:

1. **Paid-up Share Capital**: The initial money invested by the shareholders.
2. **Retained Earnings/Reserves and Surplus**: Profits that the business has kept instead of distributing them to shareholders.

The **Statement of Changes in Owner's Equity** shows how the owner's equity balance changes over a period. It starts with the beginning balance of the equity accounts, explains the reasons for increases or decreases (such as profits or losses), and shows the final balance.

This statement is also called the **Profit and Loss Appropriation Account** or the **Income Disposal Statement** because it shows how the earnings (profits) are allocated or used.

Profit and Loss Appropriation Account

For the year ending……..

To transfer to general reserve To transfer to sinking fund To interim dividend To proposed dividend To balance c/d		By balance b/d By net profit (for the current year)	

10.3.4 Statement of Changes in Financial Position

The **Statement of Changes in Financial Position**, also known as the **Funds Flow Statement** or **Cash Flow Statement**, provides details about the movement of funds in and out of a business over a specific period. It explains how the business's financial situation has changed, including its financial and investment activities. Essentially, this statement shows the reasons for any changes in the business's financial position from the start to the end of the period.

The statement of changes in financial position can be presented in two main ways:

1. **Funds Flow Statement**:

This statement analyzes the changes in a business's financial condition between two periods. It uses the term **"funds"** to refer to **working capital**. The funds flow statement shows where the funds came from and how they were used. It helps management understand financial changes and make decisions about business strategy and performance.

1. **Cash Flow Statement**:

A cash flow statement explains changes in the business's cash position between two balance sheet dates. It tracks the movement of cash in and out of the company, providing a clear picture of how cash resources are being managed over time.

Illustration No.1:

From the following Trial Balance of Mr. Singh, prepare Trading and Profit and Loss Account for the year ended 31st Dec 2009

10.4 SUMMERY

Financial statements are crucial for decision-making, not only for management but also for external parties like investors, creditors, customers, suppliers, financial institutions, employees, potential investors, the government, and the general public. The analysis and interpretation of these statements depend on the information they provide.

Financial statements summarize the data recorded in a business, and they are usually prepared for a specific accounting period. There are two main types of financial statements:

1. **Balance Sheet** (Position Statement)
2. **Income Statement** (Profit and Loss Account)

According to Generally Accepted Accounting Principles (GAAP), a complete set of financial statements includes:

1. A balance sheet
2. An income statement
3. A statement of changes in the owner's equity
4. A statement of changes in financial position

The **Income Statement** shows the business's performance by listing the revenue earned and the expenses incurred to generate that revenue. If the revenue exceeds the expenses, there is a profit; if the expenses are higher than the revenue, a loss occurs. The Statement of Retained Earnings (also called the Profit and Loss Appropriation Account or Income Disposal Statement) shows how the earnings are distributed.

The Statement of Changes in Financial Position, also known as the Funds Flow Statement, provides information on how funds have moved in and out of the business during a period. This statement explains the sources and uses of funds and gives insights into the company's financial and investing activities.

10.5 SELF ASSESSMENT QUESTIONS

1-Mark Multiple Choice Questions:

1. **What is the primary objective of financial statements?**
   a) To record daily business transactions
   b) To provide information about a company's financial performance and position
   c) To track the inventory of a business
   d) To forecast future market trends
   Answer: b) To provide information about a company's financial performance and position
2. **Which financial statement provides a summary of a business's financial position at a specific point in time?**
   a) Income Statement
   b) Balance Sheet
   c) Statement of Cash Flows

d) Statement of Changes in Owner's Equity

Answer: b) Balance Sheet

3. **The Income Statement is also known as:**

   a) Statement of Changes in Financial Position

   b) Statement of Equity

   c) Profit and Loss Account

   d) Cash Flow Statement

   Answer: c) Profit and Loss Account

4. **What does the Statement of Changes in Owner's Equity primarily show?**

   a) Variations in a company's revenue and expenses

   b) Movements in the owner's equity over a period

   c) The company's cash inflows and outflows

   d) A detailed list of liabilities and assets

   Answer: b) Movements in the owner's equity over a period

5. **Which statement highlights the cash flows and financial restructuring of a business?**

   a) Income Statement

   b) Statement of Changes in Financial Position

   c) Balance Sheet

   d) Statement of Changes in Owner's Equity

   Answer: b) Statement of Changes in Financial Position

6. **The Balance Sheet includes which of the following components?**

   a) Revenue and expenses

   b) Assets, liabilities, and owner's equity

   c) Cash inflows and outflows

   d) Variations in retained earnings

   Answer: b) Assets, liabilities, and owner's equity

5-Mark Questions:

1. Define financial statements.
2. List the different types of financial statements.
3. Describe the difference between current and fixed assets with examples.
4. Illustrate how an income statement reflects the operational position of a business.
5. Critically evaluate the usefulness of financial statements in decision-making for investors.

10.6: REFERENCE:

1. Tulsian, P. C. (2002). *Financial accounting*. Pearson.
2. Rao, M. E. (2006). *Accounting for managers*. New Age International Private Limited.
3. Gupta, A. (2016). *Financial Accounting for Management Analytical perspective*. Pearson.

UNIT 11 FINANCIAL STATEMENT OF A COMPANY

Objectives:

After studying this unit, you should be able to Understand-

1. Preparation of Statement of Profit and Loss
2. Preparation of Statement of Balance Sheet

Structure:

11.1 INTRODUCTION

This unit focuses on the preparation and presentation of financial statements in compliance with **Schedule III of the Companies Act, 2013**, which provides a standardized framework for presenting financial information. It begins by outlining the **contents and forms** mandated under Section 129 of the Act, ensuring uniformity and comparability across companies. The unit then explains the prescribed **form for preparing the Statement of Profit and Loss**, highlighting its structure and components. Additionally, it introduces the **vertical form of a summarized Balance Sheet**, emphasizing major headings and key financial categories. These guidelines aim to enhance transparency and reliability in financial reporting, equipping learners with the knowledge to prepare compliant and professional financial statements.

11.2 SCHEDULE III OF THE COMPANIES ACT, 2013

Schedule III of the Companies Act, 2013 outlines the format and guidelines for preparing the Statement of Profit and Loss, Balance Sheet, and Notes to Financial Statements for all companies registered under the Act. Previously, the Old Schedule VI of the Companies Act, 1956 required updates to align with the notified accounting standards and improve disclosure requirements. To address this, the Ministry of Corporate Affairs issued a revised version of Schedule VI through Notification No. S.O. 447(E) on February 28, 2011. The revised Schedule VI applied to financial statements prepared for the financial year starting on or after April 1, 2011. Under the Companies Act, 2013, this revised schedule is now referred to as Schedule III.

As per section 2 (40) of the Companies Act, 2013 includes-

1. Balance sheet at the end of Financial Year
2. A Profit and Loss Account
3. Cash flow statement for the Financial Year
4. A Statement of change in Equity, if applicable
5. Any explanatory note annexed to or forming part of any documents referred to in sub-clause (i) to (iv)

11.2.1 Contents and Forms [Section 129]

1. The Balance Sheet must present a true and fair view of the company's financial position as of the end of the financial year. It should be prepared in the format specified in Part I of Schedule III.
2. The Statement of Profit and Loss must accurately reflect the company's profit or loss for the financial year. It should follow the format outlined in Part II of Schedule III.

11.3 FORM OF PREPARING A STATEMENT OF PROFIT AND LOSS

Vertical form has been referred under Companies Act, 2013 for Statement of Profit and loss of a Company

Specimen of Statement of Profit and Loss
Name of the Company…….

Statement of Profit and Loss for the year ended…..

Particulars	Note No.	Figure for the Current reporting period	Figure for the previous reporting period
I Revenue from Operations	1		
II Other Income	2		
III. Total Revenue [I+II]			
iv Expenses:			
Cost of Material Consumed	3		
Purchase of Stock in trade			
Changes in Inventories	4		
Employee Benefits Expenses	5		
Finance cost	6		

Depreciation and Amortization Expenses			
Other Expenses	8		
Total Expenses			
v. Profit before Tax (iii-iv)			
vi. Exceptional items			
vii. Profit before extra ordinary items			
Items and Tax (v-vi)			
viii. Extraordinary items			
ix. Profit before tax (vii-viii)			
X Tax expenses			
1) Current Tax			
2) Differed Tax			
xi) Profit/Loss for the Period			
xii) Earning per Equity Share			
1) Basic			
2) Diluted			

Illustration 1: From the following information prepare statement of Profit and Loss Account for the year ended 31st March 2018

Revenue from Operations	2605
Other Income	40
Cost of Material consumed	1,000
Changes in Inventories	275
Employee benefit expenses	850
Finance cost	20
Depreciation and amortization expenses	150
Other expenses	100
Tax rate 30%	

Solution:

Particulars	Note	Amount

	No.	(Rs)
I Revenue from Operations		2605
II Other Income		40
II Total Revenue (I+II)		2645
IV Expenses		
Cost of Material Consumed		1000
Changes in Inventories		-275
Employee Benefit Expenses		850
Finance Cost		20
Other Expenses		100
Total Expenses		1845
v. Profit before Tax (iii-iv)		800
vi. Tax Expenses @ 30%		-240
vii. Profit for the Period		560

11.4 VERTICAL FORM OF SUMMARIZED BALANCE SHEET WITH MAJOR HEADINGS

Part I schedule III to the Companies Act, 2013 prescribes only vertical form Balance Sheet of a Company-

Name of the Company

Balance Sheet As at…

EQUITY AND LIABILITIES	Note No	Figure for the Current Reporting Period	Figure for the Previous Reporting Period
(1) Shareholders' Funds			
a. Share Capital	1		
b. Reserves and Surplus eg Debit Balance of Profit & Loss A/C as negative figure	2		
c. Money received against Shares Warrants			
(2) Share Application Money pending Allotment			

(3)Non-Current Liabilities			
(a) Long-term Borrowings eg Bonds /Debentures/ Loans repayable 12 months	3		
b. Deferred tax liabilities (Net)			
c. Other long term liabilities eg. Trade payables to be settle after 12 month			
d. Long term provisions eg. Provision for employee benefit to be settled after 12 month			
4**. Current Liabilities**			
a. Short term borrowing ex. Loan repayable on demand	4		
b. Trade Payables	5		
c. Other Current liabilities eg. Bank overdraft, unpaid divided, matured deposit	6		
d. Short term Provisions ex. Provision for tax , proposed divided etc.	7		
II Assets			
I. No Current Assets			
a. Fixed Assets			
i. Tangible Assets	8		
ii. Intangible Assets	9		
iii. Capital work in Progress			
iv. Intangible assets under Development			
b. No Current investments ex. Investment in property	10		
c. Deferred Tax Assets (Net)			
d. Long term loans and advances	11		
e. Other Non Current Assets	12		
2. Current Assets			
a, Current investments	13		

b. Inventories eg. Raw materials, work in progress, finished goods	14		
c. Trade Receivables	15		
d. Cash and Cash equivalents	16		
e. Short term loans and Advances	17		
f. Other Current Assets	18		

Illustration 2: From the following information prepare a Balance Sheet of XYX ltd as on 31st march 2018, as per schedule III to the Companies Act.

P&L A/c (Dr.)	200
12% Debentures	200
Proposed Dividend	20
Equity Share Capital (10 each)	500
Cheques & Drafts on hand	48
15% Pref Share Capital (100 each)	400
Prepaid Expenses	50
Bank Overdraft	45
Interest accrued on Debentures of Tata Steels	12
Building under construction	115
2,500.12% Tata Steel Deb. of 100 each, 80 paid up	200
Premium on Red. of Debentures	20
Application Money pending allotment	40
Bills Payables	75
Calls-in Advance	5
Employees' earned leave payable on Retirement	45
Stores & Spares	50
Securities Deposit for Telephone	5
Brands	110
Computer Software under development	20
Bills Receivables	120

Plant & Machinery	120
2% Debentures of Reliance Ltd. (20% Redeemable within 1 year	100
Investment in Land & Building	200

Solution:

XYZ Ltd

Balance Sheet 31st March, 2018

Particulars	Note No	Current year (Rs)	Previous Year (Rs)
I. 1. EQUITY AND LIABILITIES			
(1) Shareholders' Funds			
(a) Share Capita	1	900	
(b) Reserves and Surplus [P & L A/c (Dr.)		-200	
(2) Share Application Money pending Allotment		40	
(3) Non-Current Liabilities			
(a) Long term Borrowings [12% Debentures]		200	
(b) Other Long term Liabilities			
(Premium on Red of Debentures)		20	
(c) Long term Provisions (Earned Leave)		45	
(4) Current Liabilities			
(a) Trade Payables (B/P)		75	
(b) Other Current Liabilities	2	50	
(c) Short term Provisions (Proposed Dividend)		20	
Total		1150	
II Assets			
(1) Non Current Assets			
(a) Fixed Assets			
(i) Tangible Assets (plants and Machinery)		120	
(ii) Intangible Assets (Brands)		110	

(iii) Capital work in progress (building)		115	
(iv) Intangible Assets under development		20	
(b) No Current Investments	3	480	
© Long term Loans and advances (Security)		5	
(2) Current Assets			
(a) Current Investments (Deb of Reliance Ltd)		20	
(b) Inventories (Store and Spares)		50	
© Trade Receivables		120	
(d) Cash and Cash Equivalents		48	
(e) other Current Assets	4	62	
Total		1150	

11.5 UNIT SUMMERY

In this unit, we have explored the standardized formats and statutory requirements for financial statements as outlined in **Schedule III of the Companies Act, 2013**. Key topics include the **contents and forms** under Section 129, the prescribed structure of the **Statement of Profit and Loss**, and the **vertical form of a summarized Balance Sheet** with its major headings. These guidelines ensure that companies prepare financial statements that are compliant, transparent, and easily interpretable by stakeholders, facilitating informed financial decisions and fostering trust in corporate reporting.

11.7 CHECK YOUR PROGRESS

1-Mark Questions

1. **What is the primary purpose of Schedule III of the Companies Act, 2013?**
   a) To regulate tax calculations for companies
   b) To standardize the format and presentation of financial statements
   c) To provide rules for auditing practices
   d) To determine dividend distribution policies
   Answer: b) To standardize the format and presentation of financial statements
2. **Which section of the Companies Act, 2013 specifies the contents and forms of financial statements?**
   a) Section 125
   b) Section 129
   c) Section 133

d) Section 135

Answer: b) Section 129

3. **What is the prescribed format for presenting a company's financial performance?**

   a) Balance Sheet

   b) Statement of Profit and Loss

   c) Statement of Cash Flows

   d) Notes to Accounts

   Answer: b) Statement of Profit and Loss

4. **How is the Balance Sheet presented under Schedule III?**

   a) Horizontal form with detailed explanations

   b) Vertical form with major headings and classifications

   c) In the form of a flowchart

   d) As a summary of cash transactions only

   Answer: b) Vertical form with major headings and classifications

5. **Which of the following is a major heading in the vertical Balance Sheet?**

   a) Equity and liabilities

   b) Profit and loss items

   c) Employee performance metrics

   d) Marketing expenses

   Answer: a) Equity and liabilities

6. **Why is the vertical form of Balance Sheet important?**

   a) It highlights cash transactions only.

   b) It provides a clear classification of assets and liabilities.

   c) It is used for internal audit purposes only.

   d) It eliminates the need for preparing Notes to Accounts.

   Answer: b) It provides a clear classification of assets and liabilities.

7. **What is included in the Statement of Profit and Loss?**

   a) Only revenues

   b) Only liabilities

   c) Revenues and expenses to determine the net profit or loss

   d) Only assets and equity

   Answer: c) Revenues and expenses to determine the net profit or loss

8. **Schedule III ensures that financial statements are:**

   a) Focused only on tax reporting

   b) Uniform, comparable, and transparent

   c) Prepared for internal use only

   d) Adjusted according to personal company preferences

   Answer: b) Uniform, comparable, and transparent

9. **What additional component is often prepared alongside the Balance Sheet and Profit and Loss Statement?**

a) Statement of Equity Changes
b) Sales Report
c) Marketing Strategy
d) Employee Payroll Details
Answer: a) Statement of Equity Changes

10. **The vertical form of the Balance Sheet categorizes information primarily into:**
a) Short-term and long-term transactions
b) Assets, liabilities, and equity
c) Revenues and expenditures
d) Profit and loss accounts
Answer: b) Assets, liabilities, and equity

11.12 REFERENCE:

1. Tulsian, P. C. (2002). *Financial accounting*. Pearson.
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UNIT 12 FINANCIAL STATEMENT ANALYSES

Objectives:

After studying this unit, you should be able to Understand

1. The role of ratio analysis as a principal tool of financial analysis.
2. How to assess the relationships between various items in a firm's financial statements using ratios.
3. To develop the ability to interpret financial statements effectively through the use of ratios.
4. To recognize the importance of interpreting ratios to evaluate the financial strengths and weaknesses of a firm.
5. To gain insights into the precautions and guidelines necessary while interpreting various financial ratios.

STRUCTURE:

12.1 INTRODUCTION

This unit delves into **Ratio Analysis**, a vital tool in financial analysis used to evaluate the performance and financial health of an organization. It begins with an introduction to the meaning and objectives of ratio analysis, emphasizing its importance in providing insights for decision-making. The unit explores the **advantages and uses** of ratio analysis while also addressing its **limitations** to offer a balanced understanding. It further classifies ratios based on **financial statements** and **user requirements**, tailoring their application to various stakeholders. Additionally, the unit introduces **Common Size Statements** and **Comparative Analysis**, which complement ratio analysis by enabling trend evaluation and benchmarking. These concepts equip learners with the analytical tools required to interpret financial data effectively and support strategic planning.

12.2 MEANING OF RATIO ANALYSIS:

Financial ratios are calculated by dividing one figure by another and are typically presented as percentages (%). They allow business owners to explore connections between seemingly unrelated financial elements, aiding in decision-making processes. Simple to compute, user-friendly, and easily comprehensible even to non-specialists, financial ratios provide unique and valuable insights that are otherwise unavailable. While ratios serve as tools to enhance judgment, they cannot substitute experience or management skills. Instead, they complement good management by enhancing its effectiveness.

The concept of ratio analysis enables the comparison of virtually any financial metrics, helping businesses identify areas for improvement. Small business owners and managers can focus on a limited set of key ratios tailored to their specific needs, such as the scale of operations, business age, current phase in the business cycle, or the information sought. In essence, "different ratios address different challenges," as some highlight trends, progress, or decline within the business.

However, it is important to note that ratio analysis is not an end goal but a tool for deeper insight into the financial strengths and weaknesses of an organization’s position.

12.2.1 Objectives of Ratio Analysis

1. **Assess Short-term Liquidity**: To check if the business can meet its short-term debts as they become due.

2. **Evaluate Long-term Solvency**: To determine if the business can regularly pay interest and repay its loans on time.
3. **Measure Operating Efficiency**: To see how effectively the business is using its resources to generate revenue.
4. **Analyze Profitability**: To understand how much profit the business earns from its operations and investments.
5. **Compare within the Business (Intra-firm)**: To evaluate the financial performance of the business over time, identify strong and weak areas, and take corrective steps.
6. **Compare with Other Businesses (Inter-firm)**: To compare the financial position and performance of the business with others in the same industry, identify strengths and weaknesses, and make improvements where needed.

12.2.2 Advantages and Uses of Ratio Analysis

1. Assessing Liquidity (Short-term Solvency):

Liquidity ratios like the Current Ratio and Quick Ratio help determine if the business can meet its short-term obligations on time, which is useful for creditors like banks and suppliers.

13 Evaluating Long-term Solvency:

Solvency ratios, such as the Debt-to-Equity Ratio, allow long-term creditors and investors to check if the business can pay regular interest and repay loans when due.

14 **Measuring Operational Efficiency**

Ratios like Working Capital Turnover, Inventory Turnover, and Debtors Turnover show how effectively the business uses its resources to generate revenue.

15 **Analyzing Profitability**:

Ratios such as Gross Profit, Net Profit, and Return on Investment help measure how well the business generates profits. These insights guide current investors on holding, selling, or buying shares and help potential investors decide on investing.

16 **Internal Performance Comparison**:

By comparing ratios from different time periods, businesses can track their performance over time, identify problem areas, and make improvements.

17 **External Comparison with Other Companies**:

Comparing a company's ratios with those of competitors helps understand its standing in the market and identify strengths or weaknesses.

18 **Industry Benchmarking**:

Comparing the company's ratios to industry standards helps evaluate its position within the industry, highlighting areas for improvement and strengths to leverage.

12.2.3 Limitations of Ratio Analysis

1. **Ignores Non-Financial Factors**

   Ratio analysis focuses only on numbers and doesn't consider qualitative aspects. For example, a customer might seem financially sound based on their statements, but their intent or reliability to repay loans may be questionable.

2. **Doesn't Adjust for Price Changes**:

   Ratios can be misleading if inflation or price changes aren't factored in. For example, the Fixed Asset Turnover Ratio might show a positive picture unless the assets are valued at current replacement costs.

3. **Subject to Personal Judgment**:

   Accountants often have to make subjective choices, such as selecting methods for depreciation (e.g., straight-line vs. written-down) or inventory valuation (e.g., FIFO vs. LIFO). These decisions can introduce personal bias, affecting the ratios derived from the financial statements.

4. **Historical Nature**:

   Ratios are based on past data from financial statements, which may not always reflect the current or future financial condition unless projected financial data is used.

5. **Indicates Problems but Doesn't Solve Them**:

Ratios only highlight potential issues, much like symptoms in the human body. The management must investigate the underlying causes to address the issues.

6. Overlooks Context Behind Numbers:

   Ratios don't account for specific circumstances affecting the figures. For instance, a low Quick Ratio for a dry fruit merchant just before a festival might reflect inventory buildup for upcoming sales, not a poor financial position.

7. Accuracy Depends on Financial Records**:**
   Ratios are only as reliable as the data they are based on. If accounts are inaccurate, such as an overvalued closing inventory, profitability and financial health may appear better than they actually are.

12.3 CLASSIFICATION OF RATIOS ON THE BASIS OF FINANCIAL STATEMENTS

Income Statement Ratios	Gross Profit Ratio, Operating Profit Ratio, Net Profit Ratio
Position Statement Ratios	These Ratios are calculated based on based on balance sheet items. Example: Current Ratio, Quick Ratio, Debt Equity Ratio
Composite Ratios	These ratios are calculated based on the items of Balance sheet and Income statement. Example-Inventory Turnover Ratio, Debtors Turnover Ratio, Creditors Turnover Ratio, Return on Investment

12.4 **CLASSIFICATION OF RATIOS BASED ON USER REQUIREMENTS**

Ratios can be categorized to meet the needs of different users such as short-term creditors, long-term creditors, management, and investors. The four main types of ratios are:

1. Liquidity Ratios

Liquidity ratios assess the ability of a business to meet its short-term liabilities as they fall due. These ratios provide insights into the enterprise's short-term financial health.

Types of Liquidity Ratios

1. Current Ratio

The Current Ratio compares a company's Current Assets to its Current Liabilities, indicating its ability to cover short-term obligations. The primary goal of the Current Ratio is to measure the business's capacity to meet short-term liabilities when they become due. It also evaluates the margin of safety for short-term creditors.

Components of Current Ratio

There are two components of Current Ratio

a. **Current Assets**

Current assets are resources that are either already in cash or can be easily converted into cash within the operating cycle or within 12 months from the balance sheet date. The classification of an asset as current or non-current depends on the purpose for which it is held.

Examples of Current Assets

a. Current Investments

Investments with a maturity period of more than 3 months but not exceeding 1 year from the date of purchase.

b. **Inventories**

Includes raw materials, work-in-progress, finished goods, stores, spares, and loose tools.

c. **Trade Receivables**

Includes amounts such as bills receivable that are expected to be collected within 12 months.

d. **Cash and Cash Equivalents**

Includes cash in hand, bank balances, cheques/drafts, and short-term investments maturing within 3 months.

e. **Short-term Loans and Advance**

Loans and advances expected to be received within 12 months, such as advance tax payments.

f. **Other Current Assets**

Includes items like prepaid expenses, accrued income, and advance tax payments.

Calculation of Current assets

a. Current Assets= Current Investments+ Inventories+ Trade Receivables +Cash and Cash Equivalents + Short-term Loans and Advances + Other Current Assets
b. Current Assets= Current Liabilities + Working Capital
Working Capital = Current Assets- Current Liabilities
c. Current Assets=Total Assets-Non Current Assets

b. Current Liabilities

Current liabilities are obligations expected to be settled within the operating cycle or within 12 months from the balance sheet date.

Examples of Current Liabilities

1. Short-term Borrowings

These include loans repayable on demand or within 12 months and deposits or advances that need to be repaid within the same period.

2. Trade Payables

Includes amounts owed for goods or services, such as trade payables and bills payable that are due within 12 months.

3. Other Current Liabilities includes:

Bank overdrafts, unpaid dividends, Matured but unpaid deposits or debentures, Current portion of long-term borrowings due within 12 months, Accrued interest (whether due or not) on borrowings, Calls-in-advance, Outstanding expenses, Taxes payable, Income received in advance

4. Short-term Provisions

Includes provisions for items like: Taxes payable, proposed dividends, Employee benefits due within 12 months

Calculation of Current Liabilities:

(a) Current Liabilities= Short-Term Borrowings+ Trade Payables + Other Current Liabilities + Short-Term Provisions

(b) Current Liabilities= Current Assets - Working Capital

(c) Current Liabilities= Total Debts (Whether Long-term or Short-term) - Non-Current Liabilities

Computation of Current Ratio

Current ratio is computed by dividing the Current Assets by the Current Liabilities. It is expressed as follows-

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

Interpretation of Current Ratio

The Current Ratio shows how many rupees of current assets are available to cover each rupee of current liabilities. A higher ratio indicates a greater safety margin for short-term creditors, while a lower ratio suggests higher risk.

Traditionally, a Current Ratio of **2:1** is considered ideal. This means if the ratio is **2 or higher**, the firm is considered financially stable and capable of meeting its short-term liabilities. However, if the ratio is below **2**, it may indicate potential difficulties in paying off current obligations. The reasoning behind the 2:1 rule is that even if the value of current assets decreases by half, the firm can still meet its short-term debts.

An excessively high Current Ratio might suggest over-investment in current assets, leading to idle funds and reduced profitability, as idle funds generate no returns. Conversely, a very low Current Ratio could mean insufficient investment in current assets, leading to poor liquidity and potential solvency risks. Generally, higher liquidity often results in lower profitability, and vice versa.

Illustration 1:

From the following information, calculate Current Ratio

Particulars	**Amount (₹)**	**Particulars**	**Amount (₹)**
Trade Payables	70,000	**Inventories**	95,000

Advance tax	4,000	Trade receivables	3,40,000
Short term borrowings	10,000	Current investments	10,000
Accrued income	2,000	Provision for Doubtful Debts	30,000
Other current liabilities	20,000	Cash & Cash Equivalents	10,000
Short term provisions	1,20,000	Short term loans and Advances	4,000
Prepaid Expenses	5,000		

Solution:

Calculation of Current assets and Current Liabilities

Current Assets	**Amount (Rs)**	**Particulars**	**Amount (Rs)**
Current investments	10,000	**Short Term Borrowings**	10,000
Inventories	95,000	Trade Payables	70,000
Trade Receivables	3,10,000	Other Current Liabilities	20,000
Cash and Cash Equivalents	10,000	Short Term Provisions	1,20,000
Short term loans and Advances	4,000		
Other Currrent Assets (4,000+2,000+5,000)	11,000		
	4,40,000		**2,20,000**

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

$= \frac{4,40,000}{2,20,000} = 2:1$

2. **Quick Ratio / Liquid Ratio / Acid Test Ratio**

Quick Ratio establishes the relationship between Quick Assets and Current Liabilities. The purpose of this ratio is to assess the firm's ability to meet its short-term obligations as they fall due, without relying on the sale or realization of inventories

Components of Quick Ratio

a. **Quick Assets**

Quick Assets are those current assets that can be converted into cash immediately or within a short time frame without a loss in value.

Examples of Quick Assets:

a. **Current Investments**:

Investments with a maturity period of more than 3 months but not exceeding 1 year from the date of acquisition.

b. **Trade Receivables**:

Includes trade receivables and bills receivables collectible within 12 months.

c. **Cash and Cash Equivalents**:

Includes bank balances, cheques or drafts on hand, cash balances, and investments maturing within 3 months.

d. **Short-term Loans and Advances**

Includes loans and advances receivable within 12 months, such as advance tax payments.

Calculation of Quick Assets

a) Quick Assets Current Investments + Trade Receivables + Cash and Cash Equivalents + Short-term Loans and Advances
b) Quick Assets Current Assets-Inventories-Other Current Assets

b. Current Liabilities:

Current Liabilities refer to those liabilities which are expected to be settled within Operating Cycle or 12 months from the date of Balance Sheet.

Examples of Current liabilities

1. Short-Term Borrowings

e.g. Loans repayable on demand or within 12 months, Deposits/ Advances repayable within 12 months

2. Trade Payables

e.g. Trade Payables, Bills Payables to be settled within 12 months

3. Other Current Liabilities

e.g. Bank Overdraft, Unpaid Dividend, Unpaid matured Deposits, Unpaid matured Debentures, That portion of Long-term Borrowings repayable within 12 months, Interest accrued (whether due or not) on borrowings, Calls-in-Advance, Outstanding Expenses, Tax Payable, Incomes received-in-advance]

4. Short-Term Provisions

e.g. Provision for Tax, Proposed Dividend, Provision for Employee Benefits to be settled within 12 months

Calculation of Current Liabilities

a) Current Liabilities = Short-Term Borrowings + Trade Payables + Other Current Liabilities + Short-Term Provisions
b) Current Liabilities = Current Assets-Working Capital
c) Current Liabilities = (Quick Assets+ Inventories+ Other Current Assets)-Working Capital
d) Current Liabilities= Total Debts-Non-Current Liabilities
e) Current Ratio= Current Assets/Current Ratio

Computation of Quick Ratio

The Quick Ratio is calculated by dividing Quick Assets by Current Liabilities. It is typically expressed as a pure ratio, such as 1:1. The formula for Quick Ratio is as follows:

Quick Ratio = Quick Assets ÷ Current Liabilities

Interpretation of Quick Ratio

The Quick Ratio represents the amount of quick assets available for each rupee of current liability. Traditionally, a ratio of **1:1** is considered satisfactory. However, this benchmark should not be applied blindly.

A firm with a quick ratio higher than 1 may still struggle to meet its short-term obligations if its quick assets include doubtful or slow-paying debtors. Conversely, a firm with a quick ratio below 1 could still meet its obligations on time if it has highly efficient inventory management.

3. **Absolute Cash/Liquidity Ratio**

The Absolute Cash/Liquidity Ratio shows the connection between an organizations's Cash and Marketable Securities and its Current Liabilities. The main purpose of this ratio is to check how well a business can quickly pay off its short-term debts without depending on the sale of inventory or collection from trade receivables.

Components of Absolute Cash/Liquidity Ratio

This ratio consists of two main components:

1. **Cash and Marketable Securities**
2. **Current Liabilities**

Calculation of Absolute Cash/Liquidity Ratio

The Absolute Cash/Liquidity Ratio is calculated by dividing **Cash and Marketable Securities** by **Current Liabilities**. It is typically represented as a simple ratio, such as 1:1.

The formula for this ratio is:

$$\text{Absolute Cash/ Liquidity Ratio} = \frac{Cash\ and\ Marketability\ Securities}{Current\ Liabilities}$$

Interpretation of Absolute Cash/Liquidity Ratio

This ratio shows how much Cash and Marketable Securities are available for every rupee of Current Liabilities. A very high ratio means the company has strong liquidity, but it might affect profitability. This is because idle cash doesn't earn returns, and marketable securities usually provide lower returns compared to the company's operating profit margin.

Illustration 2: From the following information calculate Absolute Cash/Liquidity Ratio-

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Current Investment Inventories Trade receivables Cash and cash equivalents	1,00000 4,00000 3,50,000 2,00000	Short term borrowings Trade payables Other current liabilities	1,10,000 3,70,000 20,000

Solution: Absolute Cash/Liquidity Ratio= Cash + Marketable Securities/Current Liabilities

= (2, 00000+1, 00000)/5, 00000= 0.6

4. Meaning of Internal Interval Measure Ratio

The Internal Interval Measure Ratio shows the relationship between Quick Assets and the Average Daily Operating Expenses of a business. The purpose of this ratio is to determine how many days, on average; the quick assets can cover daily operating expenses.

Components of Internal Interval Measure Ratio

The two main components of this ratio are:

1. **Quick Assets**: These are Current Assets excluding Stock and Prepaid Expenses.
2. **Average Daily Operating Expenses**: Calculated as:

   Cost of Goods Sold + Other Operating Expenses – Non cash operating cost (eg: Depreciation)/No. of days in a year

Calculation of Internal Interval Measure Ratio

This ratio is calculated by dividing Quick Assets by Average Daily Operating Expenses. It is typically expressed in terms of the number of days, weeks, or months. The formula is:

Internal Interval Measure Ratio=Quick Assets / Average Daily Operating

Illustration 1: From the following information calculate Internal Interval Measure Ratio-

Current Investment	1,00,000	Cost of goods sold	8,00,000

Inventories	4,00,000	Other operating Expenses	50,000
		Depreciation	1,20,000
Trade receivables	3,50,000	Provision for Doubtful debts	50,000
Cash and cash equivalents	2,00,000		

Solution: Quick Assets (3, 50,000-50,000) +2, 00,000+₹1, 00,000 = 6, 00,000

Average Daily Operating Expenses (8, 00,000+ 50,000-1, 20,000)/365= 2,000

Internal Interval Measure Ratio= Quick Assets/Average Daily Operating Expenses

= 6, 00,000 /2,000 = 300 days

1.6.2 Solvency Ratio

Long-term creditors focus on the company's ability to stay financially stable in the long term because their funds are tied up for extended periods (over one year). Long-term solvency refers to the company's capacity to meet its long-term financial obligations as they become due. Creditors providing long-term loans are primarily concerned with:

1. **Safety of Principal**: Ensuring the loan amount remains secure throughout the loan period.
2. **Timely Loan Servicing**: This includes: **Paying interest** on the loan regularly, **repaying the loan** through scheduled installments.

For example, if a company takes a loan of ₹1 crore at 12% interest for 5 years, repayable in 60 EMIs of ₹2, 10,000, the lender will want to ensure:

a. The ₹1 crore principal is secure for the full 5-year term.
b. The EMIs of ₹2, 10,000 are paid on time each month.

Solvency ratios evaluate a company's long-term financial health. They assess whether the business can consistently pay interest and repay the principal amount either at maturity or through scheduled installments on time.

Types of Solvency Ratio

Category	Ratios

Capital Structure Ratios	1. Debt-Equity Ratio 2. Debt to Total Assets Ratio 3. Proprietary Ratio 4. Capital Gearing Ratio 5. Equity Ratio
Coverage Ratios	6. Interest Coverage Ratio 7. Preference Dividend Coverage Ratio 8. Debt Service Coverage Ratio 9. Fixed Charges Coverage Ratio

1. Debt Equity Ratio

The Debt-Equity Ratio shows the relationship between a company's Debt (Non-Current Liabilities) and Equity (Shareholders' Funds). The main purpose of calculating the Debt-Equity Ratio is to assess the company's long-term financial stability. It measures whether the company can:

1. Pay interest on its debt regularly.
2. Repay the principal amount at maturity or in scheduled installments.

Components of Debt-Equity Ratio

The ratio has two key components:

1. **Debt**: This refers to Non-Current Liabilities, such as: Long-term borrowings (e.g., Debentures, Bonds, and Term Loans from Banks or Financial Institutions), Long-term provisions.

   Debt can be calculated in different ways:

   Debt = Long-term Borrowings + Long-term Provisions

   Debt = Total Debt - Current Liabilities

   Debt = Capital Employed - Equity
   (Where Capital Employed = Equity + Debt)

2. **Equity**: This represents funds provided by shareholders (both equity and preference).

   Equity can also be calculated using various methods:

   Equity = Equity Share Capital + Preference Share Capital + Reserves & Surplus

Equity = Non-Current Assets + Current Assets - Current Liabilities - Non-Current Liabilities

Equity = Non-Current Assets + Working Capital - Non-Current Liabilities

Equity = Capital Employed - Non-Current Liabilities

Equity = Total Assets - Total Debt

Computation of Debt Equity Ratio

The Debt-Equity Ratio is calculated by dividing the total Debt by the total Equity. It is typically represented as a simple ratio, such as 2:1. Mathematically, it can be expressed as:

Debt-Equity Ratio = Debt ÷ Equity

Interpretation of Debt-Equity Ratio

The Debt-Equity Ratio measures the safety margin for long-term creditors. It shows how much equity is used compared to debt in financing the business. A lower ratio indicates more equity than debt, providing a higher safety margin for creditors since equity acts as a cushion for repayment. On the other hand, a higher ratio means greater reliance on debt, which increases risk for creditors.

Typically, a Debt-Equity Ratio of **2:1** (debt being twice the equity) is considered ideal. The ratio's impact can be explained as follows:

A. Low Debt-Equity Ratio

Implications for Creditors:

1. Provides a greater margin of safety, as the business relies more on equity than debt.

Implications for the Firm:

1. Easier to manage debt payments.
2. Less pressure and interference from creditors in decision-making.
3. Easier to secure additional loans if needed.
4. Limited benefit from "trading on equity" (leveraging debt for higher returns) when the firm's returns are higher than interest costs.

B. High Debt-Equity Ratio

Implications for Creditors:

1. Increases risk, as debt is significantly higher than equity.

Implications for the Firm:

1. Debt payments become difficult during tough business conditions.
2. Creditors may exert more pressure and influence on management decisions.
3. Raising additional loans becomes challenging.
4. Higher potential gains from "trading on equity" if returns exceed the cost of borrowing.

Illustration No.1: From the following information calculate Debt equity Ratio-

Equity share capital (10 each)	1,50,000	Tangible Fixed Assets	9,00,000
8% Preference share capital	1,00,000	Intangible fixed Assets	1,50,000
Reserve and Surplus	1,50,000	Noncurrent Investments	50,000
15% long term borrowing	8,00,000	Current Assets	5,00,000
Current liabilities	4,00,000		

Solution:

Debt = Long-term Borrowings = 8, 00,000

Equity = Equity Share Capital + Pref. Share Capital + Reserves & Surplus

1, 50,000+ 1, 00,000+1, 50,000= 4, 00,000

Or

Equity = Non-Current Assets + Current Assets - Current Liabilities – Non Current Liabilities

(9, 00,000+1, 50,000+50,000) + 5, 00,000- 4, 00.000-8, 00,000= 4, 00,000

Debt Equity Ratio= Long term Debts/Shareholder's fund

8, 00000/4, 00000 = 2:1

2. **Debt to Total Assets Ratio**

The Debt to Total Assets Ratio shows the relationship between a company's debt and its total assets. This ratio measures how much of a company's total assets are financed through debt. It helps assess the safety margin for long-term debt providers by showing the extent to which debt is supported by assets.

The ratio has two main components:

1. **Debt:** Refers to non-current liabilities, which are obligations expected to be settled after 12 months. Examples include long-term borrowings like debentures, bonds, loans from banks, financial institutions, long-term provisions, and advances.

Debt can be calculated in different ways:

Debt = Long-term Borrowings + Long-term Provisions

Debt = Total Debt - Current Liabilities

Debt = Capital Employed - Equity

2. **Total Assets:** Represents all assets, including non-current and current assets. Total Assets can also be calculated in different ways:

   Total Assets = Non-Current Assets + Current Assets

   Total Assets = Equity Share Capital + Preference Share Capital + Reserves & Surplus + Non-Current Liabilities + Current Liabilities

   Total Assets = Shareholders' Funds + Non-Current Liabilities + Current Liabilities

   Total Assets = Capital Employed + Current Liabilities

Computation

The Debt to Total Assets Ratio is calculated by dividing a company's total debt by its total assets. It is expressed as a simple ratio, such as 2:1. The formula is:

Debt to Total Assets Ratio = Debt ÷ Total Assets

Interpretation of Debt to Total Assets Ratio

The Debt to Total Assets Ratio highlights the safety margin available to long-term creditors. A **high ratio** indicates that the company relies more on debt to finance its assets, which increases risk for creditors. Conversely, a **low ratio** means the company is using more equity, providing a greater safety margin for creditors as equity is considered a cushion for repayment.

Illustration 1: From the following information calculate Debt to Total Assets-

Particulars	Amount (₹)
Equity Share Capital (₹10 each)	1,50,000
18% Preference Share Capital	1,00,000
Reserves & Surplus	1,50,000
15% Long-term Borrowings	8,00,000
Current Liabilities	4,00000
Tangible Fixed Assets	9,00,000
Non-Current Investments	50,000
Current Assets	5,00,000
Intangible fixed Assets	1,50,000

Solution:

Debt =Long-term Borrowings = 8, 00000
Total Assets = Non-Current Assets + Current Assets

(9, 00,000+1, 50,000 +50,000) +5, 00000 = 16, 00,000

Or. Total Assets = Equity Share Capital + Pref. Share Capital+ Reserves & Surplus+ Non-Current Liabilities + Current Liabilities

1,50,000 + 1,00,000+ 1,50,000+ 8,00,000 + 4,00,000= 16,00,000

Debt to Total Assets Ratio= Debt/ Total Assets = 8, 00000/16, 00000 = 1:2

3. Proprietary Ratio

The Proprietary Ratio represents the relationship between the proprietors' funds (or shareholders' funds) and the total assets of a business. The primary aim of calculating the proprietary ratio is to determine the proportion of total assets financed by the proprietors' funds. This ratio indicates the financial stability and solvency of a business.

Components of the Proprietary Ratio

The proprietary ratio consists of two main components:

1. **Proprietors' Funds (or Shareholders' Funds)**
   These represent the funds owned by all shareholders, including equity and preference shareholders. Proprietors' funds can be calculated in various ways:

a. Proprietors' Funds=Equity Share Capital+ Preference Share Capital + Reserves and Surplus
b. Proprietors' Funds=Non Current Assets +Current Assets− (Current Liabilities +Non-Current Liabilities)
c. Proprietors' Funds=Capital Employed−Non-Current Liabilities
d. Proprietors' Funds=Non-Current Assets +Working Capital−Non-Current Liabilities
e. Proprietors' Funds=Total Assets−Total Debts

2. **Total Assets**

This refers to all the assets owned by the business, including both non-current and current assets. Total assets can be calculated in several ways:

a. Total Assets=Non-Current Assets + Current Assets
b. Total Assets=Equity Share Capital +Preference Share Capital Reserves and Surplus +Non-Current Liabilities+ Current Liabilities
c. Total Assets=Shareholders' Funds+ Non Current Liabilities + Current Liabilities
d. Total Assets=Capital Employed +Current Liabilities
e. Total Assets=Shareholders' Funds +Total Debts

Computation of Proprietary Ratio

The **Proprietary Ratio** is calculated by dividing the proprietors' funds by the total assets. It is typically expressed as a simple ratio, such as 1:4. The formula for the proprietary ratio is:

Proprietary Ratio $= \frac{\text{Propritors' Fund}}{Total\ Assets}$

Interpretation of Proprietary Ratio

The proprietary ratio highlights the extent to which the assets of a business are financed through proprietors' funds.

A **high proprietary ratio** indicates a strong financial position, with a larger safety margin for creditors. It also suggests that the enterprise relies less on borrowed funds, meaning it does not fully capitalize on trading on equity.

A **low proprietary ratio** signals a higher level of risk for creditors, as the business depends more on external financing. However, it also implies that the enterprise is leveraging borrowed funds to potentially enhance returns through trading on equity.

4. Capital Gearing Ratio

The **Capital Gearing Ratio** represents the relationship between funds with fixed financial obligations and the equity shareholders' funds. The purpose of calculating this ratio is to assess the proportion of funds requiring fixed financial payments relative to the equity shareholders' funds.

Components of Capital Gearing Ratio

The ratio consists of two primary components:

1. **Funds with Fixed Financial Obligations**

   These include financial instruments and borrowings that involve fixed payment commitments, such as Debentures, Bonds, and Loans from financial institutions Preference share capital

2. **Equity Shareholders' Funds**

   This refers to the funds belonging to equity shareholders, calculated as:

   Equity Shareholders' Funds=Equity Share Capital Reserves and Surplus−Fictitious Assets

Computation of Capital Gearing Ratio

The **Capital Gearing Ratio** is determined by dividing the funds with fixed financial obligations by the equity shareholders' funds. It is expressed as a simple ratio, such as 3:1. The formula is:

Capital Gearing Ratio= $\frac{\text{Fund bearing fixed financial payments}}{Equity\ shareholder's fund}$

Interpretation of Capital Gearing Ratio

The capital gearing ratio reflects the margin of safety available to providers of funds with fixed financial obligations.

A high capital gearing ratio indicates greater reliance on funds with fixed financial payments (such as loans or preference shares) compared to equity. This implies **a** lower safety margin for providers of fixed-payment funds, as equity acts as their cushion. Conversely, a low capital gearing ratio signifies greater reliance on equity, which provides a higher safety margin for fixed-payment fund providers.

If the ratio is **less than 1**, the company is considered **lowly geared**, meaning equity forms a larger portion of the capital structure. If the ratio is **greater than 1**, the company is deemed **highly geared**, meaning it relies more on fixed-payment funds.

The capital gearing ratio also highlights the level of risk associated with meeting fixed financial obligations and the potential for trading on equity. The implications of being highly geared or lowly geared are as follows:

Basis of Comparison	**Highly Geared Company**	**Lowly Geared Company**
Risk	High	Low
Opportunity for Trading on Equity	High	Low
Equity Shareholders' Gain	- Increases significantly if ROI > Interest & Pref. Dividend rate - Decreases significantly if ROI < Interest & Pref. Dividend rate	- Increases moderately if ROI > Interest & Pref. Dividend rate - Decreases moderately if ROI < Interest & Pref. Dividend rate

A business should maintain a **balanced gearing ratio**, avoiding extremes of very high or very low gearing. To determine whether the ratio is satisfactory, it should be compared against:

1. The company's historical ratios.
2. Ratios of other similar companies in the same industry.
3. The industry average.

5. Equity Ratio

The **Equity Ratio** expresses the relationship between shareholders' funds and capital employed in a business. The primary purpose of calculating the equity ratio is to determine the proportion of shareholders' funds in the total capital employed by the business.

Components of Equity Ratio

The equity ratio has two main components:

1. **Shareholders' Funds**

This refers to the total funds contributed by both equity and preference shareholders. Shareholders' funds can be calculated using various methods:

a. Shareholders’ Funds=Equity Share Capital Preference Share Capital Reserves and Surplus
b. Shareholders' Funds= Non-Current Assets + Current Assets - Current Liabilities - Non- Current Liabilities
c. Shareholders' Funds = Capital Employed-Non-Current Liabilities
d. Shareholders' Funds = Non-Current Assets + Working Capital-Non-Current Liabilities
e. Shareholders' Funds Total Assets - Total Debts

2. **Capital Employed**

This represents the total long-term funds provided by both long-term creditors and shareholders. It includes non-current liabilities and shareholders' funds. Capital employed can be calculated as follows:

a. Capital Employed = ((Equity Share Capital + Pref. Share Capital + Reserves & Surplus)]+ Non-Current Liabilities.
b. Capital Employed= Shareholders' Funds + Non-Current Liabilities
c. Capital Employed= Non-Current Assets (Excluding Non-Trade Investments) + Current Assets-Current Liabilities
d. Capital Employed= Non-Current Assets (Excluding Non-Trade Investments) + Working Capital
e. Capital Employed = Total Assets (Excluding Non-Trade Investments) - Current Liabilities

Computation of Equity Ratio

The **Equity Ratio** is calculated by dividing the shareholders' funds by the capital employed. It is commonly expressed as a simple ratio, such as 2:1. The formula for this ratio is:

Equity Ratio= $\frac{\text{Shareholder's fund}}{Capital\ Employed}$

Interpretation of Equity Ratio

The **Equity Ratio** reflects the proportion of shareholders' funds in relation to the capital employed. A **high equity ratio** indicates greater reliance on equity compared to debt, providing a larger safety cushion for long-term creditors, as shareholders' equity serves as their margin of safety. Conversely, a **low equity ratio** suggests higher dependence on debt financing.

6. Interest Coverage Ratio

The **Interest Coverage Ratio** represents the relationship between a firm's net profit before interest and tax (EBIT) and the interest payable on its long-term borrowings. The purpose of calculating the Interest Coverage Ratio is to evaluate a firm's ability to service its debt, specifically its capacity to meet fixed interest obligations on long-term borrowings.

Components of Interest coverage ratio

There are two components of Interest Coverage Ratio as follows:

1. Net Profit before Interest and Tax
2. Interest on Long-term Borrowings

Computation of Interest Coverage Ratio

The **Interest Coverage Ratio** is calculated by dividing the net profit before interest and tax (EBIT) by the interest on long-term borrowings. This ratio is typically expressed as a certain number of times. The formula is:

Interest Coverage Ratio= $= \frac{\text{Profit before Interest and Tax}}{Interest\ on\ long\ term\ Debt}$

Interpretation of Interest Coverage Ratio

The **Interest Coverage Ratio** indicates how many times a company's profits before interest and tax (EBIT) can cover the interest on its long-term borrowings. It reflects the firm's ability to meet its interest payments from its profits. A higher ratio suggests better debt servicing capacity.

For example, an interest coverage ratio of 5 means that even if the company's net profit before interest and tax drops by 80%, it will still be able to cover its interest payments. A higher ratio generally indicates a stronger ability to pay interest, but if the ratio is too high, it could suggest the company is not using enough debt or is operating too efficiently.

7. Preference Dividend Coverage Ratio

The **Preference Dividend Coverage Ratio** measures the relationship between a company's net profit after interest and taxes and the preference dividend paid on preference shares. The purpose of calculating this ratio is to assess a firm's ability to meet the fixed preference dividend payments on preference shares.

Components of Preference Dividend Coverage Ratio

The two key components of this ratio are:

1. **Net Profits after Interest and Taxes**
2. **Preference Dividend on Preference Shares**

Computation of Preference Dividend Coverage Ratio

This ratio is calculated by dividing the net profit after interest and taxes by the preference dividend on preference shares. It is usually expressed as the number of times the preference dividend is covered. The formula is:

Preference Dividend Coverage Ratio= $\frac{\text{Net Profit after Interest and Tax}}{Preference\ Dividend\ on\ Preference\ Share}$

Interpretation of Preference Dividend Coverage Ratio

The **Preference Dividend Coverage Ratio** indicates how many times the preference dividend is covered by the company's profits. It helps determine the limit beyond which the company may struggle to meet its preference dividend obligations.

For example, a coverage ratio of 5 means that even if the company's net profit after interest and taxes declines by 80%, it will still be able to pay the preference dividend. A higher ratio indicates a better ability to pay the preference dividend, but an extremely high ratio may suggest underutilization of preference share capital or overly efficient operations.

8. Debt Service Coverage Ratio

The **Debt Service Coverage Ratio (DSCR)** measures the relationship between a company's net profit before interest and tax (EBIT) and its total debt obligations, including both the interest and principal portions of the installment payments.

Components of debt-service coverage ratio

There are two components of this ratio as follows

1. Net Profit before Interest and Tax
2. Interest and Principal portion of Installment

Computation of Debt Service Coverage Ratio

Debt Service Coverage Ratio= Net Profit before Interest and Tax/ Intersect+ Principal portion of the investment/1-Tax rate

Interpretation of Debt-Service Coverage Ratio

The **Debt Service Coverage Ratio** indicates how many times the company's profits can cover its interest and principal payments on long-term debts. It reflects the firm's ability to meet its debt obligations, including both interest and principal, from its profits.

For example, a Debt-Service Coverage Ratio of 5 means that even if the company's net profit before interest and tax drops by 80%, it will still be able to pay both interest and principal installments from its profits. A higher ratio suggests better financial capacity to meet debt obligations, while an excessively high ratio may indicate underutilization of debt or overly efficient operations.

Therefore, a business should aim for a **balanced ratio**, neither too high nor too low. To evaluate whether the ratio is satisfactory, it should be compared with the company's historical ratios, the ratios of similar companies in the same industry, or the industry average.

9. Fixed Charges Coverage Ratio

The **Fixed Charges Coverage Ratio** measures the relationship between cash generated from operations before interest and taxes (EBIT) and the total fixed financial charges, which include both interest and other fixed financial obligations, before tax.

Fixed Charge Coverage Ratio= $\frac{\text{Cash from operations before Interest and Tax}}{Interest\ plus\ fixed\ financial\ charges\ before\ tax}$

1.6.3 Activity Ratios

Activity Ratios assess how efficiently a firm utilizes its available resources. These ratios evaluate the effectiveness of asset management within the enterprise. Often referred to as **Turnover Ratios**, they measure the speed at which resources are converted into revenue from operations.

Types of Activity Ratios

The commonly calculated **Activity Turnover Ratios** include:

1. **Total Assets Turnover Ratio**
2. **Capital Turnover Ratio**
3. **Fixed Assets Turnover Ratio**
4. **Current Assets Turnover Ratio**
5. **Net Working Capital Turnover Ratio**
6. **Inventory/Stock Turnover Ratio**
7. **Receivables/Debtors Turnover Ratio**
8. **Payables/Creditors Turnover Ratio**

1. **Total Assets Turnover Ratio**

The **Total Assets Turnover Ratio** measures the relationship between a company's net revenue from operations (or net sales) and its average total assets. The purpose of calculating this ratio is to evaluate how efficiently a company utilizes its total assets to generate revenue.

Components of Total Assets Turnover Ratio

This ratio consists of the following components:

1. **Net Revenue from Operations/Net Sales:**

   Includes both credit and cash revenue from operations.

2. **Average Total Assets:**

   Calculated as:

Average Total Assets = Opening Stock + Closing Stock/2

Total assets can be determined in various ways:

(a) Total Assets = Non-Current Assets + Current Assets

(b) Total Assets = Equity Share Capital + Preference Share Capital + Reserves & Surplus + Non-Current Liabilities + Current Liabilities

(c) Total Assets = Shareholders' Funds + Non-Current Liabilities + Current Liabilities

(d) Total Assets = Capital Employed + Current Liabilities

Computation of Total Assets Turnover Ratio

The **Total Assets Turnover Ratio** is calculated by dividing the net revenue from operations (or net sales) by the average total assets. This ratio is typically expressed as a certain number of times. The formula is:

Total Assets Turnover Ratio= $\frac{\text{Net Revenue from operations/Sales}}{Average\ Total\ Assets}$

Interpretation of Total Assets Turnover Ratio

The **Total Assets Turnover Ratio** reflects the company's ability to generate revenue from operations or sales for every unit of investment in total assets. Generally, a higher ratio indicates more effective management and utilization of total assets, while a lower ratio suggests inefficiency.

It is important to note that there is no direct correlation between sales and all total assets, as sales are influenced by several other factors, such as product quality, delivery terms, credit policies, after-sales service, advertising, and publicity.

To determine if the ratio is satisfactory, it should be compared with: The Company's past performance, Ratios of similar businesses within the same industry, the industry average.

2. Capital Turnover Ratio

The **Capital Turnover Ratio** measures the relationship between a company's net revenue from operations (or net sales) and its average capital employed. The purpose of calculating this ratio is to evaluate how efficiently a company utilizes its capital employed to generate revenue.

Components of Capital Turnover Ratio

This ratio consists of the following components:

1. **Net Revenue from Operations/Net Sales:** Includes both credit and cash revenue from operations.
2. **Average Capital Employed**

Average Capital Employed= Opening Capital employed+ Closing Capital employed/2

Capital employed represents the long-term funds provided by shareholders and long-term creditors. It can be determined in the following ways-

a) Capital Employed = (Equity Share Capital + Preference Share Capital + Reserves & Surplus) + Non-Current Liabilities
b) Capital Employed = Shareholders' Funds + Non-Current Liabilities
c) Capital Employed = Non-Current Assets (excluding non-operating assets) + Current Assets - Current Liabilities
d) Capital Employed = Non-Current Assets (excluding non-operating assets) + Working Capital
e) Capital Employed = Total Assets (excluding non-operating assets) - Current Liabilities

Computation of Capital Turnover Ratio

The **Capital Turnover Ratio** is calculated by dividing the net revenue from operations (or net sales) by the average capital employed. This ratio is generally expressed as a certain number of times. The formula is as follows:

Capital Turnover Ratio= $\frac{\text{Net Revenue from operations/Sales}}{Average\ Capital\ Employed}$

Interpretation of Capital Turnover Ratio

The **Capital Turnover Ratio** reflects a company's ability to generate revenue from operations or sales for each unit of capital employed. Generally, a higher ratio indicates efficient management and utilization of capital employed. However, an excessively high ratio might suggest over-trading or under-capitalization, which could result in the current ratio being lower than a reasonable level, and vice versa.

An enterprise should aim for a balanced ratio—neither too high nor too low. To assess whether the ratio is satisfactory, it should be compared against:

3. Fixed Assets Turnover Ratio

The **Fixed Assets Turnover Ratio** measures the relationship between net revenue from operations (or net sales) and the average net fixed assets of a company. The purpose of this ratio is to evaluate how effectively a company utilizes its fixed assets to generate revenue.

Components of Fixed Assets Turnover Ratio

The Fixed Assets Turnover Ratio consists of the following components:

1. **Net Revenue from Operations/Net Sales**

   Includes both credit and cash revenue from operations.

2. **Average Net Fixed Assets:**

Calculated as: Opening Net Fixed Assets + Closing Net Fixed Assets / 2

Computation Fixed Assets Turnover Ratio

Fixed Assets Turnover Ratio= Revenue from Operations or Sales / Average Net Fixed Assets

Interpretation of Fixed Assets Turnover Ratio

The **Fixed Assets Turnover Ratio** reflects the firm's ability to generate revenue from operations or sales for every unit of investment in fixed assets. Generally, a higher ratio indicates more efficient management and utilization of fixed assets, whereas a lower ratio suggests inefficiency.

It is important to note that sales are not solely dependent on fixed assets, as other factors such as product quality, delivery and credit terms, after-sales service, advertising, and promotional efforts also play a significant role.

4. **Current Assets Turnover Ratio**

The **Current Assets Turnover Ratio** measures the relationship between net revenue from operations (or net sales) and the average current assets of a company. The purpose of this ratio is to assess how efficiently a company utilizes its current assets to generate revenue.

Components of Current Assets Turnover Ratio

1. Net Revenue from Operations/Net Sales: Includes both credit revenue and cash revenue from operations.
2. Average Current Assets:

Calculated as- Opening Current Assets + Closing Current Assets/2

Computation of Current Assets Turnover Ratio

Current Assets Turnover Ratio= $\frac{\text{Net Revenue from operations/Sales}}{\textit{Average Current Assets}}$

Interpretation of Current Assets Turnover Ratio

The **Current Assets Turnover Ratio** reflects the firm's ability to generate net revenue from operations or sales for every unit invested in current assets. Generally, a higher ratio signifies more efficient management and utilization of current assets, while a lower ratio indicates inefficiency.

It is important to note that there is no direct correlation between sales and current assets, as sales are influenced by various other factors such as product quality, delivery and credit terms, after-sales service, advertising, and promotional activities.

4. Working Capital Turnover Ratio

The **Working Capital Turnover Ratio** measures the relationship between **Net Revenue from Operations/Net Sales** and **Average Working Capital.** The goal of calculating the **Working Capital Turnover Ratio** is to evaluate how efficiently the company is utilizing its working capital.

Components of Working Capital Turnover Ratio

There are two components of Working Capital Turnover Ratio as follows

1. Net Revenue from Operations/Net Sales = Credit Revenue from + Operations Cash Revenue from Operations

2. Average Working Capital (Opening Working Capital + Closing Working Capital)/2

Computation of Working Capital Turnover Ratio:

Working Capital Turnover Ratio= $\frac{\text{Net Revenue from operations/ Net Sales}}{Average\ Working\ Capital}$

Interpretation:

The Working Capital Turnover Ratio measures a company's efficiency in generating revenue from operations or sales for every unit of working capital employed. A higher ratio typically signifies better management and utilization of working capital, while a lower ratio may indicate inefficiency. To evaluate whether this ratio is satisfactory, it should be compared to the company’s historical performance, the ratios of comparable businesses in the same sector, or the industry average.

5. **Inventory Turnover ratio**

This ratio establishes the relationship between cost of revenue from Operations and average inventory.

There are two components of Inventory Turnover Ratio as follows:

1. Cost of Revenue from Operations

(a) Opening Inventory + Net Purchases Direct Expenses - Closing Inventory
(b) Cost of Materials Consumed + Purchases of Stock-in-Trade + Changes in Inventories of Finished Goods + Direct Expenses
(c) Revenue from Operations - Gross Profit
(d) Revenue from Operations + Gross Loss

2. Average Inventory = (Opening Inventory Closing Inventory)/2ponents:

Computation

Inventory Turnover Ratio= $\frac{\text{Cost of Revenue from operations}}{Average\ Inventory}$

Interpretation:

The Inventory Turnover Ratio reflects how quickly inventory is converted into revenue from operations. Generally, a higher ratio signifies efficient management, as it indicates that either the same level of revenue is achieved with less inventory investment, or revenue has grown without an increase in inventory. However, extreme values in the ratio warrant closer examination. An excessively high ratio could suggest that inventory levels are too low, potentially leading to frequent stock outs and higher stock out costs. Conversely, a very low ratio might indicate excessive inventory, slow-moving goods, or obsolete stock, resulting in increased carrying costs. Therefore, it is important for a company to maintain a balanced and satisfactory Inventory Turnover Ratio.

6. **Debtors Turnover Ratio**

This ratio establishes a relationship between credit revenue from operations and average trade receivables.

Components of Debtors Turnover Ratio

There are two components-

1. Credit Revenue from operations= Revenue from operations-Cash revenue from operation
2. Average trade Receivables= Opening trade receivables + Closing trade receivables/2

Debtors Turnover Ratio = $\frac{\text{Cost of Revenue from operations}}{Average\ Trade\ Receivables}$

Interpretation:

The Debtors Turnover Ratio reflects the quality of trade receivables and the effectiveness of a company's credit collection efforts. It measures how quickly debtors are converted into cash within a given period. Generally, a higher ratio suggests a shorter collection period, indicating prompt payments by trade receivables, while a lower ratio indicates a longer collection period, suggesting delays in payments.

However, extreme values require further analysis. An excessively high ratio might result from a highly restrictive credit policy, which could limit sales and reduce profits. Conversely, a very low ratio could stem from overly liberal credit policies, potentially leading to higher risks of bad debts and slower cash flow. Therefore, maintaining a balanced and reasonable Debtors Turnover Ratio is essential for financial efficiency.

7. **Creditors Turnover Ratio**

This ratio establishes the relationship between net credit purchase and average trade payables.

Components of Creditors Turnover Ratio

There are two components-

1. Net Credit Purchase= Net Purchase- Cash purchase
2. Average trade payables= Opening trade payables + Closing trade payables/2

Creditors Turnover Ratio = $\frac{\text{Net Credit purchase}}{Average\ Trade\ payables}$

Interpretation

The Creditors Turnover Ratio represents how quickly a company settles its payables within a year. Typically, a higher ratio indicates a shorter payment period, suggesting either limited credit availability or prompt payment to creditors. Conversely, a lower ratio reflects a longer payment period, indicating either extended credit terms or delayed payments to creditors.

Profitability Ratio

Profitability Ratios evaluate how effectively a company’s management generates returns from its revenue and investments. These ratios are key indicators of the company’s financial performance and operational efficiency.

Types of Profitability Ratios

I. Profitability Ratios in Relation to Revenue from Operations/Sales:

1. **Gross Profit Ratio**
2. **Operating Profit Ratio**
3. **Operating Ratio**
4. **Net Profit Ratio**
5. **Expenses Ratios**

II. Profitability Ratios in Relation to Investment:

1. **Return on Total Assets (ROTA)**
2. **Return on Capital Employed (ROCE) / Return on Investment (ROI)**
3. **Return on Shareholders' Funds (ROE)**
4. **Return on Equity Shareholders' Funds (ROES)**

III. Profitability Ratios in Relation to Equity Shareholders' Funds:

1. **Return on Equity Shareholders' Funds**
2. **Earnings per Share (EPS)**
3. **Dividend per Share (DPS)**
4. **Price-Earnings Ratio (P/E Ratio)**
5. **Dividend Payout Ratio (D/P Ratio)**
6. **Earnings Yield (EY)**
7. **Dividend Yield (DY)**
8. **Market Response Ratio (MRR)**

1. Gross Profit Ratio = $\frac{\text{Gross Profit}}{Revenue\ from\ operations}$ x 100

2. Operating Ratio = $\frac{\text{Operating cost}}{Revenue\ from\ operations}$ x 100

3. Operating Profit Ratio = $\frac{\text{Operating Profit}}{Revenue\ from\ operations}$ x 100

4. Net Profit Ratio= $\frac{\text{Net profit before tax}}{Revenue\ from\ operations}$ x 100 $\frac{\text{Net profit after tax}}{Revenue\ from\ operations}$ x 100

5. Return on Total assets (Pre-tax)

Components on Return on Total Assets

1. Net Profit before Interest and Tax
2. Average Total Assets = All assets (excluding No operating assets)

   Or Shareholders fund+ Total Debt Or Capital Employed+ Current liabilities

Return on Total Assets (Pre-tax)

= Net Profit before Interest and Tax/Average Total Assets or Average Noncurrent Assets/Average tangible Assets x 100

Return on Total Assets (Post-tax)

= Net Profit before Interest and Tax + / Average Total Assets or Average Noncurrent Assets/Average tangible Assets x 100

6. Return on Investment

There are two components-

1. Net profit before interest, tax and pref. dividend
2. Average capital employed= Opening capital employed+ Closing capital employed/2

Computation of Return on Investment

1. Return on Capital employed (Pre-tax)= Net profit before interest and tax/ Average capital employed x 100
2. Return on Capital employed (Post-tax)= Net profit before interest and tax + interest/ Average capital employed x 100
3. ROI is the product of two ratio i.e. EBIT Ratio and Capital Turnover ratio-

   ROI= EBIT Ratio X Capital Turnover Ratio

   EBIT/ Revenue from Operations X Revenue from operations/ Average Capital employed.

7. Return on Shareholder's fund

There are two components-

1. Net Profit Interest and Tax
2. Average shareholders fund

Return on Shareholder's fund = $\frac{\text{Net Profit before interest and Tax}}{Average\ shareholders\ fund}$ x 100

8. Return on Equity shareholders' Funds

There are two components-

1. Net Profit after Interest, Tax and Preference Dividend (including participating dividend if any. due to Participating Preference Shareholders).
2. Average Equity Shareholders' Funds = [Opening Equity Shareholders' Funds + Closing Equity Shareholders' Funds)/2

a. Equity Shareholders' Funds = Equity Share Capital + Net Reserves & Surplus
b. Equity Shareholders' Funds = Non-Current Assets + Current Assets-Current Liabilities - Non-Current Liabilities - Pref. Share Capital
c. Equity Shareholders' Funds = Non-Current Assets + Working Capital - Non-Current Liabilities - Pref. Share Capital
d. Equity Shareholders' Funds = Capital Employed - Non-Current Liabilities - Pref. Share Capital
e. Equity Shareholders' Funds = Total Assets - Total Debt - Pref. Share Capital

Return on Equity shareholders' Funds = $\frac{\text{Net Profit after interest, tax and preference Dividend}}{Average\ Equity\ shareholders\ fund}$ x 100

9. Earnings Per Share

There are two components-

1. Net Profit after Interest, Tax and Preference Dividend
2. Number of Equity Shares

EPS= $\frac{\text{Net Profit after interest, tax and preference Dividend}}{Number\ of\ equity\ Shares}$

10. Dividend Per Share

DPS= $\frac{\text{Profit distributed as Equity Dividend}}{Number\ of\ equity\ Shares}$

11. Per Earning Ratio

PER = $\frac{\text{Market Price Per Share}}{Earning\ per\ Shares}$

12. Dividend Payout Ratio

DPR= $\frac{\text{Earning per Share}}{Dividend\ per\ Shares}$

13. Earning yield

Earning yield= $\frac{\text{Earning per Share}}{Market\ price\ per\ Shares}$ x 100

14. Dividend yield= $\frac{\text{Dividend per Share}}{Market\ price\ per\ Shares}$ x 100

15. Market Response Ratio= $\frac{\text{Market value per Share}}{Book\ Value\ per\ Shares}$ x 100 **or** $\frac{\text{Average Market value per Share}}{Net\ \frac{worth}{No}.\ equity\ shares}$

12.5 **COMMON SIZE STATEMENT**

A practical and convenient method for standardizing financial statements is to represent each item on the profit and loss statement as a percentage of sales, while items on the balance sheet are expressed as a percentage of total assets. This approach results in what are referred to as *common size statements*.

12.6COMPARATIVE ANALYSIS

A common way to analyze a company's capital structure is by comparing its debt ratio to that of other companies in the same industry. The simplest method is to compare a company's debt ratio with the average debt ratio of the industry it belongs to. This approach assumes that companies in the same industry are similar and that, on average, they are operating with an ideal capital structure. However, these assumptions are not always valid. Companies in the same industry might not be alike due to differences in size, how much capital they use, their product range, business risks, tax situation, and other factors. Additionally, since companies often try to match the industry average, the industry's average debt ratio may not actually reflect the best structure for each individual company.

12.7 SUMMERY

Financial ratio analysis is a simple yet powerful way to understand a company's financial health by comparing different numbers from its financial statements. These ratios are grouped into five types: **liquidity, leverage, turnover, profitability, and valuation ratios**. **Liquidity ratios** show how well a company can pay its short-term bills, with the current ratio and acid-test ratio being the key measures. **Leverage ratios** focus on how much debt a company uses to finance its operations. Important examples include the debt-equity ratio, which shows the balance between debt and equity, and the interest coverage ratio, which checks if the company can easily pay its interest expenses. **Turnover ratios** measure how efficiently the company uses its assets to generate sales. Examples include the inventory turnover ratio, which shows how quickly stock is sold, and the total assets turnover ratio, which looks at how well all assets are used. **Profitability ratios** show how much profit the company earns. Key ratios include the gross profit margin, net profit margin, and return on equity, which measures the returns shareholders earn on their investment. Finally, **valuations ratios** help understand how the market values the company. The price-earnings (P/E) ratio shows how much investor are willing to pay for each unit of profit, while the market value-to-book value ratio compares the company's market value to its book value. Together, these ratios provide a clear picture of a company's financial position, helping investors, managers, and other stakeholders make better decisions.

12.8 SELF ASSESSMENT QUESTIONS

Multiple choice Questions:

1. **Which of the following categories of ratios is based on the financial statements of a company?**
   a) Profitability ratios
   b) Managerial ratios
   c) Operational ratios
   d) Market ratios
   Answer: a) Profitability ratios
2. **Which financial statements are primarily used in ratio analysis?**
   a) Income statement and cash flow statement
   b) Balance sheet and income statement
   c) Cash flow statement and owner's equity statement
   d) Tax returns and profit distribution statement
   Answer: b) Balance sheet and income statement
3. **Which of the following is an example of a ratio used to analyze a company's profitability?**
   a) Current ratio
   b) Return on assets (ROA)
   c) Debt-equity ratio
   d) Quick ratio
   Answer: b) Return on assets (ROA)
4. **Which classification of ratios is focused on the needs of external users like investors and creditors?**
   a) Liquidity ratios
   b) Profitability ratios
   c) Classification based on user requirements
   d) Market value ratios
   Answer: c) Classification based on user requirements

5. **What does a Common Size Statement allow users to analyze?**
   a) Only the company’s sales performance
   b) The financial performance relative to sales or total assets
   c) The company's tax liabilities
   d) The depreciation rate of assets
   Answer: b) The financial performance relative to sales or total assets
6. **Which of the following is true about Comparative Analysis?**
   a) It compares financial statements of two different companies over the same period
   b) It compares the performance of a company against industry averages
   c) It looks at financial performance over several periods to identify trends
   d) It is used to determine a company's market share
   Answer: c) It looks at financial performance over several periods to identify trends
7. **Which of the following is a key advantage of ratio analysis?**
   a) It simplifies the preparation of financial statements
   b) It helps in assessing the company's operational efficiency
   c) It provides detailed tax planning strategies
   d) It eliminates the need for external audits
   Answer: b) It helps in assessing the company's operational efficiency

Questions:

1. What are the main categories of financial ratios?
2. What are liquidity ratios, and which are the key ones?
3. How is leverage ratios defined and assessed?
4. What are turnover ratios, and why are they important?
5. What are profit margin ratios, and how do they provide insights into profitability?
6. From the following Balance Sheet-

Particulars	31.03.2018 (₹)
I. EQUITY AND LIABILITIES	
1. Shareholders’ Funds	
Share Capital	2,00000
Reserves and Surplus	2,00000
2. Non-Current Liabilities	
Long-Term Borrowings	8,00000
3. Current Liabilities	
Short-Term Borrowings	40,000
Trade Payables	1,00000
Other Current Liabilities	1,40,000
Short-Term Provisions	1,20,000
Total	16,00000

II. ASSETS	
1. Non-Current Assets	
Fixed Assets	10,00000
Non-Current Investments	1,00000
2. Current Assets	
Current investments	20,000
Inventories	1,90,000
Trade Receivables	2,60,000
Cash and Cash Equivalents	10,000
Short-Term Loans and Advances	10,000
Other Current Assets	10,000
Total	16,00000

Calculate-

(a) Gross Profit Ratio (b) Operating Ratio, (c) Net Profit Ratio, (d) Return on Investment, (e) Earnings Per Share, (f) Dividend per Share, (g) Price Earnings Ratio. (h) Dividend Payout Ratio, (1) Earning Yield, (j) Dividend Yield, (k) Market Response Ratio (1) Return on Total Assets (m) Return on Shareholders' Funds (n) Return on Equity Shareholders' Funds.

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