DCAM-04

Vardhaman Mahaveer Open University, Kota

Elementary Computer Accounting

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Elementary Computer Accounting

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INTRODUCTION

It is generally accepted that business organisations have to reveal certain financial and management information to the government and public users. And of development of information technologies there were develped many Computer Accounting Software that make accounting easy, for those who uses them like tally. With the introduction of Computers in business, the manual method of accounting is being gradually replaced. And finaly, the data base technology has revolutionized the accounts department of the business organisations. This book is divided into fourteen chapters provides the knowledge of the Computer Accounting System for course Code- CCA-03. First three chapter deals with the background of computer accounting, accounting software packages and use of tally software as a accounting language. Chapter four to ten give the basic knowledge of Double Entry System, Types of Accounts, Accounts Vouchers, Books of Accounts, Bank Reconcilation Statement and Financial Accounts with profit and loss account and balancesheet and chapter ten on inventory configuration and inventory masters. Chapter eleven focuses on application of Value Added Tax in Rajasthan. Last three chapters measures the Financial Performance through Ratio Analysis, Fund Flow and Cash Flow Statements and Budgets. The subject matter has been designed in such a manner that will effectively communicate the desired study material in a lucid and simple language.

UNIT - 1

Computer Accounting

Outline of the Unit:

1.0 Objectives

1.1 Introduction

1.2 Computer and its characteristics

- 1.2.1 Characteristics of computer
- 1.2.2 Component of computer

1.3 Accounting in Computer Environment

- 1.3.1 Role of Computers in Accounting
- 1.3.2 Need and Requirements of Computersied Accounting
- 1.3.3 Computerised Accounting

1.4 Advantage of computer Accounting

1.5 Disadvantage of computer Accounting

1.6 Features of Computer Accounting

1.7 Current Computer Accounting Scenario

1.8 Summary

1.9 Key Words

1.10 Abbreviations

1.11 Hint / Key to Activity

1.12 Questions for Practice

1.13 References

1.0 Objectives

After studying this unit, you should be able to:

- State the meaning and characteristics of computer
- Describe the components of computer
- Explain the limitations of a computer
- Explain the role of computer in accounting;
- State the need for computerised accounting;
- Describe the basic requirements of computerised accounting.
- Advantages of computerized accounting

1.1 Introduction

Accounting is an important part of every company. Businesses are required to keep books on their credits and debits. As many professional accountants and auditors state - accounting is a language of business which is accepted in all developed and developing countries.

Every company applies accounting because it is generally accepted that companies have to reveal certain financial and management information to the government and public users and of course because accounting is indispensable tool in business decision-making process. With the development of information technologies there were developed many computer accounting software that make accounting as easy as ABC for those who uses them like tally. From this point accounting can be divided into two basic categories:

i. Manual accounting system.

ii. Computerized accounting systems.

With the expansion of business the number of transactions increased. The manual method of keeping and maintaining records was found to be unmanageable. With the introduction of computers in business, the manual method of accounting is being gradually replaced. And finally, the database technology has revolutionized the accounts department of the business organisations.

1.2 Computer and its Characteristics

Computer is an electronic device that can perform a variety of operations in accordance with a set of instructions called programme. It is a fast data processing electronic machine. It can provide solutions to all complicated situations. It accepts data from the user, converts the data into information and gives the desired result. Therefore, we may define computer as a device that transforms data into information.

1.2.1 Characteristics of computer:

A Computer is better than human being. It possesses some characteristics. These are as follows:

- **Speed** It can access and process data millions times faster than humans can. It can store data and information in its memory, process them and produce the desired results. It is used essentially as a data processor. All the computer operations are caused by electrical pulses and travels at the speed of light. Most of the modern computers are capable of performing 100 million calculations per second.
- **Storage** Computers have very large storage capacity. They have the capability of storing vast amount of data or information. Computers have huge capacity to store data in a very small physical space.
- **Accuracy** The accuracy of computer is very high and every calculation is performed with the same accuracy. Errors occur because of human beings rather than technological weakness; main sources of errors are wrong program by the user or inaccurate data.
- **Diligence** A computer is free from tiredness and lack of concentration. Even if it has to do 10 million calculations, it will do even the last one with the same accuracy and speed as the first.
- **Versatility** Computer can perform wide range of jobs with speed, accuracy, and diligence. In any organisation, often it is the same computer that is used for diverse purposes such as accounting, playing games, preparing electric bills, sending e-mail and so on.
- **Communication** Computers are being used as powerful communication tools. All the computers within an office are connected by cable and it is possible to communicate with others in the office through the network of computer.
- **Processing Power** Computer has come a long way today. They began as mere prototypes at research laboratories and went on to help the business organisations, and today, their reach is so extensive that they are used almost everywhere. In the course of this evolution, they have become faster, smaller, cheaper, more reliable and user friendly.

1.2.2 Components of Computer

A computer consists of the major components i.e., Input Unit, Central Processing Unit and Output Unit. Diagrammatically, these components may be presented as follows:

- **Input Unit** Input unit is controlling the various input devices which are used for entering data into the computer. The mostly used input devices are keyboard, mouse, and scanner. Other such devices are magnetic tape, magnetic disk, light pen, bar code reader, smart card reader, etc. Besides, there are other devices which respond to voice and physical touch. Physical touch system is installed at airport for obtaining the online information about departure and arrival of flight. The input unit is responsible for taking input and converting it into binary system.
- **Central Processing Unit (CPU)** The CPU is the control centre for a computer. It guides, directs and governs its performance. It is the brain of the computer. The main unit inside the computer is the Central Processing Unit. Central Processing Unit is to computer as the brain is to human body. This is used to store program, photos, graphics, and data and obey the instructions in program. It is divided into three subunits:

(a) Control Unit

(b) Memory Unit

(c) Arithmetic Logic Unit (ALU)

- **Control Unit** Control unit controls and co-ordinates the activities of all the components of the computer. This unit accepts input data and converts it into computer binary system.
- **Memory Unit** This unit stores data before being actually processed. The data so stored is accessed and processed according to instructions which are also stored in the memory section of computer well before such data is transmitted to the memory from input devices.
- **Arithmetic and Logic Unit** It is responsible for performing all the arithmetical calculations and computations such as addition, subtraction, division, and multiplication. It also performs logical functions involving comparisons among variable and data items.
- **Output unit** After processing the data, it ensures the convertibility of output into human readable form that is understandable by the user. The commonly used output devices include like monitor also called Visual Display Unit, printer etc.

1.3 Accounting In Computer Environment

Accounting is the method in which financial information is gathered, processed, and summarized into financial statements and reports. An accounting system can be represented by the following graphic.

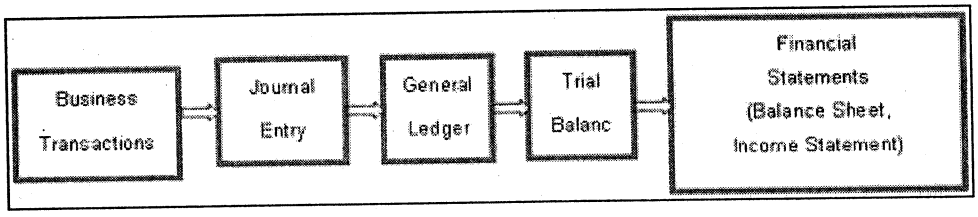


Diagram 01:01 Accounting System

Source: Compile from website

The purpose of accounting is to provide information used in decision making. Accounting may be viewed as a system (a process) that converts data into useful information.

Information processes include:

(i) Recording

(ii) Maintaining

(iii) Reporting

Every business has numerous processes. Some simple, others complex and cumbersome. But as the business grows, acquires new customers, enters new markets and keeps pace with constant changes in statutory regulations... the company will need to maintain highly accurate and up-to-date accounting, inventory and statutory records.

This is where a computerized accounting helps simplify, integrate, and streamline all the business processes, cost-effectively and easily.

1.3.1 Role of computers in accounting

The most popular system of recording of accounting transactions is manual which requires maintaining books of accounts such as Journal, Cash Book, Special purpose books, ledger and so on. The accountant is required to prepare summary of transactions and financial statements manually. The advanced technology involves various machines capable of performing different accounting functions, for example, a billing machine. This machine is capable of computing discount, adding net total and posting the requisite data to the relevant accounts.

With substantial increase in the number of transactions, a machine was developed which could store and process accounting data in no time. Such advancement leads to number of growing successful organisations. A newer version of machine is evolved with increased speed, storage, and processing capacity. A computer to which they were connected operated these machines. As a result, the maintenance of accounting data on a real-time basis became almost essential. Now maintaining accounting records become more convenient with the computerised accounting. The computerised accounting uses the concept of databases. For this purpose an accounting software is used to implement a computerized accounting system. It does away the necessity to create and maintain journals, ledgers, etc., which are essential part of manual accounting. Some of the commonly used accounting softwares are Tally, Cash Manager, Best Books, etc.

Accounting software is used to implement a computerised accounting. The computerised accounting is based on the concept of database. It is basic software which allows access to the data contained in the data base. It is a system to manage collection of data insuring at the same time that it remains reliable and confidential.

1.3.2 Need And Requirements of Computersied Accounting

The need for computerised accounting arises from advantages of speed, accuracy and lower cost of handling the business transactions.

(i) Numerous Transactions - The computerised accounting system is capable of handling large number of transactions with speed and accuracy.

(ii) Instant Reporting - The computerised accounting system is capable of offering quick and quality reporting because of its speed and accuracy.

(iii) Reduction in paper work - A manual accounting system requires large physical storage space to keep accounting records/books and vouchers/ documents. The requirement of stationery and books of accounts along with vouchers and documents is directly dependent on the volume of transactions beyond a certain point. There is a dire need to reduce the paper work and dispense with large volumes of books of accounts. This can be achieved by introducing computerised accounting system.

Following are the components of Computerised accounting software:

(i) Preparation of accounting documents - Computer helps in preparing accounting documents like Cash Memo, Bills and invoices etc., and preparing accounting vouchers.

(ii) Recording of transactions- Every day business transactions are recorded with the help of computer software. Logical scheme is implied for codification of account and transaction. Every account and transaction is assigned a unique code. The grouping of accounts is done from the first stage. This process simplifies the work of recording the transactions.

(iii) Preparation of Trial Balance and Financial Statements - After recording of transaction, the data is transferred into Ledger account automatically by the computer. Trial Balance is prepared by the computer to check accuracy of the records. With the help of trial balance the computer can be programmed to prepare Trading, Profit and Loss account and Balance Sheet.

1.3.3 Computerised Accounting

Transaction processing system (TPS) is the first stage of computerized accounting system. The purpose of any TPS is to record, process, validate and store transactions that occur in various functional areas of a business for subsequent retrieval and usage. TPS involves following steps in processing a transaction: Data Entry, Data Validation, Processing and Revalidation, Storage, Information and Reporting. It is one of the transaction processing systems which is concerned with financial transactions only. When a system contains only human resources it is called manual system; when it uses only computer resources, it is called computerised system and when it uses both human and computer resources, it is called computer-based system. These steps can be explained with an example making use of Automatic Teller Machine (ATM) facility by a Bank-Customer.

(i) **Data Entry** : Processing presumes data entry. A bank customer operates an ATM facility to make a withdrawal. The actions taken by the customer constitute data which is processed after validation by the computerised personal banking system.

(ii) **Data Validation** : It ensures the accuracy and reliability of input data by comparing the same with some predefined standards or known data. This validation is made by the 'Error Detection' and 'Error Correction' procedures. The control mechanism, wherein actual input data is compared with predetermined norm is meant to detect errors while error correction procedures make suggestions for entering correct data input. The Personal Identification Number (PIN) of the customer is validated with the known data. If it is incorrect, a suggestion is made to indicate the PIN is invalid. Once the PIN is validated, the amount of withdrawal being made is also checked to ensure that it does not exceed a pre specified limit of withdrawal.

(iii) **Processing and Revalidation** : The processing of data occurs almost instantaneously in case of Online Transaction Processing (OLTP) provided a valid data has been fed to the system. This is called check input validity. Revalidation occurs to ensure that the transaction in terms of delivery of money by ATM has been duly completed. This is called check output validity.

(iv) **Storage** : Processed actions, as described above, result into financial transaction data i.e. withdrawal of money by a particular customer, are stored in transaction database of computerized personal banking system. This makes it absolutely clear that only valid transactions are stored in the database.

(v) **Information** : The stored data is processed making use of the Query facility to produce desired information.

(vi) **Reporting** : Reports can be prepared on the basis of the required information content according to the decision usefulness of the report.

SELF ASSESSMENT QUESTION 01 : A

Q. Accounting ..... is used to implement a computerized accounting

1.4 Advantage of computer Accounting

Fast, Powerful, Simple and Integrated - Computerized accounting is designed to automate and integrate all the business operations, such as sales, finance, purchase, inventory and manufacturing. With Computerized accounting, accurate, up-to-date business information is literally at the fingertips. The Computerized accounting combine with enhanced MIS, Multi-lingual and Data organization capabilities to help the company simplify all the business processes easily and cost-effectively.

(i) **Complete Visibility** - Computerized accountings giving the company sufficient time to plan, increase the customer base, and enhance customer satisfaction. With Computerized accounting the company will have greater visibility into the day-to-day business operations and access to vital information.

(ii) **Enhanced User Experience** - Computerized accounting allows the company to enter data in a variety of ways which makes work a pleasure. Adapting to the specific business needs is possible.

(iii) **Accuracy, Speed** - Computerized accounting has User-definable templates which provides fast, accurate data entry of the transactions; thereafter all documents and reports can be generated automatically, at the press of a button.

(iv) **Scalability** - Computerized accounting adapts to the current and future needs of the business, irrespective of its size or style.

(v) **Power** - Computerized accounting has the ability to handle huge volumes of transactions without compromising on speed or efficiency.

(vi) **For Improved Business Performance** - Computerized accounting is a highly integrated application that transforms the business processes with its performance enhancing features which encompass accounting, inventory, reporting and statutory processes. This helps the company access information faster, and takes quicker decisions. Computerized accounting also guarantees real-time optimization of operations and enhanced communication.

(vii) **Quick Decision Making** - Generates real-time, comprehensive MIS reports and ensures access to complete and critical information, instantly.

(viii) **Complete Reliability** - Computerized accounting makes sure that the critical financial information is accurate, controlled and safe from data corruption.

1.5 Disadvantage of computer Accounting

The limitations of computer are depending upon the operating environment they work in. These limitations are given below as :

(i) **Cost of Installation** - Computer hardware and software needs to be updated from time to time with availability of new versions. As a result heavy cost is incurred to purchase a new hardware and software from time to time.

(ii) **Cost of Training**- To ensure efficient use of computer in accounting, new versions of hardware and software are introduced. This requires training and cost is incurred to train the staff personnel.

(iii) **Self Decision Making**- The computer cannot make a decision like human beings. It is to be guided by the user.

(iv) **Maintenance**- Computer requires to be maintained properly to help maintain its efficiency. It requires a neat, clean and controlled temperature to work efficiently.

(v) **Dangers for Health**- Extensive use of computer may lead to many health problems such as muscular pain, eyestrain, and backache, etc. This affects adversely the working efficiency and increasing medical expenditure.

(vi) **Flexible reporting**- The reporting is flexible in computerised accounting system as compared to manual accounting system. The reports of a manual accounting system reveal balances of accounts on periodic basis while computerized accounting system is capable of generating reports of any balance as when required and for any duration which is within the accounting period.

(vii) **Accounting Queries** - There are accounting queries which are based on some external parameters. For example, a query to identify customers who have not made the payments within the permissible credit period can be easily answered by using the structured query language (SQL) support of database technology in the computerised accounting system. But such an exercise in a manual accounting system is quite difficult and expensive in terms of manpower used. It will still be worse in case the credit period is changed.

(viii) **On-line facility** - Computerised accounting system offers online facility to store and process transaction data so as to retrieve information to generate and view financial reports.

(ix) **Scalability** - Computerised accounting system are fully equipped with handling the growing transactions of a fast growing business enterprise. The requirement of additional manpower in Accounts department is restricted to only the data operators for storing additional vouchers. There is absolutely no additional cost of processing additional transaction data.

(x) **Accuracy** - The information content of reports generated by the computerized accounting system is accurate and therefore quite reliable for decision making. In a manual accounting system the reports and information are likely to be distorted, inaccurate and therefore cannot be relied upon. It is so because it is being processed by many people, especially when the number of transactions to be processed to produce such information and report is quite large.

(xi) **Security** -Under manual accounting system it is very difficult to secure such information because it is open to inspection by any eyes dealing with the books of accounts. However, in computerised accounting system only the authorised users are permitted to have access to accounting data. Security provided by the computerised accounting system is far superior compared to any security offered by the manual accounting system. Fraud and embezzlement are usually achieved on a computer system by altering data or programs. There are numerous techniques, varying from additions and deletions to input data, through changing the standing information files, modifying the behavior of programs, to duplicating or suppressing output. Although most frauds that have been reported had gone on for some time, it could be that 'one shot' frauds have been more frequent but more often escape detection. Satyam scandal is one of the examples.

SELF ASSESSMENT QUESTION 01 : B
Q What are various advantages of Computer Accounting?

1.6 Features of Computer Accounting

The computerized accounting systems provide major advantages such as speed and accuracy of operation, and, perhaps most importantly, the ability to see the real-time state of the company's financial position.

A typical computerized accounting package will offer a number of different facilities. These include:

(i) On-screen input and printout of sales invoices

(ii) Automatic updating of customer accounts in the sales ledger

(iii) Recording of suppliers' invoices

(iv) Automatic updating of suppliers' accounts in the purchases ledger

(v) Recording of bank receipts

(vi) Making payments to suppliers and for expenses

(vii) Automatic updating of the general ledger

(viii) Automatic adjustment of stock records

(ix) Integration of a business database with the accounting program

(x) Automatic calculation of payroll and associated entries

Computerized accounting programs can provide instant reports for management, for example:

(i) Aged debtors' summary – a summary of customer accounts showing overdue amounts

(ii) Trial balance, trading and profit and loss account and balance sheet

(iii) Stock valuation

(iv) Sales analysis

(v) Budget analysis and variance analysis

(vi) GST/VAT returns

(vii) Payroll analysis

When using a computerized accounting system the on computer, input screens have been designed for ease of use. The main advantage is that each transaction needs only to be inputted once, unlike a manual double entry system where two or three entries are required.

The computerized ledger system is fully integrated. This means that when a business transaction is inputted on the computer it is recorded in a number of different accounting records at the same time.

The main features of a computerized accounting system are listed below:

(i) **Speed** – data entry onto the computer with its formatted screens and built-in databases of customers and supplier details and stock records can be carried out far more quickly than any manual processing.

(ii) **Automatic document production** – fast and accurate invoices, credit notes, purchase orders, printing statements and payroll documents are all done automatically.

(iii) **Accuracy** – there is less room for errors as only one accounting entry is needed for each transaction rather than two (or three) for a manual system.

(iv) **Up-to-date information** – the accounting records are automatically updated and so account balances (e.g. customer accounts) will always be up-to-date.

(v) **Availability of information** – the data is instantly available and can be made available to different users in different locations at the same time.

(vi) **Management information** – reports can be produced which will help management monitor and control the business, for example the aged debtors analysis will show which customer accounts are overdue, trial balance, trading and profit and loss account and balance sheet.

(vii) **GST/VAT return** – the automatic creation of figures for the regular GST/VAT returns.

(viii) **Legibility** – the onscreen and printed data should always be legible and so will avoid errors caused by poor figures.

(ix) **Efficiency** – better use is made of resources and time; cash flow should improve through better debt collection and inventory control.

(x) **Staff motivation** – the system will require staff to be trained to use new skills, which can make them feel more motivated. Further to this with many 'off-the-shelf' packages like MYOB the training can be outsourced and thus making a particular staff member less critical of business operations.

(xi) **Cost savings** – computerized accounting programs reduce staff time doing accounts and reduce audit expenses as records are neat, up-to-date and accurate.

(xii) **Reduce frustration** – management can be on top of their accounts and thus reduce stress levels associated with what is not known.

(XIII) **The ability to deal in multiple currencies easily** – many computerized accounting packages now allow a business to trade in multiple currencies with ease. Problems associated with exchange rate changes are minimized.

1.7 Current Computer Accounting Scenario

For about 100 years, the control of accounting rules and auditing standards rested in the hands of the accounting profession with very little input from other sources other than the SEC for rules relating to publicly-traded companies.

Following Enron, WorldCom and other major corporate scandals, the past three years have seen substantial changes in the approach to accounting rule-making, auditing standards and regulation of accounting firms, including independence issues.

Note how the current changes came about. The numerous scandals and restatements of financial statements were caused not only by unscrupulous managers who were flagrantly falsifying the books, but also by the very complex accounting rules that evolved. Some regulations run to hundreds of pages and leave themselves open to different interpretations. In an effort to boost earnings, management uses every possible loophole to increase profits but still remain within the guidelines. This includes the use of aggressive revenue recognition, estimates and asset valuations which, when they later turn out to be incorrect, causes major restatements. The blame should not be placed only on the shoulders of accountants and rule makers. In the past two decades business has become so complex and global that transactions never contemplated previously are being concluded every day. Revenue recognition - a relatively simple concept in the past - has become a major issue as businesspeople construct very complicated deals with different types of revenue streams and conditions. For public companies, in particular, there is pressure to boost earnings and share prices. The concept of "conservatism" has disappeared in the preparation of financials.

Corporate governance has also undergone major changes. Regulators recognize that it is mainly management that perpetrates the frauds and weak controls assist in rampant abuses of accounting rules. While most of the changes affect public companies, there is a trickle-down effect to companies of all sizes. The focus is now on independent boards of directors, qualified audit committees and internal control evaluations, as well as major increases in fines for white-collar crime.

Public accountants were taken by surprise by the reaction to the scandals and audit failures. And within the past two years much of the power to regulate the profession has been taken away from them. The Sarbanes-Oxley law made substantial changes, including the creation of the Public Company Accounting Oversight Board, which now reviews firms performing audits of public entities. The American Institute of Certified Public Accountants (AICPA) and various state boards, realizing that they have lost power, are now trying to become proactive in improving controls and self-regulation, including transparent peer reviews of accounting firms.

Auditors have always maintained that the purpose of the audit was not to discover fraud. Legally, they were correct. In fact, one of the oldest judgments in auditing case law in England states that "auditors are watchdogs, not bloodhounds". The public, however, had the perception that the auditors were in fact "checking the books" and that their report was a stamp of approval on which they could rely. Auditing standards have now been changed and the auditors must now approach audits with skepticism. Auditors are required under FAS 99 to conduct a review of the possibility of fraud in engagements. The audited clients are now going through fraud questionnaires with the auditors, who also interview staff members to analyze where the possibility of fraud could exist. CPAs are being trained to focus on the main conditions which give rise to fraud, i.e., greed/pressure to meet targets and opportunity and rationalization why the action taken was justified.

The Financial Accounting Standards Board (FASB), an independent body created by the sec, is still the main accounting rule-making body. However, for the first time, greater emphasis is being placed on user input rather than guidance only from preparers and auditors. While the major changes taking place are geared for the protection of investors in public companies, there has finally been a realization that banks, lenders and other creditors also have a vested interest in getting accurate financial statements. And these entities can provide valuable input to improve the quality.

A User Council has been established, of which the writer is a member, and regular meetings are held to discuss how financial accounting disclosures can be improved. This is the first time that we have been given a direct line to the FASB. We have also been consulted as to whether private companies should be subject to the same accounting rules as public companies. Yet the cost of financial statement preparation may well become disproportionate for small companies who do not prepare statements for outside shareholders. One of the recent speakers at the CFA Committee for Cooperation with Accountants was Daniel Noll, director of accounting standards at the AICPA, who discussed this issue with us. The general consensus should not be two sets of rules, but there may be some items which private companies could omit, e.g., pension liability disclosures, and it should be left to individual lenders to discuss the waiving of compliance with specific items. CFA is assisting in the AICPA study of the subject by sending out a questionnaire to members.

Auditors now realize that it's "back to basics." Prior to Enron, the trend for accounting firms was to diversify into all types of consulting services. Auditing was considered a commodity. At one stage there was even a suggestion that "CPA" should be changed to "Certified Professional Advisor." In a sense, this is what actually happened, to the detriment of the quality of auditing. Unfortunately, things had to get worse before they got better. Now tremendous emphasis is placed on audit quality and auditor independence. There has

even been a suggestion that for auditors to be truly independent, they should not be hired by the management on whom they are reporting. This revolutionary idea: public companies should set up an audit-selection committee comprising non management shareholders, lenders and some independent members. This committee would appoint the auditors and fix their compensation. This is the first time it has been suggested that lenders have input in the process.

It is impossible for auditors to check every transaction. This would make the cost of the audit prohibitively expensive. Statistical sampling is the accepted standard and, provided no exceptions are found within the sample, it may be assumed that the transactions being checked are correct. With business becoming more complex, auditing has become much more difficult. Auditors now realize that they must focus on revenue recognition, off-balance liabilities and fair value of assets. One major problem: employees of the audit firms initially checking the documents- the foundation for building the financial statements-have the lowest level of experience in the firm. By the time information reaches the senior and experienced staff it is too late. Experienced auditors, who can perform a "smell test", are needed in addition to the technical checking which takes place. This involves a detailed understanding of the client's business and the industry in which they operate.

Most lenders do not rely on audited financial statements for lending purposes and instead accept reviewed statements, even for larger loans. Thankfully the AICPA has issued new guidelines on performance of review engagements and standards for accounting and review services. The chairman of the AICPA Accounting and Review Services Committee stated, "We are at a point where we felt there needed to be some clarification to make the review more meaningful". This is exceptionally good news for users of reviewed statements. The new provisions expand guidelines and analytical procedures, methods of inquiry and development of expectations. While the consideration of fraud has always been a part of the review engagement, the standard also includes new specific provisions on fraud. A required inquiry regarding fraud and management will now have to sign off as to whether any knowledge of fraud or suspicion exists, involving management or others, which could have a material effect on the financial statements.

Regarding "expectations", CPAs are given specific instruction on how they should compare client financial data with expectations based on their understanding of the entity, along with the industry in which it operates. CPAs have always used a variety of analytical procedures from simple comparisons to complex models i.e., trend analysis, ratio analysis and benchmarking, but now these methods have to be documented. This also includes comparing actual results with forecasts from the entity and, with non financial information, may be significant.

The CPA's inquiries during the review must be sufficiently flexible and open ended to identify any new consistencies between expectations and results and to resolve any inconsistencies to the extent possible and appropriate. As all this information now has to be documented, including what procedure the accountant used, lenders should ask for copies of these documents. If prepared correctly, they should provide invaluable information about the operating results and variances from projections and/or industry norms.

More changes have taken place in financial reporting in the last three years than during the last 100 years. Many changes benefit lenders. And lenders are being invited to participate in the improvement of accounting and auditing standards as never before. We should not lose this opportunity of sailing with the tide which has turned in our favor.

1.8 Summary

With the expansion of business the number of transactions increased. The manual method of keeping and maintaining records was found to be unmanageable. Computer is a device that accepts data, stores

data, processes data as desired, retrieves the stored data as and when required and prints the result in desired format. With the introduction of computers in business, the manual method of accounting is being gradually replaced. And finally, the database technology has revolutionised the accounts department of the business organisations. In this lesson, we have study about characteristics of computer, role of computers in accounting, need of computerised accounting, etc.

The computer system requires a specialised training of staff, which makes them feel more valued. This motivates them to develop interest in the job. However, it may also cause resistance when we switch over from a manual system to a computer system.

1.9 Key Words

Accounting	:	Accounting is the method in which financial information is gathered, processed, and summarized into financial statements and reports.
Computerised Accounting	:	It is software to solve accounting problems.
Input	:	Using Input we can send the information to the computer.
CPU	:	It is the Heart of computer.
Software	:	Collection of program is known as software

1.10 Abbreviations

AICPA	-	The American Institute of Certified Public Accountants
ALU	-	Arithmatic Logic Unit
ATM	-	Automatic Teller Machine
CPU	-	Central Processing Unit
FASB	-	Financial Accounting Standards Board
OLTP	-	Online Transaction Processing
PIN	-	Personal Identification Number
SQL	-	Structured Query Language
TPS	-	Transaction Processing System

1.11 Hint / Key To Activity/ Self Assessment

SELF ASSESSMENT 01: A

Software

SELF ASSESSMENT 01: B

(i) Fast, Powerful, Simple and Integrated

(ii) Complete Visibility

(iii) Enhanced User Experience

(iv) Accuracy, Speed

(v) Scalability

(vi) Power

(vii) For Improved Business Performance

(viii) Quick Decision Making

(ix) Complete Reliability

1.12 Questions For Practice

1. Why we use Computer Accounting?
2. Write differences between Manual and Computerised Accounting Systems.
3. Explain the current trends in Accounting.
4. What are the disadvantages of Computerised Accounting?
5. The framework of storage and processing of data is called as.....
6. Database is implemented using.....
7. A sequence of actions taken to transform the data into decision useful information is called.....
8. An appropriate accounting software for a small business organisation having only one user and single office location would be.....

1.13 References/Suggested Books

1 V. Rajaraman , Introduction to Computers.

2 Taxali , Introduction to Tally, BPB Publication

3 C.S. Murthi , Fundamental of Computers, Himalaya Publication

4 Fundamental of Accounting, Himalaya Publication

5 Turban Jhon Willey & Sons, IT for Management,.

UNIT - 2

Accounting Software Packages

Outline of the Unit:

2.0 Objectives

2.1 Introduction

2.2 Generic Considerations before Sourcing an Accounting Software

2.3 Accounting Packages

- 2.3.1 Ready to use
- 2.3.2 Customised
- 2.3.3 Tailored

2.4 Features of Accounting Software

2.5 Various types of Accounting Software

2.6 Quickbooks Accounting Software

2.7 Most Popular Accounting Software: Tally

2.8 Summary

2.9 Key Words

2.10 Abbreviations

2.11 Hint / Key to Self Assessment Question

2.12 Questions for Practice

2.13 References

2.0 Objectives

On completion of this unit, you will be able to

- Understand various Accounting Softwares
- Understand the features of Quick Book Accounting Software
- Understand the features of Tally

2.1 Introduction

Accounting software is an integral part of the computerised accounting system. An important factor to be considered before acquiring accounting software is the accounting expertise of people responsible in organisation for accounting work. People, not computers, are responsible for accounting.

The need for accounting software arises in two situations : (a) when the computerised accounting system is implemented to replace the manual system or (b) when the current computerised system needs to be replaced with a new one in view of changing needs.

2.2 Generic Considerations before Sourcing an Accounting Software

The following factors are usually taken in considerations before sourcing an accounting software.

- **Flexibility**

An important consideration before sourcing accounting software is flexibility, viz. data entry and the availability and design of various reports expected from it. Also, it should offer some flexibility between the users of the software, the switch over between the accountants (users), operating systems and the hardware. The user should be able to run the software on variety of platforms and machines, e.g. Windows 98/2000, Linux, etc.

- **Cost of Installation and Maintenance**

The choice of the software obviously requires consideration of organisation ability to afford the hardware and software. A simple guideline to take such a decision is the cost benefit analysis of the available options and the financing opportunities available to the firm. Some times, certain software which appears cheap to buy, involve heavy maintenance and alteration costs, e.g. cost of addition of modules, training of staff, updating of versions, data failure/restoring costs. Conversely, the accounting software which appear initially expensive to buyers, may require least maintenance and free upgrading and negligible alteration costs.

- **Size of Organisation**

The size of organisation and the volume of business transactions do affect the software choices. Small organisations, e.g. in non-profit organisations, where the number of accounting transactions is not so large, may opt for a simple, single user operated software. While, a large organisation may require sophisticated software to meet the multi-user requirements, geographically scattered and connected through complex networks.

- **Ease of Adaptation and Training needs**

Some accounting software is user friendly requiring a simple training to the users. However, some other complex software packages linked to other information systems require intensive training on a continuous basis. The software must be capable of attracting users and, if its requires simple training, should be able to motivate its potential users.

- **Utilities/MIS Reports**

The MIS reports and the degree to which they are used in the organisation also determine the acquisition of software. For example, software that requires simply producing the final accounts or cash flow/ratio analysis may be ready- to-use software. However, the software, which is expected to produce cost records, needs to be customised as per user requirements.

- **Expected Level of Secrecy (Software and Data)**

Another consideration before buying accounting software is the security features, which prevent unauthorised personnel from accessing and/or manipulating data in the accounting system. In tailored software for large businesses, the user rights may be restricted to purchase vouchers for the purchase department, sales vouchers to the billing accountants and petty cash module access with the cashier. The operating system also matters. UNIX environment allows multi-users compared to Windows. In UNIX, the user cannot make the computer system functional unless the user clicks with a password, which is not a restriction in Windows.

- **Exporting/Importing Data Facility**

The transfer of database to other systems or software is sometimes expected from the accounting software. Organisations may need to transfer information directly from the ledger into spreadsheet software such as Lotus or Excel for more flexible reporting. The software should allow the hygienic, untouched data transfer.

Accounting software may be required to be linked to MIS software in the organisation. In some ready to use accounting softwares, the exporting, importing facility is available but is limited to MS Office modules only, e.g. MS Word, MS Excel, etc. However, tailored softwares are designed in manner that they can interact and share information with the various sub components of the organisational MIS.

- **Vendors Reputation and Capability**

Another important consideration is the reputation and capability of about the vendor. This depends upon how long has he been the vendor is in business of software development, whether there are other users of the software and extent of the availability of support mechanisms outside the premises of the vendor.

2.3 Accounting Packages

Every Computerised Accounting System is implemented to perform the accounting activity (recording and storing of accounting data) and generate reports as per the requirements of the user. From this perspective. The accounting packages are classified into the following categories :

(i) Ready to use

(ii) Customised

(iii) Tailored

Each of these categories offers distinctive features. However, the choice of the accounting software would depend upon the suitability to the organisation especially in terms of accounting needs.

2.3.1 Ready-to-Use

Ready-to-Use accounting software is suited to organisations running small/ conventional business where the frequency or volume of accounting transactions is very low. This is because the cost of installation is generally low and number of users is limited. Ready-to-use software is relatively easier to learn and people (accountant) adaptability is very high. This also implies that level of secrecy is relatively low and the software is prone to data frauds. The training needs are simple and sometimes the vendor (supplier of software) offers the training on the software free. However, these software offer little scope of linking to other information systems.

2.3.2 Customised:

Accounting software may be customised to meet the special requirement of the user. Standardised accounting software available in the market may not suit or fulfil the user requirements. For example, standardised accounting software may contain the sales voucher and inventory status as separate options. However, when the user requires that inventory status to be updated immediately upon entry of sales voucher and report be printed, the software needs to be customized.

Customised software is suited large and medium businesses and can be linked to the other information systems. The cost of installation and maintenance is relatively high because the high cost is to be paid to the vendor for customisation. The customisation includes modification and addition to the software contents, provision for the specified number of users and their authentication, etc. Secrecy of data and software can be better maintained in customised software. Since the need to train the software users is important, the training costs are therefore high.

SELF ASSESSMENT - 1

Q Write required properties for an accounting software.

2.3.3 Tailored:

The accounting software is generally tailored in large business organisations with multi users and geographically scattered locations. These software requires specialised training to the users. The tailored software is designed to meet the specific requirements of the users and form an important part of the organisational MIS. The secrecy and authenticity checks are robust in such softwares and they offer high flexibility in terms of number of users. .

2.4 Features Of Accounting Software

Today's accounting software packages are designed to simplify and automate complex, manual financial management processes and improve the accessibility, accuracy, and timeliness of mission-critical financial data. By streamlining and accelerating vital activities such as budget creation, allocation, and management; cash flow analysis; accounts payable and receivable; management of capital equipment and other assets; and financial reporting, accounting software can dramatically increase the productivity of finance staff members, while improving financial performance management and strategic company planning. Most of the accounting software applications on the market provide the following features and capabilities, to improve all facets of financial planning, management, control, and analysis:

- **General Ledger Management**

This module enhances visibility into virtually all standard financial transactions such as accounts receivable, accounts payable, payroll, and sales orders. Additionally, accounting software packages allow finance professionals to quickly and easily conduct consolidations by dynamically combining multiple ledgers (such as those from different departments or business units) into a single, complete financial statement.

- **Controlling and Budget Management**

With an accounting software solution, financial teams can achieve and maintain tighter control over departmental and corporate budgets, and conduct more rapid and accurate internal and time accounting, cost accounting, product costing/cost of goods sold assessment, and more.

- **Cash Management**

Many businesses struggle to correctly anticipate their cash flow requirements. Accounting software applications, and their cash management capabilities, can help a business more accurately assess both their current and future cash needs. Additionally, it can automate reconciliations, as well as the processing, execution, and tracking of all transactions that directly impact available cash levels.

- **Financial Forecasting**

Effective financial management is about more than just analyzing past trends, it's about using that insight to enhance future planning. With an accounting software system, a business can more accurately predict and estimate potential profits and pending losses, revenue and cash flows, and other important financial events. They can then use this information to define and implement more successful corporate strategies.

- **Fixed Asset Management**

Tracking a fixed capital asset portfolio can be a complex process, particularly for those businesses that own an extensive amount of real estate or capital equipment. But, with an accounting software solution, the evaluation, acquisition, operation, maintenance, and valuation of all types fixed assets is dramatically simplified.

- **Compliance Management**

Because financial regulations have become much more stringent in the last several years, most accounting software applications provide complete transaction audit trails, as well as rules-based controls and advanced reporting capabilities that help facilitate compliance with Sarbanes-Oxley, BASEL II, and other laws and guidelines.

- **Advanced Financial Planning**

In the past, most companies have created their financial and business plans by analyzing historical data, to uncover patterns and trends that may provide some indication of future events. However, that approach provides only a portion of the insight needed. That's why some accounting software packages have incorporated advanced planning tools that simulate potential business scenarios, such as mergers and acquisitions. This can help a business better predict how major decisions will impact their financial standing.

2.5 Various Types of Accounting Software:

Accounting softwares were one of the first applications to come up in offices along with the advent of Software and Hardware. The reason being moneys are the first of our concerns when we think of control. The leaders of accounting software like Quickbooks, Peachtree, MYOB are still around and doing well with varying degrees of success.

Typically, an Accounting Software is developed using a Database, a Front End RAD tool **visual basic** and a Report Writer such as crystal reports. Accounting softwares can be for the desktop, network (client server) and web. Accounting softwares developed using these tools provide great speed and usability, but, to upgrade them to multi user large database environments is mostly unsuccessful as the overhead begins to climb nullifying the benefit of lean code which the C++ tools provide.

A well designed Accounting Software caters to multiple domains. So, a well designed accounting software can, in theory, meet the needs of multiple types of firms. However, in practice a certain amount back bending is required to use a Generic Accounting Software in a construction or church or call center or fund management environment. Here the versatility of the software boils down to the design of the Chart of Accounts which can accommodate a wide range of accounting requirements.

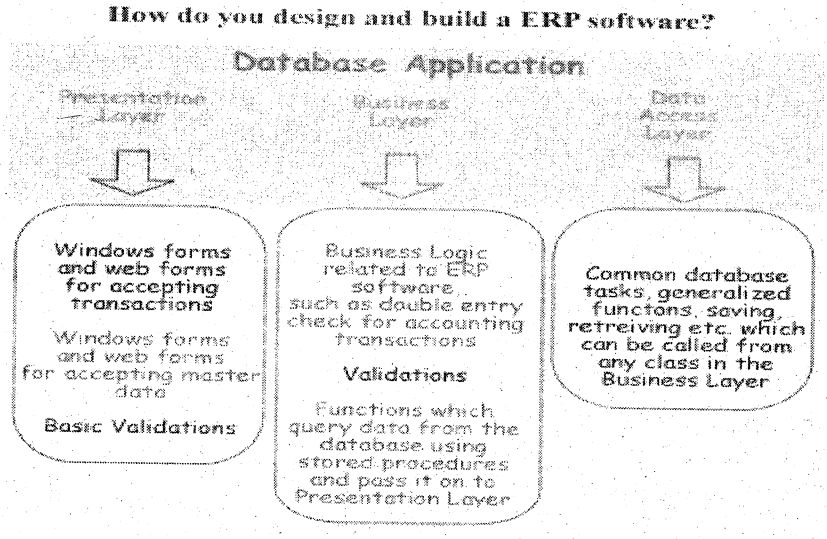


Diagram 02:01 Database Application
Source: Compile from website

For most small businesses, a generic accounting software will be sufficient unless their needs are very specific. However, with the cost of software and hardware on a downward spiral combined with the high speed and processing power, the small business too can think of highly customized software incorporating their own design and commercial requirements.

The different categories or types of accounting software are as follows:

(i) Small business/personal accounting software which are mainly meant for home users. They are simple and inexpensive with simple functioning such as management of budgets.

(ii) Low end accounting software are for small business markets that are capable of serving a single national market. Such software are characterized by 'single entry' products.

(iii) Mid market accounting software are for companies with large businesses. These software are capable of serving the needs of multiple national accountancy standards and facilitate accounting in multiple currencies.

(iv) High end accounting software are complex and expensive business accounting software that are also known as Enterprise Resource Planning or ERP software.

However, you have to keep certain things in mind before buying an accounting software, like the prices of the software, its different features, its after-sales support and alike. Most of the accounting software include all the important accounting modules. The more specialized features a software has, the more expensive it becomes. Your software features must be compatible with your business. Also, the after-sales support is important like FAQ package, local service center and others.

There are a lot of top accounting software available in every category. So, it is not easy to select the best ones. Below are top five accounting software in every category.

(i) Small business/personal accounting software:

1. ePeachtree (Best Software)
2. MYOB Plus for Windows (MYOB Software)
3. Peachtree Complete Accounting (Best Software)
4. QuickBooks Online (Intuit)
5. Small Business Manager (Microsoft)

(ii) B. Low-End Accounting Software:

1. BusinessVision 32 (Best Software)
2. MAS 90 & MAS 200 (Best Software)
3. QuickBooks Pro 2003 (Intuit)
4. ACCPAC Pro Series (ACCPAC International)
5. Vision Point 2000 (Best Software)

(iii)C. Middle-Market Accounting Software:

1. ACCPAC Advantage Series Corporate Edition (Best Software)
2. Great Plains (Microsoft) MAS 90 & MAS 200 (Best Software)
3. Navision (Microsoft)
4. SouthWare Excellence Series (SouthWare)
5. SYSPRO (SysproUSA)

(iv) D. High-end accounting ERP Market:

1. Axapta (Microsoft Software)
2. e-Business Suite (Oracle)

3. MAS 500 (Best Software).
4. Solomon (Microsoft)
5. ACCPAC Advantage Series Enterprise Edition (Best Software)

Variety of accounting software is available in the market. The most popular software used in India are Tally and Ex. The basic features of all accounting software are same on a global basis. The legal reporting requirements in a given country and the business needs affect the software contents. The other popular softwares are Sage, Wings 2000, Best Books, Cash Manager, and Ace Pays, etc

- **A small business accounting software**

A small business accounting software has to meet the requirements of many basic requirements of businesses like, recording of a purchase, sale, payment, receipts, credit note, debit note etc. To implement these features, an accounting software has to have been designed with all requirements in view. At the time of design, the financial statements which are to be generated have to be prepared and taken into consideration before going ahead.

Additionally, todays Accounting Software should include on the fly data entry, data grids, dropdown lists, list boxes, and help.

- **Construction accounting software**

A construction firm requirements are different as they come. A good construction software will include modules for General Construction, Materials, Highway, Mechanical and other areas like sewer, oil pipelines etc. Audit trail, closing of books, job costing, general ledger, over/under billing, overhead allocation, construction-specific payroll features, union reporting, certified Payroll reporting, payables and receivables. Many of the construction projects are executed on site. This necessitates special features like remote access, updation, and retrieval of data.

A construction order is an ongoing project in stages and is usually executed on receipt of payments for each stage. A good construction management software should be able to add new sub contractor in the middle of a project being executed and maintain sub-contracts by job and sub-contract number. Generating and printing the sub-ledger, which includes not only invoices but also change orders, holdback amounts, amounts payable, and actual contract information for each sub-contractor. A good construction management software can record all costs related to a particular job or order and thus enable closer accounting control.

Querying features include inquiry by PO status, payment status, order status, job status, and material receipt or dispatch status. Managing the sub contractors is a major requirement in any construction project and today most construction management software include features to closely manage them. Inventory control software is sold as a separate software. However, a construction software should include inventory control with features to track material flow to different projects, and their status.

Project monitoring features like tracking actual cost vs budgeted cost, materialwise, jobwise, projectwise, are standard.

- **Day Care Accounting Software**

A day care accounting software is a simple software which tracks each family's balance and shows the child care billing history of registration fees, tuition charges, family discounts and payments.

Child care billing for subsidized families may be easily divided between family co-payments and government agencies and can even handle divorced parent situations. Recording of late payment fees and

print balance due notices to all families who are past due. A good day care software retrieves family, child and immunization information from the database in a report format. You can also manage tuition charges, customer balances payments and financial reporting. Nowadays, all software allows recording electronically transfer funds without the use of cash or paper checks.

Integrating a Calendar into accounting software is a common feature. Managing different daycare and school age programs are standard features. Fitting these schedules for each child is also common. Almost all software implements plan schedules for the school year, calendar year, summer, or just one week or month at a time.

A few good child care software allow child check in on a hand held pocket PC too. The hand held pocket PC also enables easy access to emergency phone numbers and email ids. Another common feature of day care software is to allow importing of photographs of students, parents, and authorized pick up persons.

- **Payroll accounting software**

A payroll accounting software records the salaries of employees working in an organization and enables prompt payment ensuring certain fairness as all are paid in a particular time frame.

A payroll accounting software starts with generating the pay slips. To generate a pay slip the software should be able to record attendance, record employee details, pay details, leave details, grading, and incentive details if any. Based on this, the software should be able to generate monthly and yearly provident fund, month and yearly professional tax, ESI etc, tax returns, salary certificate, gratuity valuation, bank statement, leave encashment valuation, MIS reports, increment details and deductions.

Payroll forms a part of HR. If an HR feature is provided, it should ideally be able to monitor the employees work performance, help the management in identifying the areas where each employee can improve and thus assist in organizing training programs, selecting the areas of training, durations, results of the training and on the whole help in improving the organizations functioning.

- **Church accounting software**

Church groups, counseling, data entry, decisions, library, mail merge, ministry groups, outreach, Sunday school, visitors, youth music, budgeting, check register, contributions, employment, fund accounting and pledges.

STFB

STFB Inc. develops and markets - Integral Accounting Enterprise, a complete accounting & ERP system with source code and distribution rights. Based on **ASP.Net, Visual Basic.Net** based platforms. Integral Accounting Enterprise is perfect for developers, Consultants, Resellers (VARS) looking for accounting packages to customize and resell to end-users.

Includes all the standard features like General ledger, inventory control, AR/AP, ordering, purchasing, payroll, help desk, shopping cart, and reports. Based on a multi-tier design which enables the programmer to separate the different layers of the application. Multi-tier design separates the Interface (Presentation Layer) from the Business Logic and the Database Layer, so the system can be easily adapted to environments or scaled across multiple systems. IAE supposedly includes a shopping cart module that is fully integrated with the inventory, ordering, accounts receivable and customer modules.

IAE includes all of the basic accounting system functionality like, purchase, sale, payments, receipts, check, cash etc. IAE includes complete source code for every part of the system, all of the tiers to the

system and the stored procedures. Some highlights of the package are adding fields, web services, add or modify any part of the system that you like, not just the front-end forms.

- **SAP Business One**

SAP has 18000 + installations around the world. SAP Business One 2005, is supposed to be easier, of better quality and supportability. Delivered through SAP global network of authorized channel partners, SAP Business One is targeted at the small and midsize companies. An affordable business management solution (really) designed for SMEs typically with 10 to 100 employees, SAP Business One is available in more than 40 country versions, used by more than 10,000 customers and delivered by a network of 1,200 partners who specialize in selling, implementing and maintaining the solution.

- **Oracle Financials**

The Oracle E-Business Suite, Financials, family of applications automates and streamlines all your financial business processes, for enterprise-wide daily business intelligence that lets you make more informed decisions, improve operations, and reduce costs. An highlight of this package is the unified data model which provides a single accurate view of all your financial information, including a 360-degree view of your customers. And Oracle Financials, running on Oracle technology, gives you industry-leading performance and scalability.

Oracle Financials is part of the Oracle E-Business Suite, integrating with other E-Business Suite applications including Oracle Marketing and Oracle Supply Chain Management. Implement one or several application families or implement the complete Oracle E-Business Suite for the fastest way to high-quality enterprise information.

Activity Based Management Advanced Collections Assets Balanced Scorecard Bill Presentment Architecture Cash Management Daily Business Intelligence for Financials Enterprise Planning and Budgeting Financial Analyzer Financial Consolidation Hub General Ledger Assets.

- **Sage**

Sage Instant is a beginner accounting system, designed for users with limited accounting and IT experience. Features include double entry book-keeping, invoicing, a link to your accountant and graphs to help you analyse your accounts. However, being a basic package there is no nonprofit version available.

***Sage* Line 50** used to be called Sage Sterling, is the original Sage product, and is an all-purpose, small business accounting solution. It comes in many varieties – Book-keeper, Accountant, Accountant Plus and Financial Controller. It allows the creation of a chart of accounts and there is a reasonable report writer. However, the package offers very little scope for modification or tailoring. It has been popular with voluntary organisations because it offers specific charity templates. However, these frequently need to be augmented with pre or post analysis of the financial information, either manually or in a spreadsheet.

SELF ASSESSMENT QUESTION 2

Q. Name the various categories of accounting package.

2.6 Quickbooks Accounting Software

- **Quickbooks**

QuickBooks is one of the earliest accounting software to appear in the market. It has managed to hold on to its position, since then. It is ideally suited for managing small business accounting and finances.

With the advent of Internet, makers of Quickbooks have been quick to enable on-line features like accessing all business accounting information. It also claims to work on any operating system you prefer. Standard features like Print checks, pay bills & track sales & expenses, create estimates & invoices, Tools for payroll & tracking employee time, Track inventory and set reorder points, Manage customers, vendors & suppliers Track Income & Expenses are included. Credit card acceptance is also included.

Cash Flow management is one of the strong points of Quickbooks. Cash flow management is the also the key to ensuring smooth functioning of an organization. Quickbooks lets you create a forecast based on past performance and future variables. This can be used to manage the company better. Quickbooks also lets you track inventory for hundreds of products thereby serving serving as a top class small business accounting and inventory software.

- **Feature of QuickBooks accounting software**

Quickbooks is the leading accounting software package for a reason: powerful features, great user interface, good support, and a standardized platform. Learnthat.com explores how to use Quickbooks in our free Quickbooks tutorials. Learn how to use some of the great features in Quickbooks, including:

(i) Complete tasks like paying employees, invoicing, bill tracking and check-writing

(ii) Track sales and expenses, and easily share this data in Word and Excel

(iii) Stay on top of your business by seeing who owes you money or which bills are coming due

(iv) Quickly create your own professional-looking custom forms

(v) Over 100 included templates for reporting

- **Track sales & expenses**

Get rid of the piles of paperwork. Easily enter customer payments & bills from vendors. Since QuickBooks organizes everything in one place, you'll be able to access all past payments & bills for each customer and vendor with just a few clicks. Quickly and easily get your accounting tasks complete - so you can get back to business!

- **Pay bills & print checks**

Easily create and print checks. Aggregate all your checks to be paid and print them in one batch. QuickBooks will keep track of each check so you can keep tabs on where your money is going.

- **Create & e-mail invoices**

Use the data you already have in QuickBooks—such as customer contact info & products/services - to make creating invoiced a snap. Choose from pre-designed QuickBooks templates or customize the layout yourself.

- **Organize data on customers, vendors, and employees all in one place**

No more hunting through piles of files or trying to remember where you stashed that important paper. QuickBooks organizes all your important small business information in one place, giving you easy access to a complete picture of your business.

- **Import data from Excel, Quicken/ Quicken for Mac, and Microsoft Office Accounting**

Get up and running fast by importing data from the tool you use to track your finances now. However little or much data you currently have, you won't have to start over from scratch.

- **Reduce data entry by downloading your bank & credit card transactions into QuickBooks**

Save time and avoid data entry errors. Instead of typing in your bank and credit card transactions, download them securely from over 3000 participating financial institutions and easily import them into QuickBooks.

- **Enter bills and set due-date reminders**

QuickBooks helps you ensure you pay your bills on time. Record bills as they come and set a reminder to make sure you pay before the due date.

- **Export data into Excel**

Export data from QuickBooks reports to Excel spreadsheets so that you can do more complex analysis or graphing in Excel.

- **Track international sales & expenses with multiple currency support**

QuickBooks supports all global currencies and does all the currency calculations for you. You can even download exchange rates or do wire transfers from right in QuickBooks.

- **Manage products & inventory**

(i) **Create purchase orders** - You can create purchase orders in seconds by selecting from vendors and inventory already in your QuickBooks. When you get the inventory in-house and record it in QuickBooks, QuickBooks will remember you have an open purchase order and automatically match the PO to the inventory bill.

(ii) **Track inventory**- Easily track your inventory to avoid overbuying and backorders. Indicate re-order points for each inventory good and turn on reminders to automatically let you know when its time to reorder.

(iii) **Advanced Tools to track raw & finished goods** - QuickBooks Premier and Enterprise Solutions help you address your more complex inventory & product management needs including: tracking both raw materials & finished goods, adjusting inventory as you creating bills of material (BOMs), and receiving inventory in one unit of measure and selling in another.

- **Monitor performance & gain insights**

(i) **Generate reports with one click to see how your business is doing** - Get pre-designed, customizable business reports to gain insights into your business. See all available reports in one screen to easily choose the right one. Drill down with one click to see the detail behind the numbers. Export any report to Excel—your QuickBooks formatting and formulas go with it. Access industry-specific reports In QuickBooks Premier and Enterprise Solutions.

(ii) **Create budgets to keep your business on track** - Create a working budget automatically, based on your recent spending history. Adjust figures individually or across line items. The spreadsheet-style format makes it easy to see the results of your changes. Refer back to the budget to see how your actual spending compares to your original budget.

(iii) **Get a real-time snapshot of your business, in one central location with the Company Snapshot** - Stay on top of your business- see who owes you money, who you owe money to, important reminders, and income/expense performance, all in one centralized location

(iv) **Easily create a business plan; Forecast sales and expenses**- Build a professional business plan quickly by answering step-by-step questions. QuickBooks fills in the numbers based on your QuickBooks data. You can export the projections to Excel for further analysis or save it as a PDF file. Click a button to create a forecast of income and expenses for the coming year, based on your

existing QuickBooks data. Increase or decrease line items by any percentage to adjust for future changes.

- **Manage Employees**

(i) **Manage payroll & payroll taxes; offer Direct Deposit** - Intuit QuickBooks Payroll Services, QuickBooks Payroll for Mac powered by PayCycle, and Payroll for QuickBooks Online save you time by eliminating steps and giving you the tools to get your payroll done right.

(ii) **Automatically populate and print 1099s for independent contractors and federal filing** - Create and print 1099 tax forms for you and your independent contractors.

QuickBooks Pro makes accounting easy with tools to organize your finances all in one place. Complete tasks like paying employees, invoicing, bill tracking and check-writing. Stay on top of your business by seeing who owes you money or which bills are coming due. Easily track sales and expenses. Quickly create your own professional-looking custom forms, such as customer estimates, invoices and reports by using any of the over 100 included templates. Share your data with programs like Word and Excel. With QuickBooks Pro, you'll spend less time on routine tasks and more time on your business. Learn how to use Quickbooks with our free and easy to use tutorial.

2.7 Most Popular Accounting Software

- **Tally**

Tally is an Accounting Software that helps you in maintaining Accounts and Inventory of your office. Tally is a Financial and Inventory Management System. Tally is one of the acclaimed Accounting Software with large user base in India and abroad, which is continuously growing. Tally is developed in India using Tally Development Language (TDL). Tally software was developed by Mr.Bharat Goenka in the year 1988.

- **Features of Tally**

(i) Accounting without codes

(ii) Comprehensive Accounting. Maintains complete range of books of Accounts, Final A/c's like Balance Sheet , Profit & loss A/c, cash and fund flow , Trial Balance and others.

(iii) Provides Multiple reports in Diverse formats

(iv) Various options for interest Calculations

(v) Maintain multiple Godowns for stock management.

(vi) Unlimited sub-classifications to get multi-dimensional analysis and comparatives.

(vii) Allow accounts of multiple companies simultaneously.

(viii) Multiple currencies in the same transaction and viewing all reports in one or more currency.

(ix) Prints online.

(x) print daybook and balance sheet and ledger , trial balance and profit and loss a/c.

(xi) Backup and restore option

(xii) Tally is allow to Cheque printing

(xiii) Multi tax calculation like VAT, TDS, TCS, FBT, etc.

(xiv) Calculate Payroll calculation easily.

(xv) Use Security levels for audit purpose.

2.8 Summary

Accounting software provides a broad range of features and functions that improve all facets of financial planning, management, control, and analysis. With accounting software, businesses can increase productivity, while enhancing financial performance management and strategic financial planning.

For companies looking to purchase an accounting package, the evaluation and selection process can be quite confusing. But, knowing what to look for can help you simplify your search and make the best possible decision. Read on to find out which key features should be included in your accounting package.

2.9 Keywords

Day Care	:	A day care accounting software is a simple software which tracks each family's balance and shows the child care billing history
Pay Roll	:	A payroll accounting software records the salaries of employees working in an organization and enables prompt payment ensuring a certain fairness as all are paid in a particular time frame.
Quick Book	:	Quickbooks is the leading accounting software package for a reason: powerful features, great user interface, good support, and a standardized platform.
SAP	:	Business is supposed to be easier, of better quality and supportability.
SAGE	:	Sage Instant is a beginner accounting system, designed for users with limited accounting and IT experience.
STFB	:	Integral Accounting Enterprise, a complete accounting & ERP system with source code and distribution rights
Tally	:	Tally is an Accounting Software that helps you in maintaining Accounts and Inventory of your office.

2.10 Abbreviations

ERP	-	Enterprise Resource Planning
ESI	-	Employee State Insurance
FAQ	-	Frequently Asked Questions
HR	-	Human Resource
MIS	-	Management Information System
MS	-	Microsoft
PC	-	Personal Computer
RAD	-	Rapid Application Development
SAP	-	System Aided Programming

2.11 Hint / Key To Activity/Self Assessment

SELF ASSESSMENT 1

The following factors are usually taken in considerations before sourcing an accounting software.

(i) Flexibility

(ii) Cost of Installation and Maintenance

(iii) Size of Organisation

(iv) Ease of Adaptation and Training needs

(v) Utilities/MIS Reports

(vi) Expected Level of Secrecy (Software and Data)

(vii) Exporting/Importing Data Facility

(viii) Vendors Reputation and Capability

SELF ASSESSMENT 2

The following are various accounting softwares.

(i) SAGE

(ii) QUICKBOOK

(iii) TALLY

(iv) DAYCARE

(v) PAYROLL

(vi) SAP

(vii) ORACLE FINANCIAL

(viii) STFB

2.12 Questions For Practice

1. Define a computerised accounting system. Distinguish between a manual and computerised accounting system.
2. Discuss the advantages of computerised accounting system over the manual accounting system.
3. Describe the various types of accounting software along with their advantages and limitations.
4. 'Accounting software is an integral part of the computerised accounting system' Explain. Briefly list the generic considerations before sourcing accounting software.
5. 'Computerised Accounting Systems are best form of accounting system'.
6. Write various features of Quickbook Accounting Software.

2.13 References/Suggested Books

1 Management Information System, Vikas Publising House.

2 IT for Management, Himalya Publication.

3 Taxali, Intoduction of Accounting.

UNIT - 3

Use of Tally Software

Outline of the Unit

3.0 Objectives

3.1 Introduction

3.2 Getting Functional with Tally

- 3.2.1 Tally start-up
- 3.2.2 Creating a Company

3.3 Accounts info

- 3.3.1 Groups
- 3.3.2 Ledgers

3.4 Accounting Voucher Types

- 3.4.1 Accounting Vouchers
- 3.4.2 Voucher Types in Tally

3.5 Tally Accounting Package Features

3.6 Summary

3.7 Key Words

3.8 Abbreviations

3.9 Hint / Key to Self Assessment Question

3.10 Questions for Practice

3.11 References

3.0 Objectives

On completion of this unit, you will be able to

- Understand the basic and advanced features of Tally
- Understand the new feature of Tally
- Identify the key component of Tally
- Create a company
- Various menus and components of Tally

3.1 Introduction

Tally is a Financial and Inventory Management System. Tally is one of the acclaimed Accounting Software with large user base in India and abroad, which is continuously growing. Tally is developed in India using Tally Development Language (TDL). Tally software was developed by Mr.Bharat Goenka. The first version of tally was released in 1988 and through continuous development, is now as one of the leading accounting packages across the world. Tally market share is more then 90%. Unlike other computerized

accounting packages which require numeric codes. Tally users have the freedom to allocate meaningful names in plain English to their data item in the system. Tally is very flexible. Tally provides a comprehensive solution to the accounting needs of business.

3.2 Getting Functional with Tally

The very first time you start Tally, you would require to 'create' a company. 'Create Company' simply means giving basic information about the company whose books of accounts Tally is to maintain for you. Tally is smart, but it does need an introduction to your company. The initial screen would appear like this:

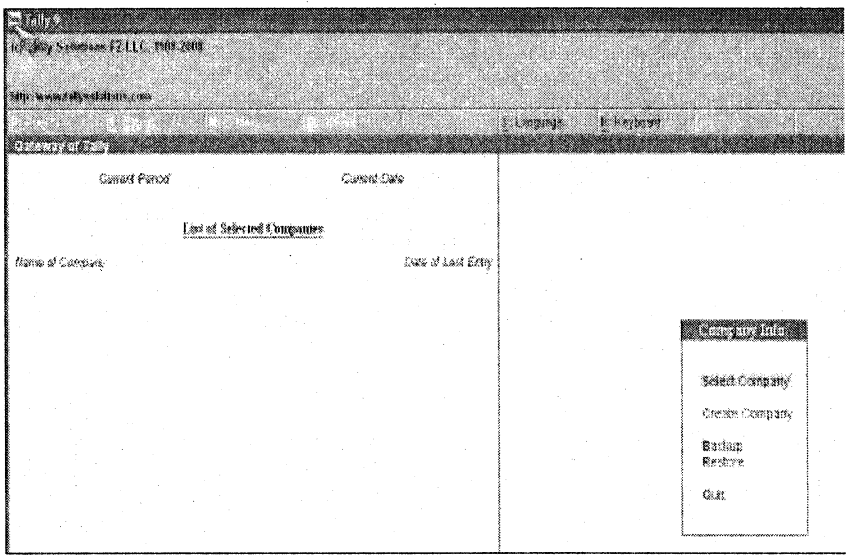


Diagram 3.1 Tally Start up Screen

3.2.1 Tally start-up

To start Tally:

Start -> Programs ->Tally 9 -> Tally 9 Release 2

Or

Double click on the Tally shortcut in the desktop to open Tally

Tally Screen Components:

(i) **Title Bar** - Displays the version number, system date and time

(ii) **Gateway of Tally** - Displays menus, screens and reports.

(iii) **Calculator** - used for calculator functions.

(iv) **Buttons toolbars** - displays buttons that provide quick interaction with tally.

(v) **Minimize Button** - Performs the standard windows function allowing us to minimize tally to work on other applications.

3.2.2 Creating a Company

When Tally first loads the Gateway of Tally area is available. When no companies are there, then the Select company option is not activated. The cursor is placed the create company meaning that a company should be created. Press enter in Create company option in order to create a company.

To create a company choose create company option in the gateway of tally screen or company information menu. While creating a new company it will ask for the following information.

(i) Directory - In this if needed we have to specify the path where the company file should be stored in your computer. By default C:\Tally\Data is the path taken.

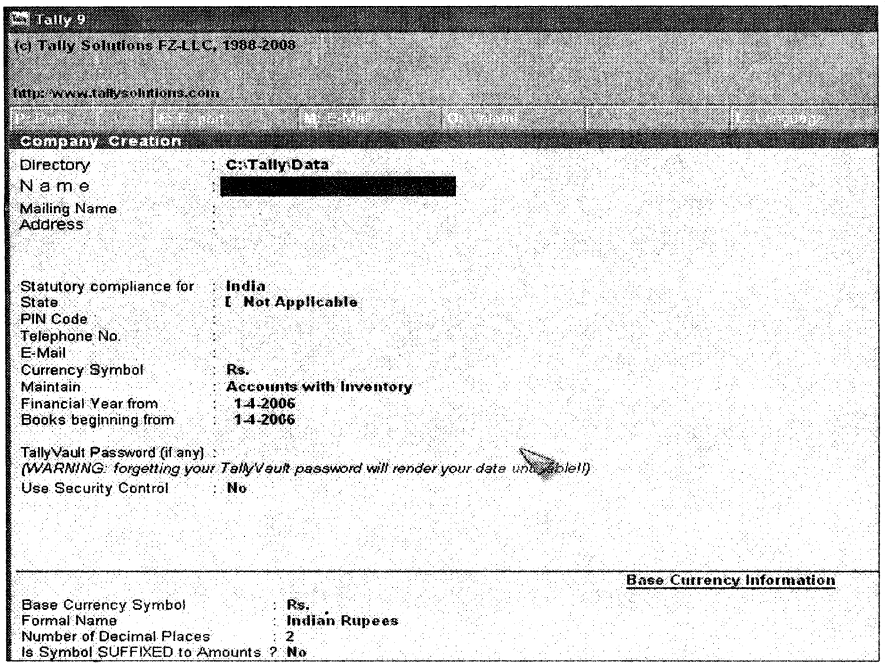


Diagram 3.2 Company Creation

(ii) Name - In this we have to type the name of the company.

(iii) Mailing Name - In this we have to type the mailing name, which is used to all the letters used in Tally.

(iv) Mailing Address - In this we have to type the mailing address, such as street, city, pincode for the company.

(v) E-mail Address - In this we have to type the E-mail id for the company.

(vi) Statutory compliance for - By default the statutory compliance for India. It is used for tax calculation for country wise.

(vii) Currency Symbol - By default the currency symbol Rs is taken. Since Tally is a Indian product.

(viii) Maintain - In this we have to choose either Accounts only or Accounts with Inventory

(ix) Financial Year - In this we have to type the starting date of the financial year. In accountancy financial year start from April 1 of year to Mar 31 of the next year. For example 1 April 2009 to 31 march 2010. Automatically tally adds 12 months with the starting date of the financial year.

(x) Book Beginning From - In this we have to specify the date in which the book should be started. The date given must lie in between the financial year starting date and ending date.

(xi) Tally Vault Password - In this we have to specify the password for the company, if so the company name will not be displayed in the Select company option.

(xii) Use Security Control - While opening the company if we need to specify the user name and password for protection (ex: other person can't open our company), we can make this option to yes and specify the user name and password.

(xiii) Base Currency Symbol - This option specifies the information about currency used in the company. Such as Base Currency Symbol, Formal Name, Number of decimal places, Is symbol suffix with amount, symbol for decimal portion, show amount in Millions, Is symbol suffixed with amount etc.

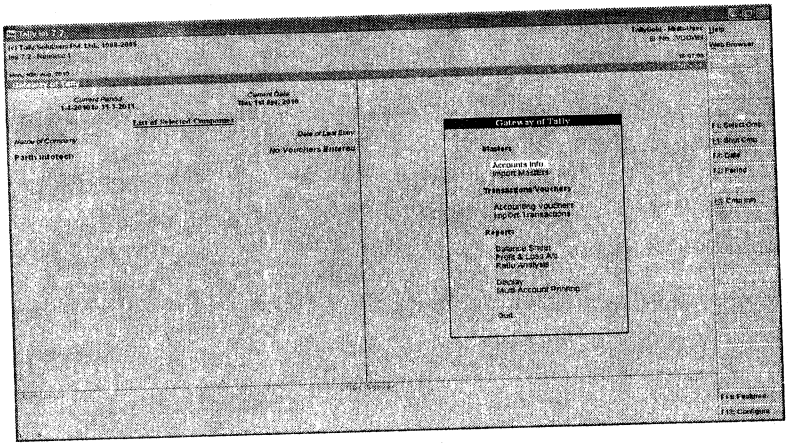


Diagram 3.3 Gateway of Tally Screen

Note: All the above information is not must, we can specify the important things and omit the others.

After creating company Gateway of Tally Screen appear on the screen.

3.3 Accounts Info

Then we click on Accounts info command to create groups and Ledgers. Groups and ledgers are important part of tally. Without having the ledgers and groups we can not enter any entry. When we open Accounts info menu then various items displays. Accounts info screen is as follows:

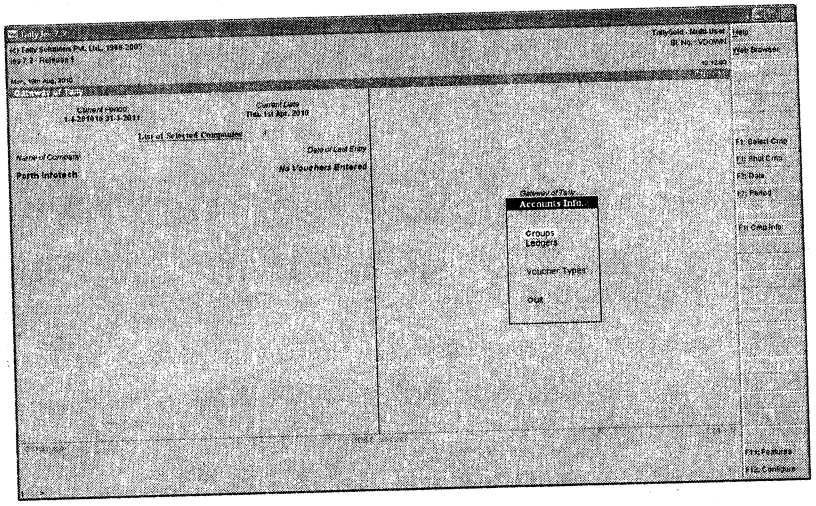


Diagram 3.4 Accounts Info Screen

3.3.1 Groups

Groups are created for same type of Ledger A/c. In Tally There are many groups which are used for making ledgers. So in the rare cases we have to create groups. These are the main groups in the tally.

(i) **Reserve and Surplus (Retained Earning):** -You can use this group heads like Investment Allowance Reserve, Select Ledger and other such reserve accounts.

(ii) **Current Assets:** - This is the primary group that has all the current assets accounts.It has Six Sub Groups under it.

(1) **Bank Accounts:** -It is used to hold all accounts of banks.

(2) **Cash in hand:** -It is used to hold ledger account of cash.

(3) **Deposits:** -It is used to hold assets like security deposits, rental deposits and all other deposits made by the company.

(4) **Loan and Advances:** -It is used to hold all advances and loans of non trading nature given by the company.

(5) **Stock in hand:** -It is used to hold certain special accounts like raw material, finished goods and work in progress.

(6) **Sundry Debtors:** -It is used to hold accounts of companies and individuals that give goods on credit to the company.

(iii) **Current Liabilities:** -This is a primary group and is used to hold outstanding and statuary liabilities of the company. The group has three sub groups under it which are as follows.

(1) **Duties and taxes:** -It consists all types of taxes and duties like Excise, Local Sales tax, Central Sales Tax, VAT etc.

(2) **Provisions:** -It is used to hold other tax provisions like Income tax, depreciation in it.

(3) **Sundry Creditors:** -It is used to hold accounts trade creditors of the company.

(iv) **Fixed Assets:** - This is used to keep accounts of all the fixed assets, patents, trade tights etc.

(v) **Investment:** - This is used to hold ledger accounts of shares, bonus and other securities of the company.

(vi) **Loan Liabilities:** - This is used to keep track of loan taken by the company. This group has three sub groups which are as follows.

(1) **Bank OD Accounts:** -It is used to hold all overdraft accounts with banks.

(2) **Secured Loans:** -It is used to hold long/medium term loans taken by the company from financial companies and Banks etc.

(3) **Unsecured Loans:** -It is used to hold the loans taken unconditionally by the company.

(vii) **Suspense Accounts:** This is used by many companies to maintain a suspense ledger which keeps track of money received or paid by the companies, whose nature of transaction is not yet known.

(viii) **Miscellaneous Expenses:** The loss of the company, which has not been written off but carried forward to the next year, should fall here. However, tally treats it as a negative profit and carries it to the profit and loss account.

(ix) **Branches/Division:** This is used to keep the names of all companies which may be branches, divisions of the company.

(x) **Sales Account:** It is used to all goods sales accounts of the companies.

(xi) **Purchase Account:** It is used to all goods purchase accounts of the companies.

(xii) **Direct Income:** It is used to hold ledger accounts of non trade income accounts that affect gross profit.

(xiii) **Indirect Income:** This is used to hold ledger accounts of those expenses of the company that determine its gross profit. For example interest received and commission received.

(xiv) **Direct Expenses:** This is used to hold ledger accounts of those expenses of the company which determine its gross profit. Expenses like salary paid to labour, transportation, electricity bills etc.

(xv) **Indirect Expenses:** This is used to hold ledger account of those expenses of the company, which determine its net profit. Expenses like advertising, maintenance of vehicles, administrative expenses etc.

- **Creating a Group**

Tally provides a list of 28 pre-defined groups. Of these, 15 are primary groups and 13 are sub-groups. We may configure our groups to enable / disable advanced mode.

Press F12 -> Accts/ Inv info -> Account Masters -> Set to yes the following options

Allow Advances entries in masters - Yes

Use Address for Ledger Accounts - Yes

Single group - Allows us to work on one group or sub-group at a time.

Gateway of Tally -> Accounts Info -> Groups -> Single -> Create

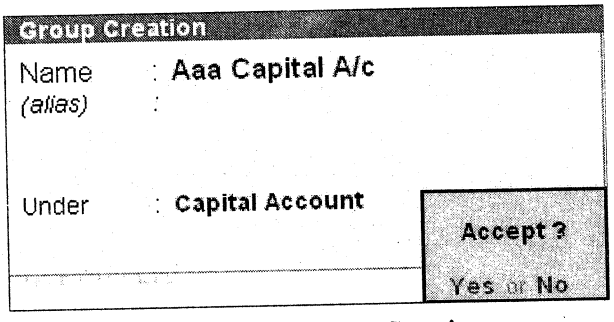


Diagram 3.5 Group Creation

(i) **Name of Group:** Enter the name of the desired group or sub-group (eg: Salary)

(ii) **Alias:** Give an alias to allow access the group using the alias in addition to its name , or leave it blank

(iii) **Under:** Specify under which existing (Parent) group the sub-classification is needed. We can create a new parent group by using Alt +c. In other words Alt +C is the shortcut key to create a ledger or group during creation or during voucher entry.

(iv) **Altering Groups:** Once created, groups can be altered by selecting Alter for single or multiple groups.

(v) **Deleting Groups:** We can delete a group via the Group Alteration screen by pressing Alt +D. However, we cannot delete Tally pre-defined groups, or groups with sub-groups, or groups containing ledgers. The lowest level must be deleted first.

3.3.2 Ledgers

Ledgers are actual account heads to which the transactions are identified. You Make all voucher entries in these accounts. You have to classify all ledgers in to groups.

- **Creating Ledgers**

Once we have created necessary Masters, now it is the turn of ledger creation. Tally on its own 2 ledgers already created listed below remaining all others we have to create.

(i) Cash (under Cash- in - hand group)

(ii) Profit & Loss Account (Primary Ledger)

Ledger is the actual account head to which we identify a transaction. We pass all accounting voucher entries using ledgers. All ledgers have to be classified into groups. Hence, a through understanding of account classification is important working with ledgers

- **List of ledgers frequently used and their related Groups**

1. Capital Account	:	Capital Account
2. Name of your creditors	:	Sundry Creditors
3. Name of your Debtors	:	Sundry Debtors
4. Name of Expenses	:	Direct Expenses or Indirect Expenses according to the nature of expenses
5. Name of Income	:	Indirect Income
6. Name of Bank	:	Bank Account
7. Name of Current Asset	:	Current Assets (i) stock in hand (ii) deposits (iii) show short term investment
8. Name of Fixed Asset	:	Fixed Asset
9. Name of Current Liabilities	:	Current Liabilities
10. Name of Fixed Liabilities	:	Fixed liabilities
11. Name of Loss	:	Direct Expenses or Indirect Exp.
12. Bad Debts	:	Indirect Exp.
13. Provision for Bad Debts	:	Current Liabilities
14. Outstanding Expenses	:	Current Liabilities
15. Advance Income	:	Current Liabilities
16. Outstanding Income	:	Current Assets
17. Sale Tax / VAT	:	Duties and Taxes
18. Excise Duty / CENVAT	:	Duties and Taxes
19. Drawing	:	Capital
20. Purchase	:	Purchase account
21. Sale	:	Sale Account

Ledgers can be created in single and multiple modes. In multiple mode you can create multiple ledgers at a time.

Go to Gateway of Tally> Accounts Info. > Ledgers> Create (under Single Ledger)

Name

Enter the Name of the account

Alias

Enter an alias name if required

Under

All accounts must be classified under their appropriate Groups. Select the Group under which the Ledger is created from the List of Groups.

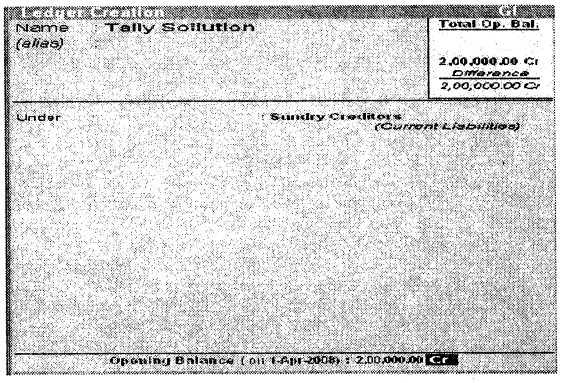


Diagram 3.6 Ledger Creation

Go to Gateway of Tally> Accounts Info > Ledgers > Create (under Multiple Ledgers)

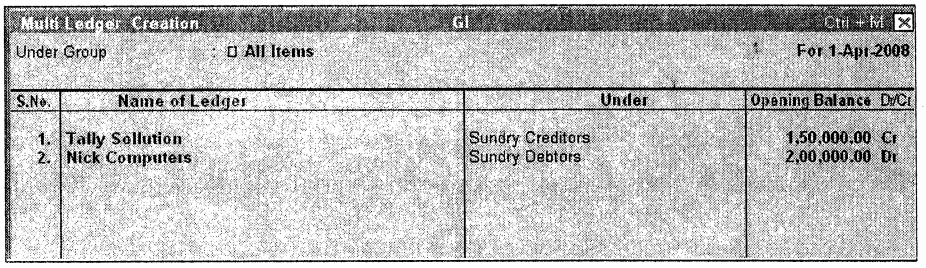


Diagram 3.7 Multi-Ledger Creation

Under Group Select the name of the group under which you want to create the Ledgers from the List of Groups.

S.No This is auto generated.

Name of Ledger Enter the name of the Ledger.

Under This field defaults to the parent group selected in Under Group

Opening Balance This is the balance remaining when you first enter your books on Tally, i.e. the date of beginning of books.

SELF ASSESSMENT 1

Q **Create a Ledger:**

Soniya Capital A/C
SBI Bank
Purchase
Sales
Rent
Electricity Bill
Wages
Stationery
Discount Paid
Insurance Paid
Discount Received
Commission Paid
Paid Monika Cash
Office Expenses

3.4 Accounting Voucher Types

For Making the Voucher Entries first of all we have to set the voucher date by pressing F2 then enter the voucher date. There are various types of vouchers in tally. Those are describes as follows:

(i) **Contra Voucher** This type of voucher is used for Cash to Bank, Bank to Cash and Bank to Bank Entries. Press F4 to select the voucher type.

(ii) **Payment Voucher** This type of voucher is used for the Cash Payment Entries. Press F5 to select the voucher type.

(iii) **Receipts Voucher** This type of voucher is used for the Cash Receipts Entries. Press F6 to select the voucher type.

(iv) **Journal** This is used for the Journal Entries like debit of credit Entries. Press F7 to select the voucher type.

(v) **Sales Voucher** This is used for the Goods Sales Entries. Press F8 to select the voucher type.

(vi) **Purchase Voucher** This is used for Goods Purchase Entries. Press F9 to select the voucher type.

(vii) **Memo** This is used to create Memorandum or Reverse Journal Voucher. Press F10 to select the voucher type.

3.4.1 Accounting Vouchers

In manual accounting, we record transactions through Journal entries. In computerized Accounting systems we do it through Voucher entry. Normally, a transaction is supported by a Document, e.g., Supplier's Bill, Copy of Sales Bill , Counter foil/ Record Slip entry of Cheque book , Pay -in-slip , Pay Register etc. For every transaction/ source document, we should enter a Voucher. A voucher contains details of the transaction.

- **Particulars**

In this field you should specify Dr or Cr. Type the letter D or Dr over the existing prompt to change, then select the ledger name from the pop-up list that Tally opens. There may be multiple Debit and Credit entries in one single voucher.

- **Debit / Credit Amount**

This field appears in Accounts voucher only. Enter the amount of transaction andpress Enter key. Tally will update current balance of the ledger and display it. This will happen only if you gave 'Yes' to the question 'Show Ledger Current Balance?' under Accounting Voucher in Vouchers Entry under F12: configure option. The total will appear on the bottom of the Debit and Credit columns. If both credit and Debit totals are not equal Tally will prompt to enter further Credit / Debit to balance the voucher. If both are equal Tally will move the cursor to Narration field.

- **The Narration field**

The last field of Voucher is Narration, here you enter details of the transaction entered in the voucher. It is not mandatory / compulsory to give narration. You can type anything about the transaction or just leave this field blank. You can turn off narration by responding No to the question 'Use Common Narration?' at voucher creation/alteration screen.

- **Saving the Voucher**

After entering narration, when you press Enter key a confirmation prompt will appear Asking 'Accept Yes/No?'. Press Y or Enter to save the voucher or press N to return cursor to the first entry allows you to

alter any data in the voucher. If you give Y Tally will save the voucher and blank screen will appear next to continue voucher entry.

3.4.2 Voucher Types in Tally

- **Payment voucher**

The payment voucher is for all payments you make through cash or Bank. These payments can be towards expenses, purchases, to trade creditors, etc. Follow the below procedure to create a payment voucher. All payment vouchers must have first entry a debit and at least one credit to a Cash or a Bank Account. You can have any number of debit and credit entries. However, if you do not credit one cash or bank account and still try to accept the voucher a message appears asking for a cash or bank account. If configured, Fund Transfer entries can also be made in payment voucher. If you have given Yes to 'Print After Saving Voucher?' in Voucher Type creation/Alteration Tally will print the voucher immediately after saving.

- **Receipt Voucher**

The receipt voucher in Tally is for all receipts into the Cash/Bank account. The voucher is similar to the payment voucher except that you debit cash or bank A/cs and credit the ledger from which you receive. The first entry in receipt must be credit and at least one debit to a cash or bank account. There can by any number of debit and credit entries. If you do not debit one Cash or bank account, a message appears asking you to rectify the entry.

If you have given Yes to 'Print After Saving Voucher?' in Voucher Type creation/Alteration Tally will print the voucher immediately after saving. Alternatively you can print any voucher later by going to Voucher Alteration screen using Display menu. Open the voucher and press Alt-P to display the 'Print Voucher' Screen. Give 'Y' to the Print? Prompt.

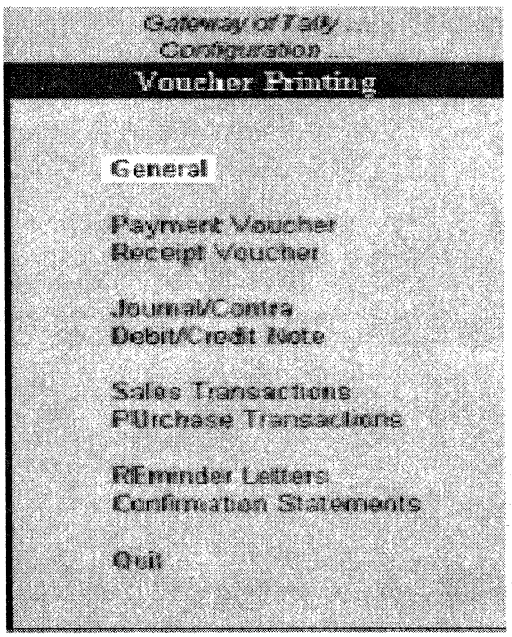


Diagram 3.8 Tally Vouchers

- **Sales Voucher**

The first entry must be a debit involving any debtor, bank or cash account and second should be a credit to ledger placed under sales account group. Rest of the accounts may be any Revenue account or any account under the Group current liabilities. Thus you can include Duties & Taxes from 3rd entry onwards.

- **Purchase voucher**

The first entry must be a credit involving any creditor, Cash or Bank account and second entry should be a debit to a ledger placed under purchase account group. Rest of the accounts may be any revenue account or any account under the Group Current Liabilities.

- **Contra Voucher**

The contra voucher is for Fund transfers between cash and Bank accounts only. The following is the rule, For example, If you pay Rs. 10000 cash into State bank Account. Your contra entry should be like this,

Particulars	Debit/credit
Cr. Cash	Credit – 15000
Dr. State bank ac	Debit – 15000

- **Credit Note**

Credit Note is raised when a buyer returns some goods that you sold him. or you give him credit due to rate difference or discount/rebate or when there is an exces debit to any party.

- **Debit Note**

You create a Debit Note when you make purchase return or when you have short billed a customer or you are granted credit by your supplier due to rate difference, discount etc.

- **Memo Voucher**

This is purely Non-accounting voucher. These entries will not affect your accounts nor does affect your final results. You can alter and convert a Memo Voucher into a regular voucher when you decide to bring the entry into your books. You can use memo vouchers to make suspense payments, vouchers not verified at the time of entry, Items given on approval.

- **Printing Configuration**

To configure voucher layouts for print output. Printing of vouchers, invoices and statements are configurable through this menu.

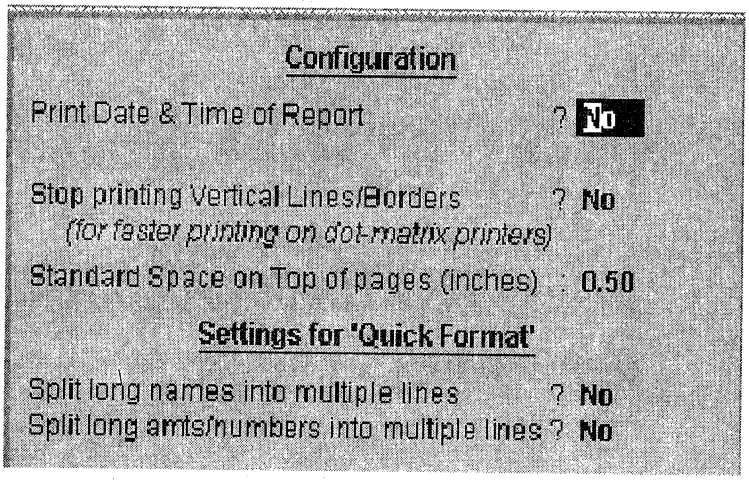


Diagram 3.9 Tally Vouchers

- **General**

This configuration is applicable for all print reports.

- **Print Date & Time of Report**

This option enables printing of system date and time on each report. (Note – vouchers, including invoices, are not reports). These are printed on the right top corner of the report as a control mechanism. It should not be confused with the date range of the report.

- **Quick Format**

Tally prints in two formats –N e at and Quick. Neat printing takes advantage of fonts of the printer and is the default. It also compresses long data like long names and amounts and auto-fits them according to space. Quick printing is suitable for Dot Matrix printers where speed is an issue. Hence, quick printing does not print fancy fonts. The auto-fit facility is, thus, not possible in quick printing. Therefore, it will truncate data longer than the allotted space. To prevent this, set Yes for the two questions under Quick Format.

- **Payment/Receipt/Journal Vouchers, Credit Note/Debit Note**

Configure the dimensions and details to print though the above options pertain to Payment Vouchers, those for other vouchers are similar. Sales Invoice, Delivery Note and Sale Order/Quotation Printing configuration of all sales vouchers like Invoices, Delivery notes and Sales Orders are accessible through Sales Transactions under Printing menu. Each transaction type is separately configurable and selectable from the sub-menu.

The different configuration for each of the above follow:

- **Sales Invoice**

This is the configuration for the Tally invoice. Change as necessary. Details of the above configuration options have been discussed in the chapter on Invoice Entry. These can be, however, set now or later as necessary. As usual, the configuration can be amended even if set.

- **Delivery Note**

Delivery Note appears very similar to Invoices. However, fields like rate and amount may be required by some companies to be printed out on Delivery Notes. Others might not wish it. Hence, select the options as relevant to your company.

3.5 Tally Acounting Package Features

Tally controls operational Features through F11: Features button. F11: Features button appear almost in every screen upon selecting a company. We get same option irrespective of screen where we launch it. Feature settings are company specific. We can activate an option for one company and deactivate the same for another company.

- **Integrate Accounts and Inventory**

This option basically affects accounts. If we set this option to Yes, the value of stock is automatically computed on the basis of Inventory and posted in Balance sheet, Profit & loss a/c and we are not allowed to input the stock value on our own as the accounts are integrated with the Inventory Part.

If we set No, our Accounts & Inventory remains separate and we have to input the value of closing stock in the ledger under Stock-in-hand group which is posted in the Balance Sheet & Profit & Loss A/c.

(i) Income /Expense Statement Instead of P&L: We change Profit and Loss A/c to Income and Expenditure statement. By default, Profit & Loss A/C

(ii) Allow Multi Currency: If we wish to record transaction in foreign currency, we should set this option to yes. On setting this feature to yes, Currency option would be available at Accounts Info

menu and in ledger creation we can specify currency for the ledger. In case we do not need foriegn currency option, we should respond No, that would keep, Accounts Info menu and ledger creation screen tidly.

(iii) Maintain Billwise Details: By default, Tally would maintain ledger wise balance and display net debit or credit balance for a ledger. If we receive or grant credit on purchase or sales, mere ledger balance may not reflect the true state of affairs-as a ledger may show an amount due which may not be over due on that date. By maintaining Bill wise details, we can get bill wise outstanding ,compute bill wise overdue interest , In case we need these features, respond Yes to this option that would allow to selectively option to maintain Bill Wise Details for ledgers. In case mere ledger balances is sufficient to meet our requirement. Respond No to keep the ledger creation screen more sleek.

(iv) Maintain Cost Centres: If we wish to make cost centre wise allocation, respond Yes that would activate Cost Centres option which we would get in Accounts inof menu.

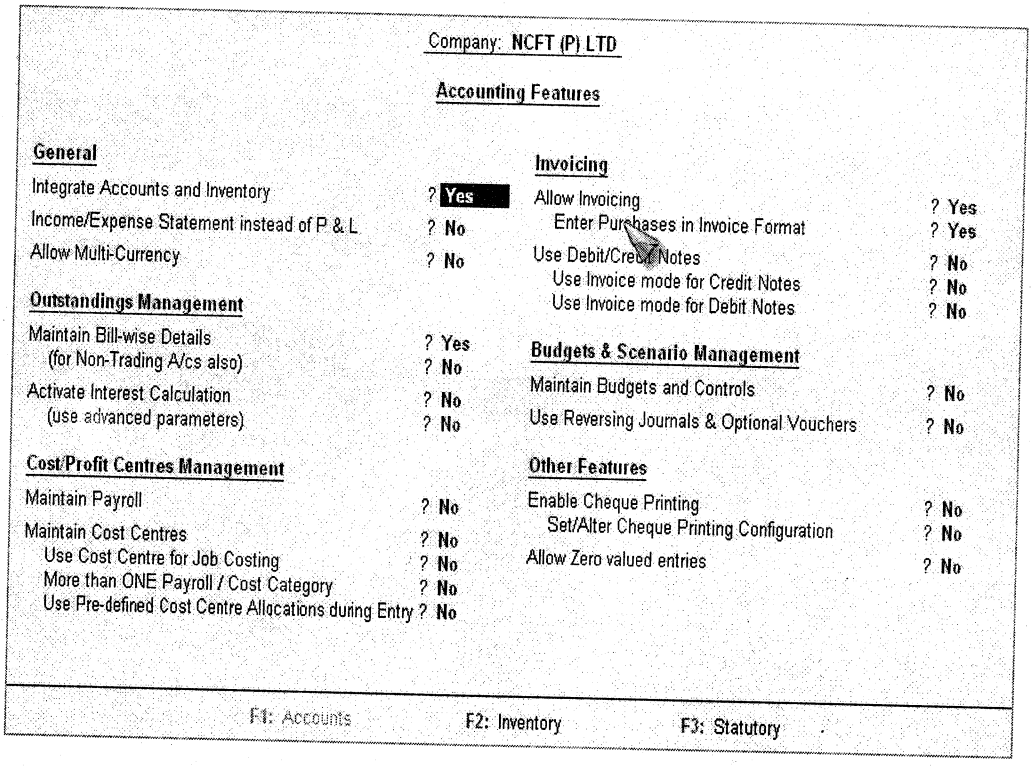


Diagram 3.10 Tally Accounting Package Features

(v) More than One cost Category: If we respond Yes to the above option, we are asked this question. If we wish to allocate a transaction to more than one set of cost centres simultaneously, respond Yes that would activate Cost Category option under accounts info menu and we would be able to allocate to multiple set of cost centres.

(vi) Interest Calculations: Interest is re-calculated with every change in balance outstanding. The Cr in the interest amount should not be confused to mean an Income. It only means that it is payable and is a liability.

(vii) Maintain Payroll: If we set this option to yes, we can create a employee pay slip.

(viii) Allow Invoicing: If we set this option to yes, we can enter sales transactions in Invoice mode also if we respond No, we will ne restricted to enter sales transactions in voucher mode only.

(ix) Maintain Budgets and Controls: If we wish to use Budget to compare with actual or other budgets and get variance or set Credit Limit for party,set this feature to yes. When we set this feature to yes,

Budget option would be avaliable at Accounts info and Credit Limits under Accounts Info-Ledger menu. In case we do not need to use Budgets or credit limits, set to No.

(x) Use Reversing Journals & Optional Vouchers:If we set this option to yes, It would be enable to voucher entry.

(xi) Allow Zero valued entries: If we need to make Voucher entires whose monetary transaction value is 0, respond yes (For example, to prepare an Invoice for sample of zero value), otherwise respond No.

(xii) Enable Cheque printing : You can choose to write cheques directly from Tally. Cheques will be printed when printing a Payment Voucher. However, first activate the capability and set dimensions

SELF ASSESSMENT 2

Q Create a Ledger:

Mohan Capital A/C
SBI Bank A/C
Purchase A/C
Sales A/C
Machinery & Furniture A/C
Investment A/C
Brokerage A/C
Typewriter A/C
Purchase from Parth Computers A/C
Rent A/C
Salary A/C
Return Inward A/C
Return Outward A/C
Drawing A/C
Sold to Suresh A/C
Traveling Expenses A/C

3.6 SUMMARY

Tally is the ultimate business solution, designed to meet the growing needs of your business. When you use Tally, you will see clear business benefits accrue right from the start. The following are the powerful advantages that you can enjoy with this versatile and robust solution:

Expand your business - with the concurrent multi-lingual capability and multi-currency features that allow you to transact beyond geographical boundaries, without language barriers.

No need to hire specialised resources – since Tally is very simple to learn and the easy interface enables you to navigate the software without difficulty.

Blazing Speed - provides you with the information you want - FAST.

Unmatched Scaleability –Tally adapts to the current and future needs of your business, irrespective of its size or style.

Sheer Power – Tally has the ability to handle huge volumes of transactions without compromising on speed or efficiency.

Real-time access to information – enables quick decision through fast and easy sharing of data from Tally.

Better cash flow and savings on interest - by using the 'receivables and payables' management feature, to help you ensure on-time collections and generate reminder letters.

Amazing Accuracy – Tally provides user-definable templates for fast, accurate data entry.

Manage your future dealings with bad debtors and persistent defaulters - using the payment performance of debtors feature, to identify them.

Faster and error-free invoicing and data entry – using the multiple price levels feature to pre-define item rates for specific categories of customers.

Identify products with high or low margins - with the profitability analysis feature, that provides you with product-wise and invoice-wise profitability.

Avoid stocking excess items and ensure that you don't run out of essential stock - by using the reorder feature, to set reorder levels for any given period.

Better planning and dramatic improvement in co-ordination of your operations with reduced paperwork – as a result of using the integration across functions feature.

Reduce costs and increase productivity – using features such as inventory management, receivables and payables management etc.

Accurate information tracking, quicker data entry and retrieval - thanks to the integrated system that ensures real-time linking of accounts and inventory.

Get a better understanding and analysis of performance levels for various periods and divisions - with the advanced MIS feature.

Enjoy better planning and forecasting – using sophisticated analytical tools that help you forecast and examine possible scenarios, and give you the ability to view provisional reports.

Save time and reduce paperwork - by automating your Payroll process with the Payroll Feature in Tally.

3.7 Keywords

Current Asset	:	This is the primary group that has all the current assets accounts.
Ledger	:	Ledgers are actual account heads to which the transactions are identified
Current Liability	:	This is a primary group and is used to hold outstanding and statuary liabilities of the company.
Loan	:	This is used to keep track of loan taken by the company.
Suspense Account	:	This is used by many companies to maintain a suspense ledger which keeps track of money received or paid by the companies, whose nature of transaction is not yet known.

3.8 Abbreviations

A/C	:	Account
Cr.	:	Credit

Dr.	:	Debit
OD	:	Overdraft
P&L	:	Profit & Loss
TDL	:	Tally Development Language
VAT	:	Value Aided Tax

3.9 Hint / Key to Activity/Self Assessment

SELF ASSESSMENT 1

Please refer to the topic Ledger creation.

SELF ASSESSMENT 2

Please refer to the topic Ledger creation.

3.10 Questions For Practice

1. Journalize the following:

No	Date	Transaction
01	01-02-2004	Maruthi & Sons Started business with capital of Rs. 2,00,000
2	02-02-2004	Paid into Indian bank Rs. 50,000
3	03-02-2004	Bought goods for cash 14,700
4	06-02-2004	Sold good to JJ Traders on Credit 7,000
5	09-02-2004	Cash Sales 19,000
6	11-02-2004	Received Commission 400
7	13-02-2004	Received seven tables from Amirtha Stores at 500 each
8	15-02-2004	Bought goods from Vignesh 2,000
9	21-02-2004	Paid cash to Amirtha Stores
10	26-02-2004	Paid rent 1,000
11	27-02-2004	Paid Salary 2,500

2. Journalize the following:

No	Date	Transaction
1	03-07-2004	Peter started business with Rs. 75,000
2	05-07-2004	Goods purchased 6,000
3	10-07-2004	Good sold Rs. 8,000
4	15-07-2004	Goods purchased from Mathew Rs. 21,000
5	17-07-2004	Goods sold to Sanjay Rs. 24,000
6	18-07-2004	Goods returned to Mathew Rs. 1,300
7	20-07-2004	Goods returned by Sanjay Rs. 500
8	23-07-2004	Opened an account with HDFC Bank Rs. 15,000

9	25-07-2004	Drew from Bank Rs. 4,000
10	25-07-2004	Furniture purchased Rs. 3,500
11	27-07-2004	Sanjay settled his account
12	28-07-2004	Settled Mathew's Account
13	29-07-2004	Insurance Premium paid Rs. 350
14	29-07-2004	Electric Charges paid Rs. 250
15	30-07-2004	Drew for Personal use Rs. 1,300
16	31-07-2004	Salary paid Rs. 1,500

3. Journalize the Following with invoice:

HS & Co started the business from 01/04/2004

01/04/2004	Received capital by cash 2,00,000
01/04/2004	Cash Deposited in HDFC Bank 50,000
04/04/2004	Credit purchases from Kiran Traders 20,000 (Inv.No. 122)
04/04/2004	Credit purchases from Pooja Traders 20,000 (Inv.No. 433)
11/04/2004	Credit purchases from Kiran Traders 20,000 (Inv.No. 144)
11/04/2004	Credit purchases from Pooja Traders 20,000 (Inv.No. 444)
11/04/2004	Returned Goods to Kiran Traders 5000 (Inv.No. 122)
13/04/2004	Returned Goods to Pooja Traders 5000 (Inv.No. 444)
16/04/2004	Credit Sales to Ram & Ram 50,000 (Inv.No.1)
16/04/2004	Credit sales to Kavitha & co 50,000 (Inv.No. 2)
16/04/2004	Cash Sales 20,000 (Inv.No. 3)
18/04/2004	Credit Sales to Ram & Ram 50,000 (Inv.No.4)
18/04/2004	Credit sales to Kavitha & co 50,000 (Inv.No. 5)
18/04/2004	Goods returned by Ram & Ram 5,000 (Inv.No.1)
18/04/2004	Goods returned by Kavitha & co 5000 (Inv.No. 5)
21/04/2004	Payment made by cheque to Kiran Traders 30,000 Ch. No. 161122
21/04/2004	Payment made by cheque to Pooja Traders 30,000 Ch. No. 161123
21/04/2004	Received cheques from Ram & Ram 75000 Ch. No. 320321
21/04/2004	Received cheques from Kavitha & co 75000 Ch. No. 112310

3.11 References/Suggested Books

1 Tally Solution: By Tally Solution Limited

2 A. B. Frielink,Auditing Automatic Data Processing,, Elsevier Publishing Company.

3 Auditing Automatic Data Processing, A. B. Frielink, Elsevier Publishing Company, Netherlands, 1959.

4 Taxali, Intoduction of Accounting- Using Tally.

UNIT – 04

Classification Of Accounts And Their Archy Of Accounts, Accounts Marker

Outline of the Unit

4.0 Objectives

4.1 Introduction

4.2 Meaning of accounting

- 4.2.1 Traditional Definition
- 4.2.2 Modern Definition
- 4.2.3 Activities Covered Under Accounting

4.3 Meaning of Accountancy

4.4 Meaning of an Accounting Cycle

4.5 Primary Objectives of Accounting

4.6 Function of Accounting

4.7 Advantages of Accounting

4.8 Limitations of Accounting

4.9 Branches of Accounting

4.10 Traditional Classification of Accounts

4.11 Accounting Equation Based Classification of accounts

4.12 Comparison of Traditional Classification and Accounting Equation Based Classification of Accounts

4.13 Distinction between Personal accounts and Impersonal Accounts

4.14 Distinction between Real and Nominal Accounts

4.15 Summary

4.16 Abbreviations

4.17 Keywords

4.18 Self-Assessment Questions

4.19 Reference/Suggested Books

4.0 Objectives

After completing this unit, you will be able to:

Define the meaning of accounting, accounting cycle, objectives of accounting, function of accounting, branches of accounting, classification of accounting, and comparison between the various kinds of accounts.

4.1 Introduction

In all activities(whether business activities or non-business activities) and in all organisation (whether business organisation like a manufacturing entity or trading entity or non-business organisation like schools, colleges, hospitals, libraries, clubs, temples, political re) which require money and other economic resources,

accounting is required to account for these resources. In other words, wherever money is involved, accounting is required to account for it. Accounting is often called the language of business. The basic function of any language is to serve as a means of communication. Accounting also serves this function.

4.2 Meaning of Accounting

4.2.1 Traditional Definition

Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.

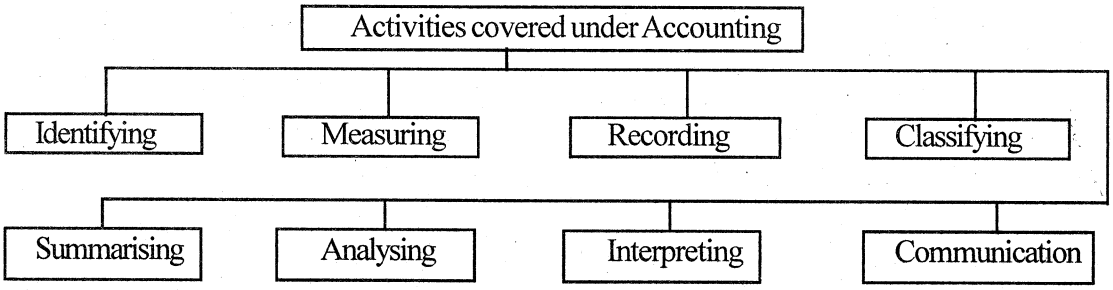
[American Institute of Certified Public Accountants (AICPA) (1941)]

4.2.2 Modern Definition

The dimension of accounting is much broader than that described above. A widely accepted definition of accounting is given by the American Accounting Association in 1966 which treated accounting as 'the process of identifying measuring and communicating economic information to permit informed judgements and decisions by the users of accounting information'.

[American Accounting Association (AAA) (1966)]

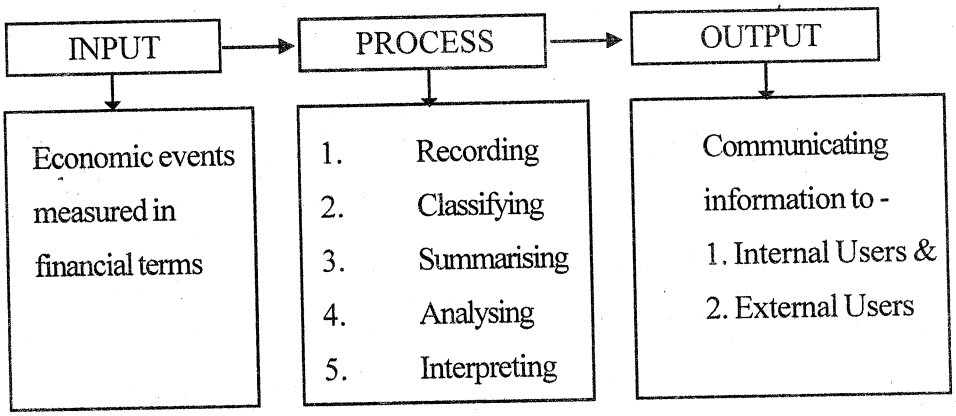
4.2.3 Activities Covered Under Accounting - Accounting covers the following activities:



1. **Identifying the Transactions and Events-** Accounting identifies transactions and events of a specific entity. A transaction is an exchange in which each participant receives or sacrifices values (e.g., purchase of raw material). An event (whether internal or external) is a happening of consequences to an entity (e.g., use of raw material for production). An entity means an economic unit that performs economic activities (e.g.,TISCO, TELCO, Birla Industries Ltd., Relience Industries Ltd.).
2. **Measuring the Identified Transactions and Events** – Accounting measures the transactions and events in terms of a common measurement unit that is the ruling currency of a country. e.g. in terms of Rupees in India.
3. **Recording** – It is concerned with the recording of identified and measured financial transactions in an orderly manner, soon after this occurrence in the proper books of accounts.
4. **Classifying** – It is concerned with the classification of the recorded transactions so as to group the transactions of similar type at one place. This function is performed by maintaining the ledger in which different accounts are opened to which related transactions are brought to one place by posting. For example, all purchase of goods made for cash or on credit on different dates are brought to purchase accounts.
5. **Summarising** – It is concerned with the summarization of the classified transactions in a manner useful to the users. This function involves the preparation of financial statements such as Income Statements, Balance Sheet, and Statement of Changes in Financial Position, Statements of Cash Flow, and Statements of Value Added.

6. **Analysing** – It is concerned with the establishment of relationship between the various items or group of items taken from Income statement of Balance Sheet or both. Its purpose is to identify the financial strengths and weaknesses of the enterprise. It provides the basis for interpretation.
7. **Interpreting**- It is concerned with explaining the meaning and significance of the relationship so established in the analysis. Now days, the first six functions are performed by electronic data processing devices and the accountant has to concentrate mainly on the interpretation aspects of accounting. The accountants should interpret the statements in a manner useful to the users, so as to enable the users to make reasoned decisions out of alternative courses of action. The accountant should explain not only what has happened but also (a) why it is happened, and (b) what is likely to happen under specified conditions.
8. **Communicating** – It is concerned with the transmission of summarised analysed and interpreted information to the users to enable them to make reasoned decisions.

Communication is preceded by an accounting cycle through which the identified and measured transactions and events pass. Accounting performs a basic function of a language, that is, to serve as a means of communication. It is an information system which communicates the accounting information to the users (whether internal or external) to enable them to make reasoned decisions. As information system, accounting by be viewed as under:



Activity 4.1

Q1. What are the activities covered under accounting?

Q2. What is meant by summarizing?

4.3 Meaning of Accountancy

Accountancy refers to a systematic knowledge of accounting. It explains 'why to do' and 'how to do' of various aspects of accounting. It tells us why and how to prepare the books of accounts and how to summarize the accounting information and communicate it to the interested parties.

4.4 Meaning of an Accounting Cycle

After identifying and measuring the financial transaction, the accounting cycle begins. 'An accounting cycle is a complete sequence beginning with the recording of the transactions and ending with the preparation of the final accounts'. The sequential steps involved in an accounting cycle are given below:

Sequential Steps involved in an Accounting Cycle

Step 1 → Journalising

Record the transaction in the Journal.

Step 2 → Posting

Transfer the transactions (recorded in the Journal), in the respective accounts opened in the Ledger.

Step 3 → Balancing

Ascertain the difference between the total of debit amount column and the total of credit amount column of a ledger.

Step 4 → Trial Balance

Prepare a list showing the balances of each and every account to verify whether the sum of the debit balances is equal to the sum of the credit balances.

Step 5 → Income Statement

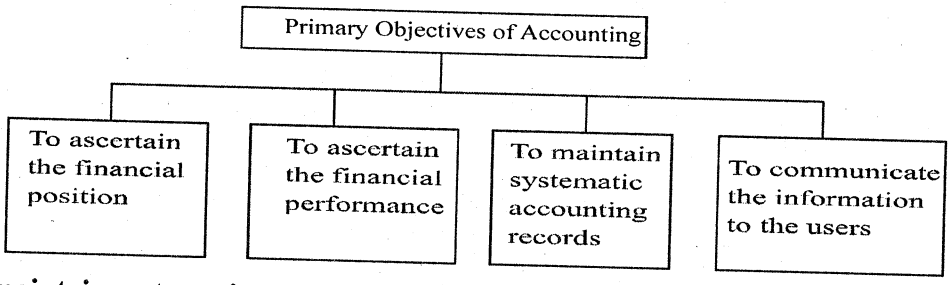
Prepare Trading and Profit & Loss Account to ascertain the profit or loss for the accounting period.

Step 6 → Position Statement (i.e. Balance Sheet)

Prepare a Balance Sheet to ascertain the financial position as at the end of the accounting period.

4.5 Primary Objectives of Accounting

The main objectives of accounting are as follows:



1. **To maintain systematic accounting records** – The basic objective of accounting is to maintain systematic accounting records of financial transactions. Written records are always better than oral records, since written records can be used by different persons for different decisions making purposes and serve as evidence of transactions. Now days, the volume of transactions is so large, a human memory cannot absorb each and every transaction. Accounting is done to keep a systematic record of (i) financial transactions, (ii) assets and (iii) liabilities.
2. **To ascertain the financial performance** – One of the objectives of accounting is to measure the financial performance of an enterprise, by preparing as Income Statement (also profit and loss account). Income statement shows the matching of current costs with current revenues during a particular accounting period and the resultant profit/loss. A systematic record of incomes and expenses facilitates the preparation of the income statement.
3. **To ascertain the financial position** – One of the objectives of accounting is to ascertain the financial position by preparing a Position Statement (also called Balance Sheet). Balance sheet shows what is owned and owned by an enterprise at a particular point of time. A systematic records

of various assets and liabilities facilities the preparation of a Position Statement (also known as Balance Sheet).

4. **Communicate information to users** – Accounting communicates information to internal users and external users. The internal users include all the organizational participants at all levels of management (i.e. top, middle and lower). Top level management requires information for planning, middle level management requires information for controlling the operations. For internal use, the information is usually provided in the form of reports, for instance Cash Budget Reports, Production Reports, Idle Time Reports, Feedback Reports, Whether to retain or Replace an Equipment Decision Reports, Project Appraisal Report, and the like.

Activity 4.2

Q1. Discuss the basic objectives of accounting?

Q2. How the systematic records are maintained?

4.6 Function of Accounting

The main functions of accounting are given below:

1. **Measurement**: Accounting measures past performance of the business entity and depicts its current financial position.
2. **Forecasting**: Accounting helps in forecasting future performance and financial position of the enterprise using past data.
3. **Decision-making**: Accounting provides relevant information to the users of accounts to aid rational decision-making.
4. **Comparison & Evaluation**: Accounting assesses performance achieved in relation to targets discloses information regarding accounting policies and contingent liabilities which play an important role in predicating, comparing and evaluating the financial results.
5. **Control**: Accounting also identifies weakness of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weakness.
6. **Government Regulation and Taxation**: Accounting provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues.

4.7 Advantages of Accounting

The advantages of accounting are as follows:

1. Facilities to Replace Memory: Accounting facilities to replace human memory by maintaining complete record of financial transactions. Human memory is limited by its very nature. Accounting helps to overcome this limitation.
2. Facilities to Comply with Legal Requirements: Accounting facilities to comply with legal requirement which require an enterprise to maintain books of accounts. For example, sec 209 of The Company Act, 1956, requires a company to maintain proper books of accounts on accrual basis; Sec 44A of The Income Tax Act 1961 requires certain persons to maintain specified books of accounts.
3. Facilities to Ascertain Net Results of Operation: Accounting facilities to ascertain net results of operation by preparing Income Statement.
4. Facilities to Ascertain Financial Position: Accounting facilities to ascertain financial position by preparing Position Statement.

5. Facilities the Users to take Decisions: Accounting facilities the users (i.e. short-term Creditors, Long-term Creditors, Present Investors, Potential Investors, Employee groups, Management, General Public, and Tax Authorities) to take decisions by communicating accounting information to them.
6. Facilities a Comparative Study: Accounting facilities a comparative study in the following four ways:
   (i) Comparison of actual figures with standard or budgeted figures for the same period and the same firm;
   (ii) Comparison of actual figures of one period with those of another period for the same firm;
   (iii) Comparison of actual figures of one firm with those of another standard firm belonging to same industry;
   (iv) Comparison of actual figures of one firm with those of industry to which the firm belong;
7. Assists the Management: Accounting assists the management in planning and controlling business activities and in taking decisions. For example, Projected Cash Flow Statements facilities the management to know future receipts and payments and to take decision regarding anticipated surplus or shortage of funds.
8. Facilities Control over Assets: Accounting facilities control over assets by providing information regarding Cash Balance, Bank Balance, Debtors, Fixed Assets, Stock etc.
9. Facilities the Statement of Tax Liability: Accounting facilities the settlement of tax liability with authorities by maintaining proper books of accounts in systematic manner.
10. Facilities the Ascertainment of Value of Business: Accounting facilities the ascertainment of value of business in case of transfer of business to another entity.
11. Facilities Raising Loans: Accounting facilities raising loans from lender by providing them historical and projected financial statements.
12. Acts as Legal Evidence: Proper books of accounts maintained in systematic manner act as legal evidence in case of disputes.

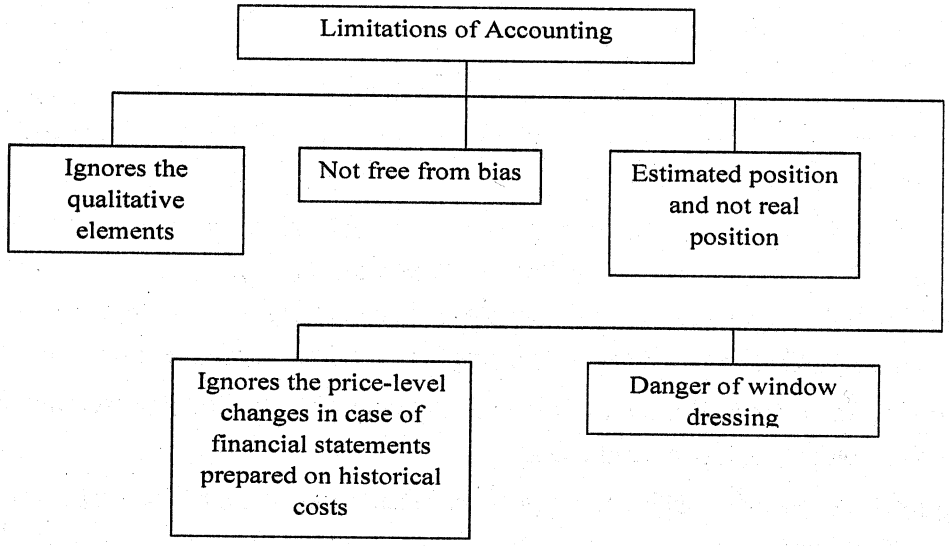
Activity 4.3

Q1. Explain the main functions of Accounting?

Q2. Discuss the advantages of accounting?

4.8 Limitations of Accounting

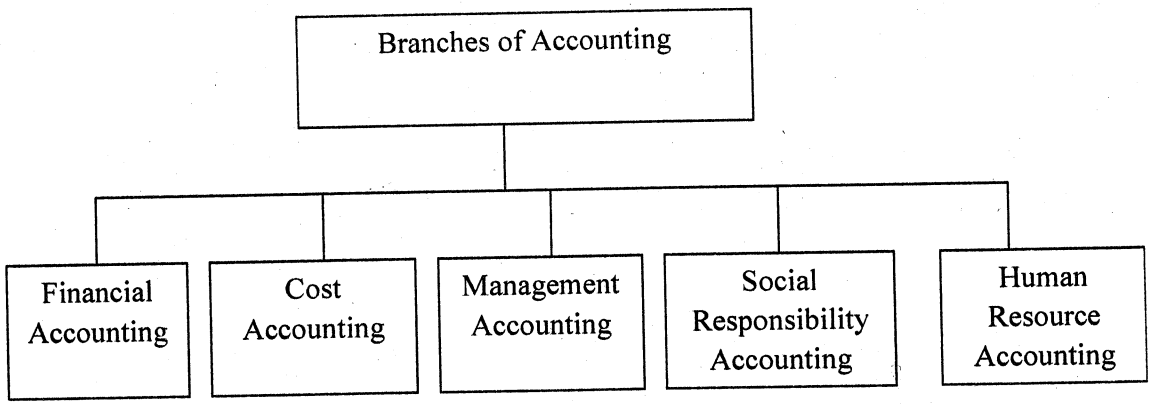
The major limitations of accounting include the following



1. Ignore the Qualitative Elements: Since the accounting is confined to the monetary matters only, the qualitative elements like quality of management, quality of labour force, public relations are ignored.
2. Not Free from Bias: In many situations, the accountant has to make a choice out of various alternatives available, e.g., choice in the method of depreciation (e.g., Straight Line or Written down), choice in the method of inventory valuation (e.g., FIFO, LIFO etc.). Since the subjectivity is inherent in personal judgment, the financial statements are therefore not free from bias. As a, result, the analysis of financial statements also cannot b said to be free from bias.
3. Estimated Position and not Real Position: Since the financial statements are prepared on a going concern basis as against liquidation basis, they report only the estimated periodic results and not the true results since the true results can be ascertained only on the liquidation of an enterprise.
4. Ignores the Price-level Changes in Case of Financial Statements Prepared on Historical Costs: In case of financial statements prepared on historical costs, the Fixed Assets are shown in the Balance Sheet at historical costs less depreciation and not at the replacement value which is often far higher than the value stated in the Balance Sheet. The analysis of such financial statements will not yield strictly comparable results unless the price-level changes are taken into accounts.
5. Danger of Window Dressing: When the management decides to enter wrong figures to artificially inflate or deflate the figure of profits, assets and liabilities, the Income Statements fails to provide true and fair view of the results of operations and Balance Sheet fails to provide true and fair view of the financial position of the enterprise.

4.9 Branches of Accounting

Economic development and technological improvements have resulted in an increase in the scale of business operations. Increasing the scale of business operations and social awareness has made the management functions more and more complex. These factors have given rise to specialised branches of accounting such as Financial Accounting, Cost Accounting, Management Accounting and Social Responsibility Accounting. These branches are as given below:



1. **Financial Accounting**: It is the process of identifying, measuring, recording, classifying, summarising, analysing, interpreting and communicating the financial transactions and events. The purpose of this branch of accounting is to keep systematic records to ascertain financial performance and financial position and to communicate the accounting information to the interested internal and external users.
2. **Cost Accounting**: It is the process of accounting and controlling the cost of a product, operation or function. The purpose of this branch of accounting is to ascertain the cost, to control the cost and to communicate information for decision-making.

3. **Management Accounting**: It is the application of accounting techniques for providing information designed to help all levels of management in planning and controlling the activities of business enterprise and in decision making. The purpose of this branch of accounting is to supply any and all information that management may need in taking decision and to evaluate the impact of its decisions and actions. Management accounting is not only confined to the area of cost accounting but also covers others areas (such as Capital Expenditure Decisions, Capital Structure Decisions, and Dividend Decisions) as well.

4. **Social Responsibility Accounting**: It is the process of identifying, measuring and communicating the social effects of business decisions to permit informed judgements and decisions by users of information. It is accounting for social costs and social benefits. Accounting for environment and ecology is part of social responsibility accounting.

5. **Human Resource Accounting**: It is the process of identifying, measuring and communicating the investments made in human resources of an enterprise.

Activity-4

Q1. Discuss the limitations of accounting?

Q2. Discuss the various branches of accounting?

4.10 Traditional Classification of Accounts

The classification of accounts according to the Traditional Approach is given below:

Classification of Accounts according to the Traditional Approach

Type of Accounts	Meaning	Examples
(a) Personal Accounts	These accounts relate to natural persons, artificial persons and representative persons.	Natural – Ram's A/c Artificial – Ram & Co's A/c Representative – Outstanding Salary A/c
(b) Real Accounts	These accounts relate to the tangible or intangible real assets.	Tangible – Land A/c Intangible – Goodwill A/c
(c) Nominal Accounts	These accounts relate to expenses, losses, profits and gains.	Expenses – Purchase A/c Loss – Loss by Fire A/c Profit & Gains – Sales A/c Discount received A/c

4.11 Accounting Equation Based Classification of accounts

Meaning of Accounting Equation

1. An accounting equation is a statement of equality between the resources and the sources which finance the resources and is expressed as under:

Resources = Sources of Finance

2. **Resources mean the assets** : The assets refer to the tangible objects (e.g. Land & Building, Plant & Machinery, Furniture, Investments, Stock, Debtors, Bank Balance, Cash Balance) or intangible rights (e.g. Patents, Trademarks, Copyright) owned by an enterprise and carrying probable future benefits.

3. **Sources of finance mean Equities** and include Internal Sources (or internal Equity) (i.e. capital) and External Sources (or External Equity) (i.e. liabilities).
4. Capital refers to the amount invested in an enterprise by its owners.
5. Liabilities are the financial obligations of an enterprise other than the owners' funds.
6. Thus, the aforesaid accounting equation may be expressed as follows:

Total Assets = Total Equities

or

Assets = Internal Equity + External Equity

or

Assets = Capital + Liabilities

7. Since, the liability holders have a definite and prior claim against the assets, the capital is also called as a residual of assets over liabilities and may be expressed as follows.

Capital = Assets – Liabilities

8. This equation is fundamental in the sense that it gives foundation to the double entry book keeping. This equation holds goods for all transactions and events and at all periods of time since every transaction and event has two aspects.

The classification of accounts according to Accounting Equation is as follows:

Type of Accounts	Meaning	Examples
(a) Assets Accounts	These accounts relate to tangible or intangible real assets.	Land A/c, Building A/c, Cash A/c, Goodwill, Patents.
(b) Liabilities Accounts	These accounts relate to the financial obligations of a term Loans.	Trade Creditors, Outstanding Expenses, Bank Overdraft, Long term Loans.
(c) Capital Accounts	These accounts relate to owners of an enterprise	Capital A/c, Drawing A/c
(d) Revenue Accounts	These accounts relate to the amount charged for goods sold or services rendered or permitting others to use enterprise resources yielding interest, royalty or dividend.	Sales A/c, Discount Received A/c, Dividend Received A/c, Royalty Received A/c, Interest Received A/c.
(e) Expenses Accounts	These accounts relate to the amount incurred or lost in the process of earning revenue.	Purchase A/c, Discount Allowed A/c, Royalty Paid A/c, Interest Payable A/c, Loss by Fire A/c.

4.12 Comparison of Traditional Classification and Accounting Equation Based Classification of Accounts

Traditional Classification of Accounts	Accounts Equation Based Classification of Accounts
1. Personal Accounts - (other than those relating to owner having debit balances - (other than those relating to owner) having credit balances - those relating to owner	- Assets Accounts - Liabilities Accounts - Capital Accounts
2. Real Accounts	Assets Accounts
3. Nominal Accounts - relating to Revenue - relating to expenses	- Revenue Accounts - Expenses Accounts

4.13 Distinction between Personal accounts and Impersonal Accounts

Type of Accounts	Meaning	Examples
(a) Personal Accounts	These accounts relate to natural persons, artificial persons and representative persons.	Natural – Ram's A/c Artificial – Ram & Co's A/c Representative – Outstanding Salary A/c
(b) Impersonal Accounts (i) Real Accounts (ii) Nominal Accounts	These accounts relate to the tangible or intangible real assets. These accounts relate to expenses, losses, profits and gains.	Tangible – Land A/c Intangible – Goodwill A/c Expenses – Purchase A/c Loss – Loss by Fire A/c Profit & Gains – Sales A/c, Discount Received A/c

4.14 Distinction between Real and Nominal Accounts

Basis of Distinction	Real Accounts	Nominal Accounts
1. Meaning	These accounts relate to the tangible or intangible real assets.	These accounts relate to expenses, losses, profits and gains.
2. Examples	Tangible – Land A/c Intangible – Goodwill A/c	Expenses – Purchase A/c Loss – Loss by Fire A/c Profit & Gains – Sales A/c Discount received A/c
3. Closing entries	No closing entry is passed to close these accounts.	Closing entries are passed to close these accounts.
4. Where shown	These are shown in the Balance Sheet.	These are transferred to Trading & Profit Loss A/c.

4.15 Summary

Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.

Economic development and technological improvements have resulted in an increase in the scale of business operations. Increasing the scale of business operations and social awareness has made the management functions more and more complex. These factors have given rise to specialised branches of accounting such as Financial Accounting, Cost Accounting, Management Accounting and Social Responsibility Accounting.

Accounting measures the transactions and events in terms of a common measurement unit that is the ruling currency of a country. e.g. in terms of Rupees in India.

4.16 Abbreviations

FA- Financial Accounting
FIFO – Fist in, First Out
LIFO – Last in, First Out.

4.17 Key Terms

- **Financial Accounting**: It is the process of identifying, measuring, recording, classifying, summarising, analysing, interpreting and communicating the financial transactions and events.
- **Human Resource Accounting**: It is the process of identifying, measuring and communicating the investments made in human resources of an enterprise.
- **Management Accounting**: It is the application of accounting techniques for providing information designed to help all levels of management in planning and controlling the activities of business enterprise and in decision making.

4.18 Self-Assessment Questions

1. What is accounting? Discuss the activities covered under accounting?
2. What are the primary objectives of accounting? Discuss.
3. What are the main functions of accounting? Explain.
4. Discuss the advantages and limitations of accounting.
5. How the accounting is classified? Discuss the main branches of accounting?
6 How the accounts are classified based on accounting equation?
7. What is an accounting equation?
8 Differentiate between personal accounts and impersonal accounts.
9. Differentiate between real and nominal accounts.
10 What is meant by accounting cycle? Discuss the steps involved in accounting cycle.

4.19 Reference/Suggested Books

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Unit - 5

Double Entry System of Accounting

Outline of the Unit

5.0 Objectives

5.1 Introduction

5.2 Meaning of Double Entry System of Accounting

5.3 Advantages of Double Entry System

5.4 Solved Illustrations

5.5 Summary

5.6 Key-Words

5.7 Self Assessment Test

5.8 References Books

5.0 Objectives

After studying this unit you should be able to understand:

- Meaning of Double Entry System of Accounting
- Meaning of Debit and Credit
- Rules of Debit and Credit
- Causes of popularity of Double Entry System
- Effect of Transactions on Accounting Equation
- Meaning of various Technical Accounting Terms

5.1 Introduction

A business transaction involves the transfer of value in the form of money, goods or services in terms of money from one party to another. One party gives some value and another party receives the same in exchange for an equivalent value. There is a reciprocal exchange of value between two parties, that is , each party receives value and gives value in exchange. It must be carefully noted that the giving and receiving aspects take place between accounts and in the same set of books.

In order to have complete record of each business transaction, its two-fold aspect must be recorded simultaneously. The best known system which recognises the two-fold aspect of every business transaction is called the Double Entry System. It is based upon the fact that just as every business transaction involves atleast two parties so the record of each transaction must be made in the light of its two-fold aspects or two accounts.

5.2 Meaning of Double Entry System of Accounting

According to this concept, every business transaction is recorded as having a dual aspect. In other words, every transaction affects at least two accounts. If one account is debited, any other account must be credited. The system of recording transactions based on this concept is called as "Double Entry System".

It is because of this principle that the two sides of the Balance Sheet are always equal and the following accounting equations will always hold good at any point of time :-

Assets = Liabilities + Capital

OR

Capital = Assets – Liabilities

5.2.1 Meaning of Debit and Credit

- **Account**

An account is a record of all business transactions relating to a particular person or item. In accounting we keep a separate record of each individual, asset, liability, expense or income. The place where such a record is maintained is termed as "Account". Such as the account of Ram, the account of Rent, the account of Machinery, the account of Salary and likewise.

All accounts are divided into two sides. The left side of an account is arbitrarily or traditionally called Debit side and the right side of an account is called Credit side. In abbreviated form, Debit is written as Dr. and Credit is written as Cr.

5.2.2 The Debit-Credit Rules

- **Debit**

Credit rules are globally accepted accounting conventions that facilitate double entry book keeping. The rules are summarized in the table:

Item	Debit	Credit
Asset	Increase in Assets	Decrease in Assets
Liabilities	Decrease in Liabilities	Increase in Liabilities
Capital or Equity	Decrease in Capital or Equity	Increase in Capital or Equity
Income or Revenue	Decrease in Income or Revenue	Increase in Income or Revenue
Expense or Loss	Increase in Expense or Loss	Decrease in Expense or Loss

For example, if the Furniture is purchased in the business, Furniture is increased whereas the Cash is decreased. Furniture and cash both are assets for the firm. Thus Furniture account is debited and Cash account is credited.

Definition: - Double Entry System may be defined as follows:-

"The Double Entry System seeks to record every transaction in money or money's worth in its double aspect- The receipt of a benefit by one account and the surrender of a like benefit by another account, the former entry being to the debit of the account receiving and the latter to the credit of that account surrendering."

- William Pickles

"Every business transaction has a two-fold effect and that it affects two accounts in opposite directions and if a complete record were to be made of each such transaction, it would be necessary to debit one account and credit another account. It is this recording of the two-fold effect of every transaction that has given rise to the term Double Entry System."

- J. R. Batliboi

Double Entry System is based upon the principle that "Every debit has a credit and every credit has a debit."

Example:

Mr. A sold goods for cash Rs. 2,000 to Mr. B. In this case the dual aspects of this transaction for Mr. A and Mr. B are as follows:

Dual aspects for Mr. A	Dual aspects for Mr. B
1. Receipt of cash Rs. 2,000.	1. Payment of cash Rs. 2,000.
2. Foregoing of goods of Rs. 2,000.	2. Receipt of goods of Rs. 2,000.

5.3 Advantages of Double Entry System

(1) **Scientific System: -** The transactions are recorded according to certain specified rules and as such, the system is more scientific as compared to any other systems of Book-Keeping.

(2) **Complete record of transactions: -** In double entry system, both the debit and credit aspects of a transaction are recorded, so that if the need arises, full details of every transaction can be easily made available at any time in future.

(3) **Preparation of Trial Balance:-** In double entry system, the amount recorded to the debit sides of various accounts will always be equal to the amounts recorded on the credit sides of various accounts. As such, trial balance can be prepared to check the arithmetical accuracy of the accounts.

(4) **Preparation of Trading and Profit and Loss Account:-** With the help of trial balance, a trader can prepare a Trading Account to find out the amount of gross profit or gross loss. Similarly, a profit and loss account can be prepared to find out the net profit earned or loss suffered during a particular period.

(5) **Knowledge of financial position of the business:-** In double entry system, separate accounts are opened for each and every asset and liability of the firm and as such, a Balance Sheet can be prepared which is a screen picture of the financial position of a business at a certain moment.

(6) **Knowledge of various information:-** In double entry system, information regarding various items or persons is readily available at any point of time such as:

- Amount of sales, purchase ;
- Amount due to be received from customers or in other words , the total number of debtors and the amount in each case;
- Amount due to be paid to suppliers or in other words , the total number of creditors and the amount in each case;
- Amount paid on account of each head of expenses separately;
- Amount earned on account of each head of income separately.

(7) **Lesser possibility of fraud:-**This system of book-keeping records each transaction in two accounts, as such, there is hardly any scope of forgery and manipulations as compared to other systems.

(8) **Legal approval:-** Double entry system meets legal requirements and books of accounts maintained under this system are accepted as true and reliable by the Companies Act and various other Acts.

(9) **Comparative Study: -** Under this system, it helps the management to compare the expenditure of the current year with those of the previous years and check the unnecessary expenditure.

(10) **Helps management in decision making: -** Under the system, the management can obtain all the requisite information quickly and hence, can use the information for making decisions.

(11) Suitable for all types of Businessman: - The system is so flexible that it can be conveniently introduced in small as well as big types of business.

5.4 Solved Illustrations

Illustration 3.4.1

A starts a new business and the following successive transactions take place:-

Transaction 1:- A started business with Rs. 75, 000 as Capital.

The effect of the transaction will be that the firm has received assets totaling Rs. 75, 000 in the form of cash and the claims against the firm are also Rs. 75, 000 in the form of capital. The transaction can be expressed in the form of an accounting equation as follows:-

Assets	=	Liabilities	+	Capital
Cash	=	Liabilities	+	Capital
75, 000	=	0	+	75, 000

Transaction 2:- A purchased Furniture for Cash Rs. 5, 000.

The effect of this transaction is that the cash is reduced by Rs. 5, 000, but a new asset of the same amount has been acquired. The transaction decreases one asset and at the same time increases the other assets with the same amount, leaving the total of the assets unchanged. The equation will now appear as follows:-

	Assets			=	Liabilities	+	Capital
	Cash	+	Furniture	=	Liabilities	+	Capital
Old equation	75, 000	+	0	=	0	+	75, 000
Transaction	(-)5, 000	+	5, 000	=	0	+	0
New equation	70, 000	+	5, 000	=	0	+	75, 000

Transaction 3:- A purchased goods for cash Rs. 20, 000.

As a result of this transaction, cash balance is reduced and another asset (goods) has come into existence, leaving the total of the assets unchanged. The equation will appear as follows:-

	Assets				=	Liabilities	+	Capital
	Cash	+	Furniture	+ Goods	=	Liabilities	+	Capital
Old equation	70, 000	+	5, 000	+ 0	=	0	+	75, 000
Transaction	(-)20, 000	+	0	+ 20, 000	=	0	+	0
New equation	50, 000	+	5, 000	+ 20, 000	=	0	+	75, 000

Transaction 4:- A purchased goods on credit for Rs. 16, 000.

This transaction will increase goods on the assets side and will create a liability in the form of Creditors. (The persons from whom goods have been purchased on credit are called creditors.) The equation will be as follows:-

	Assets				=	Liabilities	+	Capital
	Cash	+	Furniture	+ Goods	=	Creditors	+	Capital
Old equation	50, 000	+	5, 000	+ 20, 000	=	0	+	75, 000

Transaction	0	+ 0 + 16, 000	=	16, 000	+	0
New equation	50, 000	+ 5, 000 + 36, 000	=	16, 000	+	75, 000

Transaction 5:- Goods costing Rs. 12, 000 sold on credit for Rs. 15, 000.

This transaction will give rise to a new asset in the form of Debtors to the extent of Rs. 15, 000. (Debtors are those persons to whom goods have been sold on credit.) But the goods will be reduced only by Rs. 12, 000, the cost of goods sold. The net increase in assets Rs. 3, 000 is the amount of profit which will be added to the capital. The effect of the transaction has been explained in the following equation:-

	Assets				=	Liabilities	+	Capital
	Cash	+ Furniture	+Goods	+ Debtors	=	Creditors	+	Capital
Old equation	50,000	+ 5,000	+ 36,000	+ 0	=	16,000	+	75,000
Transaction	0	+ 0	- 12,000	+ 15,000	=	0	+	3,000
New equation	50,000	+ 5,000	+ 24,000	+ 15,000	=	16,000	+	78,000

Transaction 6:- Paid Rs. 1,000 for rent.

The effect of this transaction is that first, it reduces cash and secondly, as the rent is an expense, it results in a loss which decreases the capital. The revised equation will appear as follows:-

	Assets				=	Liabilities	+	Capital
	Cash	+ Furniture	+Goods	+ Debtors	=	Creditors	+	Capital
Old equation	50,000	+ 5,000	+ 24,000	+ 15,000	=	16,000	+	78,000
Transaction	(-)1,000	+ 0	+ 0	+ 0	=	0	(-)	1,000
New equation	49,000	+ 5,000	+ 24,000	+ 15,000	=	16,000	+	77,000

From the study of the above transactions it may be concluded that every transaction has a double effect and in each case Assets = Liabilities + Capital.

Illustration 5.4.2

Show the accounting equation on the basis of the following transactions:-

	Rs.
1. Started business with cash	1,20,000
2. Rent received	10,000
3. Invested in Shares	50,000
4. Received dividend	5,000
5. Purchased goods on credit from X	35,000
6. Paid cash for household expenses	7,000
7. Sold goods for cash (costing Rs. 10,000)	14,000
8. Cash paid to X	35,000
9. Deposited into bank	20,000

Solution

Accounting Equation

SNo.	Assets				= Liabilities +	Capital
	Cash +	Shares +	Stock +	Bank	= Creditors +	Capital
1.Transaction	1,20,000 +	0 +	0 +	0	= 0 +	1,20,000
Equation	1,20,000 +	0 +	0 +	0	= 0 +	1,20,000
2.Transaction	+10,000 +	0 +	0 +	0	= 0 +	10,000
New Equation	1,30,000 +	0 +	0 +	0	= 0 +	1,30,000
3.Transaction	- 50,000 +	50,000 +	0 +	0	= 0 +	0
New Equation	80,000 +	50,000 +	0 +	0	= 0 +	
4.Transaction	1,30,000					
	+ 5,000 +	0 +	0 +	0	= 0 +	
	5,000					
New Equation	85,000 +	50,000 +	0 +	0	= 0 +	1,35,000
5.Transaction	0 +	0 +	35,000 +	0	= 35,000 +	0
New Equation	85,000 +	50,000 +	35,000 +	0	= 35,000 +	
6.Transaction	1,35,000					
	- 7,000 +	0 +	0 +	0	= 0 -	
	7,000					
New Equation	78,000 +	50,000 +	35,000 +	0	= 35,000 +	
7.Transaction	1,28,000					
	+14,000 +	0 -	10,000 +	0	= 0 +	
	4,000					
New Equation	92,000 +	50,000 +	25,000 +	0	= 35,000 +	
8.Transaction	1,32,000					
	-35,000 +	0 +	0 +	0	= -35,000 +	0
New Equation	57,000 +	50,000 +	25,000 +	0	= 0 +	
9.Transaction	1,32,000					
	-20,000 +	0 +	0 +	20,000	= 0 +	0
Final Equation	37,000 +	50,000 +	25,000 +	20,000	= 0 +	
	1,32,000					

Explanation

Transaction 1:- Started business with cash Rs. 1, 20,000.

Accounts effected: - Assets: Cash increases.

Liabilities: Capital increases.

Transaction 2:- Rent received Rs. 10,000.

Accounts effected: - Assets: Cash increases.

Liabilities: Rent received is income, thus Capital increases.

Transaction 3:- Invested in Shares Rs. 50,000.

Accounts effected:- Assets : Investment in Shares is asset, thus Shares increases and Cash decreases.

Liabilities: No effect.

Transaction 4:- Received dividend Rs. 5,000.

Accounts effected: - Assets: Cash increases.

Liabilities: Dividend received is income, thus Capital increases.

Transaction 5:-	Purchased goods on credit from X, Rs. 35,000.
Accounts effected: -	Assets: Stock increases.
	Liabilities: Creditors increases.
Transaction 6:-	Paid cash for household expenses, Rs. 7,000.
Accounts effected: -	Assets: Cash decreases.
	Liabilities: Capital decreases.
Transaction 7:-	Sold goods for cash (costing Rs. 10,000) for Rs. 14, 000.
Accounts effected: -	Assets: Cash, to the value of sales, increases; Stock, to the extent of cost, decreases.
	Liabilities: Profit on sale is Rs. 4,000, thus Capital increases to the extent of Rs. 4,000.
Transaction 8:-	Cash paid to X, Rs. 35,000.
Accounts effected: -	Assets: Cash decreases.
	Liabilities: Creditors decreases.
Transaction 9:-	Deposited into bank, Rs. 20,000.
Accounts effected: -	Assets: Cash decreases; Bank increases.
	Liabilities: No effect.

Illustration 5.4.3

If the capital of a business is Rs. 2, 00,000 and outside liabilities are Rs. 50,000, calculate total assets of the business.

Solution

Assets = Liabilities + Capital

= Rs. 50,000 + Rs. 2, 00,000

= Rs. 2, 50,000.

Illustration 5.4.4

If total assets of a business are Rs. 2, 00,000 and net worth (capital) is Rs. 1, 50,000, calculate creditors.

Solution:-

Creditors (liabilities) = Assets – Capital

= 2, 00,000 – 1, 50,000

= 50,000

Illustration 5.4.5

(a) X started business on 1st Jan. 2009 with capital of Rs. 1, 50,000 and a loan of Rs. 40,000 taken from HDFC Bank. On 31st Dec. 2009 his assets were Rs. 3, 00,000. Find out his capital on 31st Dec 2009 and profits made or losses incurred during the year 2009.

(b) If in the above illustration, the proprietor had introduced additional capital of Rs. 25,000 and had withdrawn Rs. 8,000 for personal purposes, find out the profit.

Solution

(a) Closing Capital = Closing Assets – Closing Liabilities

= Rs. 3, 00,000 – Rs. 40,000

= Rs. 2, 60,000

Profit = Closing capital – Opening capital

= Rs. 2, 60,000 – Rs. 1, 50,000

= Rs. 1, 10,000

(b) Profit = Closing capital + Drawing – Additional capital – Opening capital

= Rs. 2, 60,000 + Rs. 8,000 – Rs. 25,000 – Rs. 1, 50,000

= Rs. 93,000

3.5 Summary

Double entry system of Book-Keeping refers to a system of accounting under which both the aspects (i.e., debit and credit) of every transaction are recorded in the accounts involved.

The individual record of a person or thing is called account. Every debit has equal amount of credit. So the total of all debits must be equal to the total of all credits. This duality is the basis of double entry records.

> Activity
>
> A started business with a capital of Rs. 6,00,000/-. He introduced Rs. 16000/- during the year as on additional capital, while personal drawings Rs. 6000/-. At the end of the year closing capital Rs. 8,00,000/-. What is his profit for the year?

5.6 Key Words

- **Business:** Any work which is legal and done with the intention of earning profit is called business.
- **Capital:** Capital represents the amount invested by the trader in his business. It may be in the form of cash, goods or assets. In other words, the rights of the owner against the firm or the business are called owner's Equity or Capital. Capital is always equal to the difference between the assets and liabilities of the enterprise.
- **Goods:** Goods is applicable to that commodity which a trader purchases for resale. It is insignificant whether such a commodity is sold in the same form or after changing its form by processing. The following are example of goods.

'Fruit' for a fruit vendor ; 'Cloth' for a cloth merchant; 'Machinery' for a machinery dealer; and 'Timber' for a timber merchant. Goods may be classified as under.

(a) Purchases: The goods which are purchased in the business for the purpose of reselling them are known as 'Purchases'. It may be cash purchases or credit purchases.

(b) Sales: The goods which are purchased with a view to resale and when they are sold, they are known as 'Sales'. It may be cash sales or credit sales.

(c) Purchases Returns: If the goods purchased are returned by the trader to its supplier due to any reason, they are called 'Purchases Returns' or 'Returns Outwards'.

(d) Sales Returns: If any sold goods are returned by the customers to the trader for any reason, it is known as 'Sales Returns' or 'Returns Inwards'.

(e) Stock: When, on a particular date, the goods remain unsold with the trader it is known as 'Stock'. At the end of the accounting period it is called 'Closing Stock' and the same on the first day of the next accounting period is known as 'Opening Stock'.

- **Transaction:** A transaction is a business dealing entered into by a trader with his customer or supplier. A transaction necessarily involves two parties. In every transaction, one of the two parties is the receiver of the benefit and the other party is the giver of the benefit.
- **Entry:** 'Entry' means the recording of a business transaction in the books of accounts.
- **Creditors:** Whenever the purchases are made on credit, the persons who supply such goods are known as 'Creditors'.
- **Debtors:** The persons who take the goods and services on credit are called the 'Debtors'.
- **Discount:** When an allowance is allowed by the trader to his customer from the amount of the saleable goods or from the receivable amount of cash it is known as 'Discount'. When it is allowed from the amount of saleable goods, it is called 'Trade Discount' and when it is allowed from the receivable amount of cash, it is called 'Cash Discount'.
- **Assets:** Anything of value owned by a person or business is known as 'Assets'.
- **Liabilities:** Anything owed, a debt, the claim of an outsider against the business is called a 'Liability'.
- **Drawings:** The amount or the goods which are withdrawn from the business by the proprietor is known as his drawings.
- **Turnover:** The total sales during a particular period-cash and credit sales are known as 'Turnover'.
- **Account:** An account is a summarized record and systematic arrangement of transaction for a period affecting one person, one kind of property or one class of gains and losses.
- **Bad Debts:** If the debtor is unable to make the payment standing in his name it is called 'Bad Debts'.
- **Insolvent:** If a person is unable to redeem his loan, he is treated as insolvent. The liabilities of such person are more than the assets and he is not in a position to make full payments for the debts taken.

5.7 Self Assessment Test

1. What do you meant by double-entry system of accounting? State the rules of debit and credit.
2. If the capital of a business is Rs. 2, 40,000 and liabilities are Rs. 40,000, calculate the total assets of the business.

   [Ans. 2, 80,000]
3. What entry (debit or credit) would you make to:-

   (a) increase in revenue;

   (b) decrease in expense;

   (c) record drawings;

   (d) Record the fresh capital introduced by the owner.

   [Ans. (a) credit; (b) credit; (c) debit in capital account, (d) credit in capital account.]
4. The position of a businessman on 31st Mar, 2010 was as follows:-

Cash Rs. 5,000; Debtors Rs. 20,000; Machinery Rs. 60,000; Stock Rs. 25,000; Capital Rs. 75,000. Calculate his liabilities.

[Ans. Rs. 35,000]

5. If a transaction has the effect of decreasing an asset, is the decrease recorded as a debit or as a credit? If the transaction has the effect of decreasing a liability, is the decrease recorded as a debit or as a credit?

[Ans. Decrease in asset will be recorded on credit side; Decrease in liability will be recorded on debit side.]

6. A commenced business on 1st April, 2009 with a capital of Rs. 1,00,000. On 31st Mar, 2010, his assets were worth Rs. 1, 60,000 and liabilities Rs. 15,000. Find out his closing capital and profits earned during the year.

[Ans. Closing capital= Rs. 1, 45,000; Profit= Rs. 45,000]

7. Prove that the accounting equation is satisfied in all the transactions of M/s RamTraders:-

		Rs.
(a)	Started business with cash	50,000
(b)	Bought furniture for	500
(c)	Purchased goods on credit	4,000
(d)	Sold goods on cash (cost Rs. 500) for	700
(e)	Received rent	200
(f)	Purchased goods for cash	1,000
(g)	Withdrew for personal use	700
(h)	Paid to creditors	400
(i)	Paid for salaries	200

[Ans. Cash Rs. 48,100; furniture Rs. 500; stock Rs. 4,500; creditors Rs. 3,600; capital Rs. 49,500.]

8. Use accounting equation to show the effect of the following transactions of M/s Ajay Traders:-

		Rs.
(a)	Started business with cash	1, 20,000
(b)	Purchased goods for cash	10,000
(c)	Rent received	5,000
(d)	Salary outstanding	2,000
(e)	Prepaid insurance	1,000
(f)	Received interest	700
(g)	Sold goods for cash (costing Rs. 5,000)	7,000
(h)	Goods destroyed by fire	500

[Ans. Cash Rs. 1, 21,700; stock Rs. 4,500; prepaid exp. Rs. 1,000; outstanding exp. Rs. 2,000; capital Rs. 1, 25,200.]

Hint. Salary outstanding is salary due but not paid, thus is a liability of the firm.Prepaid insurance is insurance paid but not due, thus is an asset of the firm.Goods destroyed by fire will result in decrease in stock and decrease in capital.

9. **(a)** A commenced business on 1st Jan. 2009 with a capital of Rs. 5, 00,000 and a loan of Rs. 1, 00,000 borrowed from Citi Bank. On 31st Dec. 2009, his assets were Rs. 8,00,000. Calculate his closing capital and profits earned during the year.

(b) If in the above case, the proprietor had introduced fresh capital of Rs. 40,000 and had withdrawn Rs. 10,000 for personal purposes, calculate his profits.

[Ans. (a) Closing capital Rs. 7, 00,000; profit Rs. 2, 00,000.

(b) Profit Rs. 1, 70,000.]

10. Mohit has the following transactions, prepare accounting equations:-

		Rs.
(a)	Business started with cash	1, 75,000
(b)	Purchased goods from Rohit	50,000
(c)	Sold goods on credit to Manish (costing Rs. 17,500)	20,000
(d)	Purchased furniture for office use	10,000
(e)	Cash paid to Rohit in full settlement	48,500
(f)	Cash received from Manish	20,000
(g)	Rent paid	1,000
(h)	Cash withdrew for personal use	3,000

[Ans. cash Rs. 1, 32,500; stock Rs. 32,500; furniture Rs. 10,000; capital Rs. 1, 75,000.]

11. Y started a business on 1st Jan. 2009 with a capital of Rs. 2, 00,000 and a loan of Rs. 75,000 from the bank. During the year, he had introduced additional capital of Rs. 60,000 and had withdrawn Rs. 36,000 for personal purposes. On 31st Dec. 2009 his assets were Rs. 3, 80,000. Find out his capital as on 31st Dec. 2009 and profit earned during the year 2009.

[Ans. closing capital Rs. 3, 05,000; profit Rs. 81,000.]

5.8 Reference Books

1 Paul, S. Kumar, *Book-keeping and Accountancy*

2 Grewal Shukla, *Accountancy*

3 Monga, J.R., *Foundation Accountancy*

4 Grewal T.S., *Double Entry Book-keeping*

Unit - 6

Accounts Vouchers

Outline of the Unit :

6.0 Objectives

6.1 Introduction

6.2 Vouchers

6.2.1 Voucher System

6.3 Preparation of Accounting Vouchers

6.3.1 Voucher Register

6.3.2 Unpaid Voucher File

6.3.3 Cheuqe Register

6.3.4 Paid Voucher File

6.3.5 Vouchers Payable Account

6.4 Advantages of the Voucher System

6.5 Limitations of the Vouchers System

6.6 Summary

6.7 Key Words

6.8 Questions

6.9 References

6.0 Objectives

After studying this chapter, you will be able to :

- Explain the preparations of accounting vouchers
- Business transaction are usually evidenced by an appropriate document or a voucher.
- A plane and method of procedure for the verifications, recording and payment of all items which require disbursement of cash.

6.1 Introduction

Business transactions are usually evidenced by an appropriate documents such as Cash memo, Invoice, Sales Bill, Pay-in-slip, Cheque, Salary slip etc. A documents which provides evidence of the transactions is called the source document or a Voucher. At times, there may be no documentary for certain items as in case of petty expenses. In such case voucher may be prepared showing the necessary details and got approved by appropriate authority within the firm. All such documents (vouchers) are arranged in chronological order and are serially numbered and kept in a separate file. All recording in books of account is drive on the basis of vouchers.

Transaction Voucher

Name of Firm :

Voucher No.	:	
Date	:	
Debit account	:	
Credit account	:	
Amount (Rs.)	:	
Narration	:	
Authorised by	:	Prepared by

Fig. 6.1 : Showing specimen transaction voucher

6.2 Vouchers

In general terms, a voucher means a documentary evidence in support a business transaction. It is a documentary evidence by which the accuracy of an entry made in the books of account can be substantiated. It may be a receipt, a counterfoil of a receipt book, an invoice or even correspondence with the concerned parties. The term Voucher has a narrower meaning when applied to the Voucher System. It is a special form on which is recorded pertinent data about a liability and the particulars of its payments.

(i) Comparison with the copy of Purchase Order to verify the quantities prices and terms.

(ii) Comparison with the Goods Received Returns to determine the receipt of items recorded in the invoice.

(iii) Verification of the arithmetical accuracy of the invoices.

After making the above verification and comparisons, the invoices or other supporting evidence is attached to the voucher and is presented to the concerned official for his final approval.

6.2.1 Voucher System

Ina small organization, it is possible for the proprietor to supervise personally all important matter. However, in case of large organizations, delegation of authority is required and therefore, it is necessary to have a proper internal check system for prevention of errors and frauds in recording the transactions and receiving or making final cash payments. The chances of frauds in case of cash payments are all the more. It is almost impossible for the disbursing official to have all information regarding the goods and services is respect of which he is required to make payments. This is because even in case of organizations of moderate size, the responsibility for issuing purchase orders, inspecting commodities received, verifying contractual and arithmetical details of invoices is divided among the employees of the various departments. The disbursing official should have, therefore, assurance of all concerned officials before making payments that the terms of the contract have been complied with and he is paying the exact amount of obligation. This is possible only when all the activities mentioned above are properly coordinated and linked with ultimate insurance of cheques to the creditors. One of the most effective system employed for this purpose is termed as Voucher System.

Voucher System may therefore be defined as "a plan and method of procedure for the verification, recording and payment of all items (other than items to be paid from petty cash) which require the disbursement

of cash." As a matter of fact, it is mainly a plan of internal check for all cash disbursement items. There are three basic requirements of Voucher System:

(a) A Voucher is to be prepared for each item of expenditure.

(b) No payment shall be made without a properly verified and authorized voucher.

(c) Development of a proper and efficient system for determining the amount to be paid on each day. This helps the disbursing official in determining the amount to be paid and the management in conveniently and continuously forecasting the amount of the cash required to meet maturing obligations.

6.3 Preparation of Accounting Vouchers

Accounting vouchers may be classified as cash vouchers, debit vouchers, credit vouchers, journal vouchers, etc. there is no set format of accounting vouchers. A specimen of a simple transaction voucher is used in practice is shown in fig.

These must be preserved in any case till the audit of the accounts and to assessments for the relevant period are completed. Now a days, accounting of computerized and the necessary accounting vouchers showing the core number and name of the accounts to be debited and credited are prepared for the purpose of necessary recording of transactions. A transaction with account debit and one credit is a simple transaction and the accounting voucher prepared for such transaction is known as Transaction Voucher, the format which is shown in fig. Voucher which records a transaction that entails multiple debits/credits and one credit/debit is called compound voucher. Compound voucher may be : (a) Debit Voucher or (b) Credit Voucher; the specimen as shown in fig.6.2

Debit Voucher

Name of Firm

Voucher No. : Date :

Credit Account :

Amount :

Authorised by : Prepared by

Debit Accounts

S.No.	Code	Account Name	Amount (Rs.)	Narration (i.e. Explanation)

Credit Entries

Voucher No. : Date :

Credit Account :

Amount :

S.No.	Code	Account Name	Amount (Rs.)	Narration (i.e. Explanation)

Authorised by : Prepared by

Fig.6.2 : Showing debit and credit vouchers.

Transactions with multiple debits and multiple credits are called complex transactions and the accounting voucher prepared for such transaction is known as Complex Voucher/Journal Voucher. The format of a complex transaction voucher is shown in fig. 6.3

Journal Voucher

Name of Firm

Voucher No. :

Date :

Debit Entries

S.No.	Code	Account Name	Amount (Rs.)	Narration (i.e. Explanation)

Credit Entries

S.No.	Code	Account Name	Amount (Rs.)	Narration (i.e. 'Explanation)

The design of the accounting vouchers depends upon the nature, requirement and convenience of the business. There is no set format of an accounting voucher. To distinguish various vouchers, different colour papers and different fonts of printing are used. Some of the specimen of the accounting vouchers are given in the earlier pages.

6.3.1 Voucher Register

The Voucher Register is a columnar journal giving the details about the Voucher Nos. and different items of expenses in respect of which payments have to be made. A Proforma of a Voucher Register is given later.

The Vouchers are recorded in a numerical sequence. The credit is given to the accounts payable while debit is given to the account or accounts to be charged for expenditure. On making payment, the date of payment and the no. of cheques are inserted in the appropriate columns in the Voucher Register. The objective of such a recording is to provide ready information about determining the amount of individual unpaid vouchers. The total outstanding liability on account of vouchers unpaid at a particular date can be found out by adding up the individual amount of the unpaid vouchers as shown in the Voucher Register.

6.3.2 Unpaid Voucher File

3 Unpaid voucher file : After the Voucher have been prepared and recorded in the Voucher Register, they are filed in an Unpaid Voucher File. They remain there till they are paid. The amount due on each voucher represents the credit balance of an account payable. Each Voucher in itself is comparable to an individual account in a Creditors' Ledger. Hence, no separate Creditors Ledger is necessary.

6.3.3 Check Register

The payment of a Voucher is recorded in Cheque Register, the proforma of which is given below :

Voucher Register

Date	Payee	Voucher No.	Paid		Credit	Debit					
			Date	Cheque No.	Voucher Payable	Purchase	Wages	Salaries	Office Expenses	Selling Expenses	Sundries
					Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
1995											
May 1	Mohan	501	May 5	430	250	250					
May 8	Kishan	502	-	-	300	300					
May 15	David	503	May 20	431	500	-	500				
					1050	**550**	**500**				

Cheque Register

Date	Cheque No.	Payee	Voucher No.	Accounts Payable Dr.	Discount Cr.	Bank Cr.
May 5	430	Mohan	501	250	10	240
May 15	431	David	503	500	5	465
				750	**15**	**705**

The Cheque Register is a modified form of Cash Payment Journal and it is so called because it is a complete record of all cheques issued. It is customary to record all cheques in a Cheque Register in the order of their sequence to avoid mistake in their recording.

When a Voucher is to be paid, it is removed from the Unpaid Voucher File. On issue of a cheque, the date, the number of cheque and amount are listed on the back of the Voucher. This helps in recording the payments in the Cheque Register. The paid vouchers and the supporting documents are cancelled through a canceling stamp to prevent their accidental or intertional reuse.

6.3.4 Paid Voucher File

After payment, vouchers are generally filed in numerical sequence in paid Voucher File. They are then readily available for examination by employees or independent auditors who may require information about a specific expenditure. The paid voucher are finally destroyed in accordance with the firm's policy concerning the retention of records.

6.3.5 Vouchers Payable Account

Vouchers Payable Account is similar to Total Creditors Account. It is credited with the total amount payable on account of different vouchers and is debited with the amount of payments made. The balance of the Vouchers Payable account should agree with the total of the Unpaid Vouchers File and also with the sum of unpaid vouchers as shown in the Voucher Register. A proforma of a Vouchers Payable Account is given below :

Vouchers Payable Account

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
1986 May 31	To Cheque Register	735	1986 May 31	By Voucher Register	1050
	To Discount	15			
	To Balance c/d	300			
		1050			1050

6.4 Advantages of The Voucher System

The Voucher System offers the following advantages :

(i) Safeguards cash disbursements : Voucher System provides for a Systematic plan for the verification and approval of all invoices, bills and other items requiring disbursement of cash. Thus, it safeguards all cash disbursements.

(ii) Reduces book-keeping work : Voucher System considerably reduces the book-keeping work. The voucher itself works as an account of the creditors and total amount due to the creditors can be found out with the help of the unpaid Vouchers File.

(iii) Recording of all current liabilities : The Voucher System provides for the immediate recording of all current liabilities. It is generally found in case of firms which do not use Voucher System they fail to record bills for items such services and expenses till such time they are actually paid. As a matter of fact, it is desirable to show all liabilities in the books of the business form the time they are incurred.

(iv) Strengthening of internal check system. The placing of responsibilities for verification and approvals strengthens the system of internal check.

(v) Planning future cash requirements : Voucher System provide continuous information for planning the future cash requirements. This enables the management to make maximum use of cash resources. Invoices in respect of which cash discounts are allowed can be paid within the discount period. Other invoices can be paid in accordance with the credit items. This helps in minimizing cost and maintaining a favourable credit standard. Moreover, seasonal borrowing for working capital can also be planned more effectively resulting in saving in interest cost.

6.5 Limitations of The Voucher System

Voucher System has the following limitations :

(i) Unsuitable for small concerns. Voucher System is neither suitable nor necessary for small business enterprises particularly those with high degree of proprietary supervision and control.

(ii) Proper personnel and finances required. Voucher System requires sufficient personnel as well as finances for its successful operation. It will be a cumbersome exercise especially for an enterprise which is not well organised. If an enterprise which uses voucher system does not have sufficient cash and is not in a position to pay the approved vouchers according to schedule, it may develop an unwieldy file of approved unpaid vouchers.

(iii) Fails to provide overall creditor's account position. The system does not provide for giving an overall position of a creditor's account.

(iv) Difficulties in case of partial payments, returns etc. the system proves as a hinderance rather than as a help in case of concerns which have many returns of goods and other corrections after approving and recording of purchase invoices. Such concerns have to make many partial payments of approved vouchers. In some cases, they have to defer payments also.

From the above, it may be concluded that Voucher System is suitable only for an enterprise which is well equipped both in respect of personnel and finances. It is not suitable for small concerns. Moreover, suitable modifications may have also to be made in the operation of the system as to need the specific needs of a particular enterprise.

6.6 Summary

1. Vouchers : A voucher means a documentary evidence in support a business transaction. It may be a receipt, a counter file of a receipt book an invoice or even correspondence with the concerned parties.
2. Voucher System : A plan and method of procedure for the verifications, recording and payment of all items (other than item to be paid from petty cash) which require disburshment of cash.
3. Business Transactions : Business Transactions are exchanges of economic considerations between parties and have two fold effects that are recorded in at least two accounts.
4. Source documents : Various business documents such as invoice bills, cash memos, vouchers, which form the basic and evidence of business transaction recorded in the books of account, are called source documents.

6.7 Key Words

Voucher	Business Transaction
Source Documents	Voucher System
Purchase order	Invoice
Cash memo	Internal Check
Voucher Register	Cheque Register

6.8 Questions For Practice

1. What is voucher? How it is prepared in a business.
2. Define voucher system. How is it work in a business organisation.
3. Write short notes on :
   - (i) Voucher Register
   - (ii) Check Register
   - (iii) Voucher payment account
   - (iv) Paid and unpaid voucher file
4. Give the advantages and limitations of the voucher system.

6.9 References and Books

1. Advanced Accountancy; R.L. Gupta
2. Financial Accounting; S.N. Maheshwari
3. Accounting : NCERT
4. Fundamentals of Accounting, Himalaya Publications

Unit - 7

Books of Accounts

Outline of the Unit

7.0 Objectives
7.1 Introduction
7.2 Types of Accounts
7.3 Journalisation
7.4 Recording of Special Transactions
7.5 Purchase Day Book
7.6 Sales Day Book
7.7 Cash Book
7.8 General Ledger
7.9 Summary
7.10 Key Words
7.11 Self Assessment Test
7.12 Reference Books

7.0 Objectives

After studying this unit you should be able to understand:

- Types of Accounts
- Meaning and Format of Journal
- Rules of Journalising
- Recording of Entries in a Journal
- Recording of Transactions in Special Purpose Subsidiary Books
  - Purchase Day Book
  - Sales Day Book
  - Cash Book
- Posting from Journal to Ledger

7.1 Introduction

The ultimate objective of the financial accounting is to prepare two basic financial statements: the income statement and the balance sheet. The accounting process helps in achieving that objective.

The details of each business transaction are first entered in source documents. Then there is recording of economic effects of each business transaction chronologically in the journal before posting to the ledger accounts pertaining to persons, properly, expenses and gains. Trial balance is extracted form the ledger which is base for financial statements.

7.2 Types of Accounts

- **Types of Accounts**

An account is a summarized record of business transactions and affects a particular type of asset, liability or capital. **Recording of business transaction in an account is called entry.** For the purpose of

recording, these transactions are classified into- (i) personal transactions; (ii) transactions related to assets, properties and liabilities; and (iii) transactions related to expenses, losses, income and gain. Based on this classification of transactions, the accounts are classified as shown in the chart given below:-

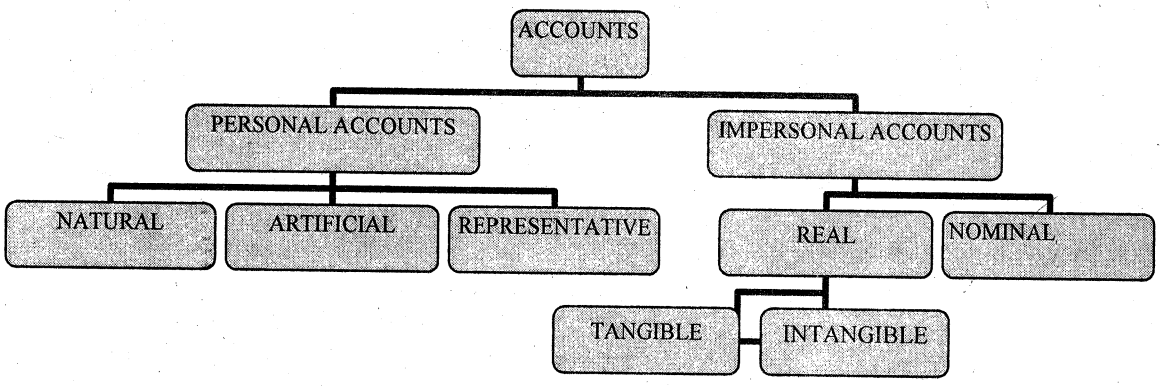


Figure - 7.1

7.2.1 Personal Accounts

The accounts which relate to an individual, firm, company or an institution are called personal accounts. Accounts of Mohan, Account of D. C. M. Ltd., Account of Delhi University, Bank Account, Capital Account of the proprietor, Drawings Account of the proprietor etc., are examples of Personal Accounts. Personal Accounts can be classified into the following three categories:-

(a) **Natural Personal Accounts:** Accounts of 'Natural Persons' means the accounts of human beings. For example, Mohan A/c, Sohan A/c, Proprietor's Capital A/c, Debtors A/c, Creditors A/c are also included in this category.

(b) **Artificial Personal Accounts:** These accounts do not have physical existence as human beings but they work as personal accounts. These are treated as artificial persons for the recording of personal transactions. For example, any Firm's account, any Company's account, accounts of government departments, any bank's account, etc.

(c) **Representative Personal Accounts:** When an account represents a particular person or group of persons, it is termed as a representative personal account. For example, if the salaries for the month of December are not paid to the employees, the amount payable to theses employees will be added and put under one common title "Salaries outstanding account". This account represents the accounts of all the persons to whom salaries have to be paid. This is therefore known as "Representative Personal account". Other examples are Prepaid Insurance Account, Unearned Commission Account.

7.2.2 Real Accounts

The accounts of all those things whose value can be measured in terms of money and which are the properties of the business are termed as Real Accounts, such as Cash Account, Furniture Account, Goodwill Account, etc. These are of two types:-

(a) **Tangible Real Accounts:** These are the accounts of those things which can be touched, felt, measured, etc. Examples are Cash Account, Stock Account, Furniture Account, etc.

(b) **Intangible Real Account:** These accounts represent such things which cannot be touched, but of course their value can be measured in terms of money. For example, Goodwill Account, Patent Account.

7.2.3 Nominal Accounts

These accounts include the accounts of all expenses and incomes. Examples - salaries paid, rent paid, bad debts, etc.

- **Debit credit rules:**

Classification	Debit-Credit Rules
Personal Account	Debit the receiver and Credit the giver
Real Account	Debit what comes in and Credit what goes out
Nominal Account	Debit expenses and losses and Credit revenue and gains

Activity

Bank Account and prepaid insurance account are in the nature of .....account.

Illustration 7.2.1

Analyze the following transactions, according to double entry system:

(a) Ram started business with cash
(b) Purchased furniture
(c) Purchased goods for cash
(d) Sold goods for cash
(e) Received cash from Shayam
(f) Deposited into bank
(g) Withdrew from bank for office use
(h) Received a cheque from a customer Shayam
(i) Withdrew from bank for personal use
(j) Withdrew cash for personal use
(k) Sold goods to Shayam on credit
(l) Purchased goods from Raman on credit
(m) Purchased furniture from Mohan on credit
(n) Borrowed from Mahesh
(o) Deposited Shayam's cheque next day
(p) Paid Raman by cheque
(q) Paid salary
(r) Paid rent by cheque
(s) Goods withdrawn for personal use

Trans-actions	Accounts involved	Nature of accounts involved	How affected	Whether to be debited or credited
(a)	Cash A/c Capital A/c	Real Personal	Cash is coming in. Ram is the giver to the business.	Debit Credit
(b)	Furniture A/c Cash A/c	Real Real	Furniture is coming in. Cash is going out.	Debit Credit
(c)	Purchases A/c Cash A/c	Real Real	Goods are coming in. Cash is going out.	Debit Credit
(d)	Cash A/c Sales A/c	Real Real	Cash is coming in. Goods are going out.	Debit Credit

(e)	Cash A/c Shayam A/c	Real Personal	Cash is coming in. Shayam is the giver.	Debit Credit
(f)	Bank A/c Cash A/c	Personal Real	Bank is the receiver. Cash is going out.	Debit Credit
(g)	Cash A/c Bank A/c	Real Personal	Cash is coming in. Bank is the giver.	Debit Credit
(h)	Cash A/c Shayam A/c	Real Personal	Cash (in the form of cheque) is coming in. Shayam is the giver.	Debit Credit
(i)	Drawings A/c Bank A/c	Personal Personal	Ram is the receiver. Bank is the giver.	Debit Credit
(j)	Drawings A/c Cash A/c	Personal Real	Ram is the receiver. Cash is going out.	Debit Credit
(k)	Shayam's A/c Sales A/c	Personal Real	Shayam is the receiver. Goods are going out.	Debit Credit
(l)	Purchases A/c Raman's A/c	Real Personal	Goods are coming in. Raman is the giver.	Debit Credit
(m)	Furniture A/c Mohan's A/c	Real Personal	Furniture is coming in. Mohan is the giver.	Debit Credit
(n)	Cash A/c Loan from Mahesh A/c	Real Personal	Cash is coming in. Mahesh is the giver.	Debit Credit
(o)	Bank A/c Cash A/c	Personal Real	Bank is the receiver. Cash (in the form of cheque) is going out.	Debit Credit
(p)	Raman's A/c Bank A/c	Personal Personal	Raman is the receiver. Bank is the giver.	Debit Credit
(q)	Salary A/c Cash A/c	Nominal Real	Salary is an expense. Cash is going out.	Debit Credit
(r)	Rent A/c Bank A/c	Nominal Personal	Rent is an expense. Bank is the giver.	Debit Credit
(s)	Drawings A/c Purchases A/c	Personal Real	Ram is the receiver. Goods are going out.	Debit Credit

Activity

1. Patent account is a ..... account.
2. Rule for Nominal account is :

7.3 Journalisation

7.3.1 General Principles

There are four phases in the accounting process:

1. Journalisation of transactions and events.
2. General ledger posting and balancing.
3. Preparation of a Trial Balance.
4. Preparation of Final Account, i. e., the Profit and Loss A/c and the Balance Sheet.

In the first phase, the transactions and events are analysed and recorded in the journal. Accountants use different types of journals, listed hereinafter, for recording different types of transactions and events.

1. Purchase day book	:	To record transactions relating to credit purchases of goods in trade.
2. Sales day book	:	To record transactions relating to credit sales.
3. Purchase return book	:	To record transactions relating to purchase returns.
4. Sales return book	:	To record transactions relating to sales return.
5. Cash book	:	To record cash, bank and discount transactions.
6. Journal proper	:	To record other transactions for which no specific journal is mentioned, and for recording entries to rectify mistakes in books of accounts.

Transactions and events are recorded in the journal in chronological order. The ledger folio in which the transaction is posted in the general ledger is entered in the journal for cross referencing. In addition, the 'Journal Proper' provides a brief narration of the transaction or the event. Papers or documents that evidence of the transaction or event should support each entry in the journal. Those papers and documents are known as Vouchers.

7.3.2 Journal

The business transactions, after their analysis, are listed in a chronological order day-by-day and first recorded in a book of accounts called journal. A **journal** is a chronological record of accounting transactions showing the names of accounts that are to be debited or credited, the amounts of the debits and credits, and any useful supplementary information about the transaction. **Journal is referred to as book of original or prime entry or simply subsidiary book.** A journal is a form of diary for business transactions.

Functions of journal:-

(i) To keep a chronological (i.e., date-wise) record of all transactions.

(ii) To analyse each transaction into debit and credit aspects by using double entry system of book-keeping.

(iii) To provide a basis for posting into ledger.

(iv) To maintain the identity of each transaction by keeping a complete record of each transaction at one place on a permanent basis.

The format of journal is shown as follows:-

Date	Particulars	L.F.No.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
(1)	(2)	(3)	(4)	(5)

The columns have been numbered only to show how the Journal is written up; otherwise the columns are not numbered.

1. **Date Column:** This column shows the date on which the transaction is recorded. The year and the month are written once, till they change.
2. **Particulars Column:** Under this column, first the names of the accounts to be debited, then the names of the accounts to be credited and lastly, the narration (i.e., a brief explanation of the transaction) are entered.

3. **L. F. i.e. Ledger Folio Column:** All entries from the journal are later posted into the ledger accounts. The page number or folio number of the ledger account where the posting has been made from the journal is recorded in the L.F. column of the journal.
4. **Debit Amount Column:** Under this column, the amount to be debited is entered.
5. **Credit Amount Column:** Under this column, the amount to be credited is entered.

7.3.3 Journalising

The process of recording a transaction in the journal with the help of debit-credit rules of the double entry system is called Journalising. The various steps to be followed in journalising business transactions are given below:

- **Step 1:** Ascertain what accounts are involved in a transaction.
- **Step 2:** Ascertain what the nature of the accounts involved is.
- **Step 3:** Ascertain which rule of Debit and Credit is applicable for each of the accounts involved.
- **Step 4:** Ascertain which account is to be debited and which is to be credited.
- **Step 5:** Record the date of transaction in the 'Date column'.
- **Step 6:** Write the name of the account to be debited, very close to the left hand side i.e. the line demarcating the 'Date column' and the 'Particulars column' along with the abbreviation 'Dr.' on the same line against the name of the account in the 'Particulars column', and the amount to be debited in the 'Debit Amount Column' against the name of the account.
- **Step 7:** Write the names of the account to be credited in the next line preceded by the word 'To' at a few spaces towards right in the 'Particulars column' and the amount to be credited in the 'Credit Amount Column' against the name of the account. The modern practice shows inclination towards omitting "Dr." and "To".
- **Step 8:** Write 'Narration' (i. e. a brief description of the transaction) within brackets in the next line in the 'Particulars column'.
- **Step 9:** Draw a line across the entire 'Particulars column' to separate one journal entry from the other.

Illustration 7.3.1

Record the following transactions in the journal of V:-

2010		Rs.
May 1	Commenced business with cash	5, 00,000
2	Goods purchased from M for cash	50,000
3	Goods purchased from A	1, 20,000
4	Goods returned to A	5,000
8	Goods sold to R	40,000
12	R returned 10% of goods	

Solution:

Journal of V

Date	Particulars	L. F. No.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2005 May 1	Cash A/c Dr. To Capital A/c (Amount brought in by V as Capital)		5, 00,000	5, 00,000
May 2	Purchases A/c Dr. To Cash A/c (Goods purchased from M for cash)		50,000	50,000
May 3	Purchases A/c Dr. To A A/c (Goods purchased from A)		1, 20,000	1, 20,000
May 4	A A/c Dr. To Purchases Return A/c (Goods returned to A)		5,000	5,000
May 8	R A/c Dr. To Sales A/c (Goods sold to R)		40,000	40,000
May 12	Sales Return A/c Dr. To R A/c (10% of goods sold to R returned by him: 10% of 40,000 = Rs. 4,000)		4,000	4,000
	Total Rs.		7, 19,000	7, 19,000

7.3.4 Compound Journal Entries

The business transactions recorded in above illustration 2 are examples of single entry in which only two accounts are affected viz., one account to be debited and another to be credited with an equal amount. On the other hand, when more than two accounts are involved in a transaction and the transaction is recorded by a single journal entry instead of passing several journal entries, such single journal entry is termed as 'compound journal entry'. In a compound entry, there may be-

(a) Several accounts to be debited and only one to be credited; or

(b) One account to be debited and several others to be credited; or

(c) Several accounts are to be debited and several others to be credited.

Journal entries falling within classes (a) and (b) above are generally termed as 'single compound entries and those in class (c) are generally termed as 'double compound entries'.

A compound entry should never be made in order to combine two entries which are not related or which did not occur on the same date or where there is no common account to be debited (or credited) in more than one instance.

Illustration 7.3.2:

Journalise the following transactions:

2010

June 1 Purchased goods worth Rs. 300 from Vimal and Rs. 500 from Kamal on credit.

June 3 Sale of goods worth Rs. 1,000 to Balram and Rs. 700 to Dhanram.

June 5 Cash of Rs. 900 received from Ramasamy and Rs. 800 from Krishnasamy.

June 7 Paid Rs. 800 to Pradeep and Rs. 500 to Kuldeep.

June 9 Withdrawn from bank Rs. 600 for office use and Rs. 300 for personal use.

Solution:

Journal

Date	Particulars	L.F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2010 June 1	Purchases A/c Dr. To Vimal A/c To Kamal A/c (Purchased goods worth Rs. 300 from Vimal and Rs. 500 from Kamal on credit)		800	 300 500
June 3	Balram's A/c Dr. Dhanram's A/c Dr. To Sales A/c (Sale of goods worth Rs. 1,000 to Balram and Rs. 700 to Dhanram)		1,000 700	 900
June 5	Cash A/c Dr. To Ramasamy's A/c To Krishnasamy's A/c (Cash of Rs. 900 received from Ramasamy and Rs. 800 from Krishnasamy)		1,700	 900 800
June 7	Pradeep's A/c Dr. Kuldeep's A/c Dr. To Cash A/c (Paid Rs. 800 to Pradeep and Rs. 500 to Kuldeep)		800 500	 1,300
June 9	Cash A/c Dr. Drawings A/c Dr. To Bank A/c (Withdrawn from bank Rs. 600 for office use and Rs. 300 for personal use)		600 300	 900

7.4 Recording of Special Transactions

(1) Trade Discount: Trade discount is allowed by the seller of the goods to the buyer of the goods at a certain percentage of the catalogue or price list. It is not recorded in the books. Both, the seller and the buyer, make the entries in their books with the net amount of the goods, i.e. after deducting the amount of trade discount from the list price of the goods. If any goods from such goods are returned by the buyer, the entries for the returned goods will be made with the net amount after deducting the trade discount. For example, if a trader sales goods of the list price of Rs. 10,000 at 20% trade discount for cash, the entry will be:-

Cash A/c	Dr.	8,000	
To Sales A/c			8,000

(2) **Cash Discount:** Generally, goods are bought or sold on credit. In the case of credit sales, the purchaser is expected to pay the amount due to the seller within a fixed period. To encourage the buyer to make his payment within the stipulated period, the seller may allow the customer a certain deduction from the amount due from him. This deduction is called 'cash discount'. It is recorded in the books. It is worth while to note that cash discount is calculated on the amount, which is arrived at by deducting trade discount out of the total amount of sale. For example, if a trader sells goods of the list price of Rs. 20,000 at 10% trade discount and 2% cash discount, the net amount will be calculated as under:

	Rs.
List price	20,000
Less: trade discount @ 10%	2,000
	18,000
Less: cash discount @ 2% (18,000 * 2%)	360
	17,640

It means that Rs. 17,640 will be paid if the payment is made in cash.

(3) **Withdrawal of goods from the business by the proprietor:** The proprietor of the business, sometimes, takes goods from the business for his personal use like cash. In this respect the following entry is made:

Drawings A/c	Dr.	
To Purchases A/c		
(Goods taken away for personal use)		

(4) **Goods given in charity:** Sometimes, the proprietor gives away in charity. Thus, goods given in charity is not treated as sale, hence it is a deduction in the amount of purchased goods. The entry is made as follows:

Donations/Charity A/c	Dr.	
To Purchases A/c		
(Goods given away in charity)		

(5) **Distribution of free samples:** A trader distributes free samples of goods for the purpose of promoting sales. The cost of free samples so distributed is debited to 'Advertisement or Publicity A/c' and credited to 'Purchases A/c'.

(6) **Loss of goods on theft or other reasons:** Sometimes when goods are stolen from the business or goods are damaged by fire, or on any other account, there is a loss to the goods. Such a loss is considered as a business loss. In this case, 'Loss on theft A/c' or 'Loss by fire A/c' is debited, and 'Purchases A/c' is credited.

(7) **Bad debts:** When any debtor does not pay the amount due from him on account of his insolvency or due to some other cause, it becomes irrecoverable and it is known as 'bad debt'. In this situation the following entry is passed:

Bad debts A/c	Dr.	
To Debtors Personal A/c		
(The amount of bad debts)		

(8) Bad debts recovered: When any amount is debited to bad debts account previously, treating it as irrecoverable and later on if it is recovered, the following entry is made in this respect:

Cash A/c Dr.

To Bad debts recovered A/c

(Bad debts recovered)

(9) On insolvency of a debtor: When any debtor becomes insolvent, the full payment cannot be realized from the property of the insolvent debtor; only partial payment is received and it is called 'Dividend'. Hence for whatever amount that is not realized; the entry in the books is made, treating it as bad debt.

Activity

Goods sold for Rs. 20000 at a trade discount 10% and cash discount 5% write down the Journal entry for the same.

Illustration 7.4.1

Record the following transactions of A & Co. in the journal proper form:

2010		Rs.
Jan 1	Assets: Cash in hand	500
	Cash at bank	8,000
	Stock of goods	4,000
	Machinery	20,000
	Furniture	5,000
	Roy & Co. (amount due to A & Co.)	2,000
	Sen & Co. (amount due to A & Co.)	3,000
	Liabilities: Loan from State Bank of India (SBI)	10,000
	Amount due to Vishwanath & Co.	5,000
Jan 2	Bought goods on credit from Patel & Co.	2,000
Jan 3	Sold goods for cash to Bose & Co.	500
Jan 4	Sold goods to Roy & Co. on credit	1,000
Jan 5	Received from Roy & Co. in full settlement of amount due on Jan 1	1,900
Jan 6	Payment made to Vishwanath & Co. by cheque	
	(Vishwanath & Co. allowed discount of Rs. 50)	4,950
Jan 8	Old furniture sold for cash (Book value Rs. 300)	350
Jan 10	Bought goods for cash	1,000
Jan 11	Received cheque from Sen & Co., deposited in bank	3,000
Jan 12	Paid for repairs to machinery	200
Jan 13	Bought goods from Vishwanath & Co. on credit	2,000
	Paid cartage on these goods	100
Jan 14	Received cheque from Roy & Co., deposited in bank	

(discount allowed to them Rs. 50) 950

Jan 17 Paid cheque to Vishwanath & Co. 2,000

Jan 18 Bank intimates that cheque received from Roy & Co. has been returned unpaid 950

Jan 19 Sold goods for cash to Dey & Co. 2,000

Jan 21 Cash deposited in bank 1,000

Jan 22 Paid municipal taxes in cash 100

Jan 25 Borrowed from New Age Investment Co., for erecting own Premises (amount deposited with bank) 20,000

Jan 26 Paid for advertisements 500

Jan 29 Sold old newspapers 50

Jan 31 Paid rent by cheque 500

Paid salaries for the month 500

Drawn by Mr. A out of the bank for personal use 500

Solution:

Journal

Date	Particulars	L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2010 Jan 1	Cash A/c Dr.		500	
	Bank A/c Dr.		8,000	
	Stock A/c Dr.		4,000	
	Machinery A/c Dr.		20,000	
	Furniture A/c Dr.		5,000	
	Roy & Co. A/c Dr.		2,000	
	Sen & Co. A/c Dr.		3,000	
	To Loan from SBI A/c			10,000
	To Vishwanath & Co.			5,000
	To Capital A/c (balancing fig.)			27,500
	(being the assets and liabilities brought forward from the previous reporting period)			
Jan 2	Purchases A/c Dr.		2,000	
	To Patel & Co. A/c			2,000
	(Bought goods on credit from Patel & Co. as per bill no....)			
Jan 3	Cash A/c Dr.		500	
	To Sales A/c			500
	(Sold goods for cash to Bose & Co. as per cash memo no...)			
Jan 4	Roy & Co. A/c Dr.		1,000	
	To Sales A/c			1,000
	(Sold goods to Roy & Co. on credit as per invoice no...)			

Jan 5	Cash A/c Dr. Discount A/c Dr. To Roy & Co. A/c (Received from Roy & Co. in full settlement of amount due on Jan 1)		1,900 100	 2,000
Jan 6	Vishwanath & Co. A/c Dr. To Bank A/c To Discount A/c (being the amount paid by cheque to Vishwanath & Co. towards settlement of Rs. 5,000)		5,000	 4,950 50
Jan 8	Cash A/c Dr. To Furniture A/c To Profit on sale of furniture A/c (being profit on sale of old furniture, book value Rs. 300, payment received in cash)		350	 300 50
Jan 10	Purchases A/c Dr. To Cash A/c (being purchase of goods for cash as per cash memo no…)		1,000	 1,000
Jan 11	Bank A/c Dr. To Sen & Co. A/c (being cheque no… received from Sen & Co. and deposited in bank)		3,000	 3,000
Jan 12	Repairs to Machinery A/c Dr. To Cash A/c (being the amount paid for repairs to machinery as per bill no….)		200	 200
Jan 13	Purchases A/c Dr. To Vishwanath & Co. A/c (being goods purchased from Vishwanath & Co. as per invoice no….)		2,000	 2,000
Jan 13	Freight Inward A/c Dr. To Cash A/c (being freight paid on goods purchased from Vishwanath & Co.)		100	 100
Jan 14	Bank A/c Dr. Discount A/c Dr. To Roy & Co. A/c (being amount received from Roy & Co. vide cheque no… dated… drawn on…., discount allowed Rs. 50)		950 50	 1,000
Jan 17	Vishwanath & Co. A/c Dr. To Bank A/c (being amount paid to Vishwanath & Co. vide cheque no…dated…drawn on…)		2,000	 2,000
Jan 18	Roy & Co. A/c Dr. To Bank A/c To Discount A/c (being cheque no…dated…drawn on…. received from Roy & Co., returned by bank unpaid)		1,000	 950 50

Jan 19	Cash A/c Dr. To Sales A/c (being goods sold for cash to Dey & Co. vide cash receipt no....)		2,000	2,000
Jan 21	Bank A/c Dr. To Cash A/c (being cash deposited with bank)		1,000	1,000
Jan 22	Municipal Taxes A/c Dr. To Cash A/c (being municipal taxes paid vide cash memo no...)		100	100
Jan 25	Bank A/c Dr. To loan from New Age Investment Co (being amount borrowed for erecting old premises, received vide cheque no...dated....drawn on.....)		20,000	20,000
Jan 26	Advertisements A/c Dr. To Cash A/c (being amount paid towards advertisement in .... Vide cash memo no....)		500	500
Jan 29	Cash A/c Dr. To Sale of newspapers A/c (being old newspapers sold)		50	50
Jan 31	Rent A/c Dr. To Bank A/c (being Rent for the month of Jan, paid vide cheque no...dated...drawn on....)		500	500
Jan 31	Salaries A/c Dr. To Cash A/c (being salaries for the month of Jan., paid)		500	500
Jan 31	Capital A/c Dr. To Bank A/c (being amount drawn by Mr. A for private use vide cheque no... dated.... Drawn...)		500	500

In Illustration 4.4.1, we recorded all types of transactions in a 'Journal Proper'. However, in practice, cash and bank transactions are recorded in a Cash Book, credit purchases are recorded in a Purchase Day Book, credit sales are recorded in a Sales Day Book, and only the following types of transactions are recorded in the 'Journal Proper':

1. Opening entries: At the commencement of the reporting period, opening balances of assets, liabilities and equity are journalized to record carry forward balances in the books of accounts for the period.
2. Closing entries: At the close of the reporting period, while preparing the profit and loss account revenue, gain, expense and loss accounts are closed by transferring their balances in the general ledger to the profit and loss account through the journal proper.
3. Rectification entries: An error occurred while recording a transaction or event is rectified through the journal proper.
4. Transfer entries: Transfer from one account head to another account head is made through the journal proper.
5. Adjustment entries: At the close of a reporting period, expenses and revenue are adjusted to match expenses with revenue for the period. Usually, those entries pertain to outstanding expenses, prepaid expenses, interest on capital and depreciation. Adjustment entries are recorded in the journal proper.

6. Dishonouring of cheques and other negotiable instruments: Non-payment or dishonouring of negotiable instruments (promissory notes, bill of exchange and cheques) is taken on record through the journal proper.
7. Miscellaneous entries: Transactions other than credit purchases, credit sales and cash and bank transactions are recorded through the journal proper.

7.5 Purchase Day Book

In view of the large number of transactions, a separate journal entitled, 'purchase day book' is maintained by enterprises to record credit purchases. However, credit purchases, other than purchases of stock-in-trade or materials being used in the manufacturing process, are not recorded in the 'purchase day book'. Similarly, cash transactions are not recorded in this journal.

Enterprises also maintain a 'purchase return book' to record return of goods to suppliers.

Illustration 7.5.1 presents the format of a 'purchase day book'.

Illustration 7.5.1: A & Co. deals in ladies garments. The rough book of the firm shows the following transactions for the month of Jan 2010.

Jan 1 Purchased from B & Co. on credit:
10 cotton salwar suits @ Rs. 500 per suit
10 silk salwar suits @ Rs. 1,500 per suit
Less: Trade discount @ 10%

Jan 10 Purchased in cash from C & Co.:
2 cotton salwar suits @ Rs. 150 per suit

Jan 15 Purchased a calculator for office use from B & Co. on credit for Rs. 500

Jan 20 Purchased from Y & Co. on credit:
10 cotton sarees @ Rs. 600 per saree
10 silk sarees @ Rs. 2,000 per saree
Less: Trade discount @ 10%

Jan 31 Purchased 10 cotton suit lengths @ Rs. 300 per suit length from Z & Co. on credit

Prepare the purchase day book of A & Co. for the month of Jan 2010.

Solution:

Purchase Day Book Of A & Co.

Date	Particulars	L. F.	Amount (Rs.)	Net Amount (Rs.)
Jan. 1 2010	M/s B & Co.			
	10 cotton salwar suits @ Rs. 500		5,000	
	10 silk salwar suits @ Rs. 1,500		15,000	
			20,000	
	Trade discount @ 10%		(2,000)	18,000
Jan. 20	M/s Y & Co.			
	10 cotton sarees @ Rs. 600		6,000	
	10 silk sarees @ Rs. 2,000		20,000	
			26,000	
	Trade discount @ 10%		(2,600)	23,400
Jan. 31	M/s Z & Co.			
	10 cotton suit lengths @ Rs. 300			3,000
	Total			44,400

Note: Transactions pertaining to cash purchase (Jan 10) and credit purchase of calculator (Jan 15) have not been recorded in the purchase day book.

The total of the purchase day book is posted to the general ledger through the journal proper periodically. The journal entry for Jan 2010 (illustration 4.5.1) should be as follows:

	Dr.	Cr.
Purchases A/c	Rs. 44,400	
To B & Co. A/c		Rs. 18,000
To Y & Co. A/c		Rs. 23,400
To Z & Co. A/c		Rs. 3,000

Usually, the number of transactions being large, personal accounts of individuals creditors is not maintained in the general ledger. Personal accounts of individuals creditors are maintained in a subsidiary ledger that does not form a part of the main books of accounts. Only the control account of creditors is maintained in the general ledger. The balance in the control account entitled 'trade creditors account', reflects the amount of liability towards suppliers of goods. The journal entry from the purchase day book should be as follows:

Purchases A/c	Dr.	Rs. 44,400
To Trade creditors A/c		Rs .44,400

Individual accounts in the subsidiary ledger are posted from the purchase day book for each transaction. The aggregate of balances in individual accounts in the subsidiary ledger should agree with the balance appearing in the 'Trade creditors account' in the general ledger.

Subsidiary ledgers, which do not form part of the main books of accounts, are known as memorandum books, because accounting entries in those ledgers do not form a part of the double entry accounting system. Subsidiary ledgers are usually maintained for 'Trade debtors', 'Advance to employees', 'Advances from customers' and such other credit transactions where a large number of personal accounts are required to be maintained by the firm.

7.6 Sales Day Book

Enterprises record credit sales of stock-in-trade in a 'Sales Day Book'. The mechanics of posting entries from the sales day book to the general ledger and the subsidiary ledger for debtors are similar to those of postings from the purchase day book. The following illustration presents the format of a sales day book:

Illustration 7.6.1:

A & Co.deals in ladies' garments. The rough book of the firm shows the following transactions for the month of Jan 2010.

Jan 2 Sold to Alpha & Co. on credit:
5 cotton salwar suits @ Rs. 600 per suit
5 silk salwar suits @ Rs. 1,800 per suit
Less: Trade discount @ 10%

Jan 3 Sold old furniture to M & Co. for Rs. 100 on credit

Jan 8 Sold to Beta & Co. on credit:
5 cotton salwar suits @ Rs. 600 per suit

5 silk salwar suits @ Rs. 1,800 per suit

Less: Trade discount @ 10%

Jan 15 Sold 2 silk sarees to M/s. Beauty for Rs. 2,500 in cash

Jan 31 Sold to Gamma & Co. on credit:

10 cotton sarees @ Rs. 800 per saree

10 silk sarees @ Rs. 2,500 per saree

Less: Trade discount @ 10%

Prepare the sales day book of A & Co. for the month of Jan 2010.

Solution:

Sales Day Book of A & Co.

Date	Particulars	L.F.	Amounts (Rs.)	Net Amount (Rs.)
Jan. 2 2010	M/s Alpha & Co. 5 cotton salwar suits @ Rs. 600 5 silk salwar suits @ Rs. 1,800 Trade discount @ 10%		 3,000 9,000 12,000 (1,200)	 10,800
Jan. 8	M/s Beta & Co. 5 cotton salwar suits @ Rs. 600 5 silk salwar suits @ Rs. 1,800 Trade discount @ 10%		 3,000 9,000 12,000 (1,200)	 10,800
Jan. 31	M/s Gamma & Co. 10 cotton sarees @ Rs. 800 10 silk sarees @ Rs. 2,500 Trade discount @ 10%		 8,000 25,000 33,000 (3,300)	 29,700
	Total			51,300

Periodical posting of the total of the sales day book to the general ledger should be made through the following journal entry:

Trade Receivables A/c Dr. Rs. 51,300

To Sales A/c Rs. 51,300

Postings to personal accounts of trade debtors should be made in the subsidiary ledger for trade debtors. As in the case of the purchase day book, the aggregate of balances in personal accounts in the subsidiary ledger should agree with the balance in the 'Trade receivables account', in the general ledger.

Enterprises also maintain a 'Sales Return Book' to record inward return of goods from customers.

7.7 Cash Book

Cash and bank transactions are recorded direct in the 'Cash Book'. A cash book is primarily a journal. It also serves the purpose of a ledger account and, therefore, the cash account and bank account are not maintained in the general ledger. Balances in the cash book are taken direct to the trial balance that lists out balances in various account heads in the general ledger. Thus, a cash book serves the dual purpose of maintaining a journal to record cash and bank transactions, and also maintaining cash and bank accounts in the general ledger. The following are the different types of cash books that are being maintained by enterprises:

1. Single-column cash book: It records only cash receipts and cash payments.
2. Double-column cash book: It provides additional information on discount received and discount allowed.
3. Three-column cash book: It has an additional column to record bank transactions.

The following illustration presents a single column cash book.

Illustration 7.7.1:

Record the following cash transactions entered by A & Co. in Jan 2010 in a single column cash book:

		Rs.
Jan 1	Cash-in-hand	1,000
Jan 6	Received from B & Co.	600
Jan 10	Paid rent	500
Jan 15	Sold goods for cash	2,000
Jan 27	Purchased furniture for cash	1,200
Jan 31	Paid salaries	800

A double-column cash book provides additional information on discount received and discount allowed. There are additional columns for discount on both debit and credit sides of the cash book. The total of discount columns are posted in the 'discount account' in the general ledger. Illustration 7.7.2 presents a double-column cash book.

Solution:

Cash Book of A & Co.

Dr.	**Reciepts**			**Payments**			**Cr.**
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan.1	To balance b/d		1,000	Jan.10	By rent a/c		500
Jan.6	To B & Co. a/c		600	Jan.27	By furniture a/c		1,200
Jan.15	To sales a/c		2,000	Jan.31	By salaries a/c		800
				Jan.31	By balance c/d		1,100
			3,600				3,600
Feb.1	To balance b/d		1,100				

Illustration 7.7.2: A & Co. commenced business on Jan 1, 2010 with a cash balance of Rs. 2,000 as capital. It had the following cash transactions for the month of Jan 2010. Prepare the cash book.

		Rs.
Jan 1	Purchased furniture	200
Jan 2	Purchased goods	300
Jan 4	Sold goods	400
Jan 6	Paid to B & Co.	500

	Allowed discount	20
Jan 15	Received from C & Co.	600
	Allowed discount	30
Jan 20	Purchased calculator	200
Jan 31	Paid Salaries	500

Solution:

Cash Book of A & Co.

Dr.	Reciepts				Payments				Cr.
Dt.	Particulars	L F	Discount (Rs.)	Cash (Rs.)	Dt.	Particulars	L F	Discount (Rs.)	Cash (Rs.)
2010 Jan 1	To Capital A/c			2,000	2010 Jan 1	By Furniture A/c			200
Jan 4	To Sales A/c			400	Jan 2	By Purchases A/c			300
Jan 15	To C & Co. A/c		30	600	Jan 6	By B & Co. A/c		20	500
					Jan 20	By Calculator A/c			200
					Jan 31	By Salaries A/c			500
					Jan 31	By balance c/d			1,500
	Total		30	3,000		Total		20	3,000
2010 Feb 1	To balance b/d			1,500					

In a three-column cash book, additional columns are provided to enter bank transactions. This helps to dispense with the 'bank account' in the general ledger. However, in case an enterprise operates more than one bank account, it is better to have a separate 'bank book' or 'bank accounts' in the general ledger. Illustration 7.7.3 presents a three-column cash book.

Illustration 7.7.3: A commenced business as A & Co. on Jan 1, 2010 with a cash balance of Rs. 2,000. Record the transactions for the month of Jan 2010 in a cash book with discount and bank columns.

		Rs.
Jan 1	Deposited cash with bank	1,500
Jan 4	Received cheque from B & Co.	1,000
Jan 5	C & Co. is paid by cheque. He allowed a discount of Rs. 20	330
Jan 6	Received cheque from M & Co. after allowing a discount of Rs. 50	450
Jan 10	Goods sold in cash to R & Co.	500
Jan 12	Cash drawn for office use	500
Jan 15	Paid for office expenses in cash	500
Jan 25	Paid salaries for Jan in cash	500
Jan 25	Cheque received from Y & Co.	400
Jan 31	Cheque received from Y & Co. returned unpaid by bank	400

Solution: **Cash Book of A & Co.**

Dr.	Reciepts					Payments			Cr.		
Dt.	Particulars	LF	Dis. (Rs)	Cash (Rs.)	Bank (Rs.)	Dt.	Particulars	L F	Dis. (Rs.)	Cash (Rs.)	Bank (Rs.)
2010 Jan 1	To Capital			2,000		2010 Jan 1	By Bank	C		1,500	
Jan 1	To Cash	C			1,500	Jan 5	By C & Co.		20		330
Jan 4	To B & Co.				1,000	Jan 12	By Cash	C			500
Jan 6	To M & Co.		50		450	Jan 15	By Office expenses				500
Jan 10	To Sales			500		Jan 25	By Salaries			500	
Jan 12	To Bank	C		500		Jan 31	By Y & Co.				400
Jan 25	To Y & Co.				400	Jan 31	By balance c/d			1,000	1,620
	Total		50	3,000	3,350		Total		20	3,000	3,350
2010 Feb 1	By balance b/d			1,000	1,620						

7.7.1 Petty Cash Book

As a matter of convenience, an imprest (a predetermined amount of cash) is sanctioned to some individuals authorized to make payments of small amounts of high frequency. Examples of such payments are: postage, conveyance, carriage, and stationery. The individual so authorized maintains a cash book known as a petty cash book. The individual periodically recoups his 'imprest' by submitting an account of payments released to him during the period. A petty cash book, usually has multiple columns to accommodate different types of payments.

7.8 General Ledger

After recording transactions in journals, the next phase in the accounting process is to prepare accounts in the general ledger. A general ledger is the principal book of accounts. Financial statements are prepared on the basis of balances in ledger accounts at the end of the accounting period. Journal entries provide information on accounts to be debited and credited in the general ledger. Therefore, journal entries form the basis for preparing accounts in the general ledger. Periodically, accounts in the general ledger are balanced. For example, if in a particular account the total of the debit side comes to Rs. 10,000 and the total of the credit side comes to Rs. 8,000, the account shows a debit balance of Rs. 2,000. Thus, a debit balance of Rs. 2,000 reflects that the total of the debit side exceeds the total of the credit side by Rs. 2,000. Illustration 7.8.1 explains the process of posting transactions from journal to accounts in the General Ledger. Accounts in the general ledger are often termed as Ledger Accounts.

Illustration 7.8.1: From the information provided in Illustration 7.4.1 prepare ledger accounts in the general ledger of A & Co.

Solution: **General Ledger of A & Co.: Capital A/c**

Dr.						Cr.	
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount(Rs.)
2010 Jan 31	To Bank A/c		500	2010 Jan 1	By balance b/d		27,500
31	To balance c/d		27,000				
			27,500				27,500
				Feb 1	By balance b/d		27,000

Cash A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount(Rs.)
2010				2010			
Jan 1				Jan 10	By Purchases A/c		1,000
3	To balance b/d		500	Jan 11	By Repairs to		
5	To Sales A/c		500		Machinery A/c		200
8	To Roy & Co.		1,900	Jan 13	By Freight Inward		
19	To Sundries A/c		350		A/c		100
29	To Sales A/c		2,000	Jan 21	By Bank A/c		1,000
	To Sale of			Jan 22	By Municipal		
	newspapers A/c		50		Taxes A/c		100
				Jan 26	By Advertisement		
					A/c		500
				Jan 31	By Salaries A/c		500
				Jan 31	By balance c/d		1,900
			5,300				5,300
Feb 1	To balance b/d		1,900				

Bank A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010				2010			
Jan 1				Jan 6	By Vishwanath & Co		4,950
11	To balance b/d		8,000	Jan 17	By Vishwanath & Co		2,000
14	To Sen & Co.		3,000	Jan 18	By Roy & Co.		950
21	To Roy & Co.		950	Jan 31	By Rent A/c		500
25	To Cash A/c		1,000	Jan 31	By Capital A/c		500
	To Loan from			Jan 31	By balance c/d		24,050
	New Age Inv.						
	Co. A/c		20,000				
			32,950				32,950
Feb 1	To balance b/d		24,050				

Stock A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 1	To balance b/d		4,000	2010 Jan 31	By balance c/d		4,000
			4,000				4,000
Feb 1	To balance b/d		4,000				

Machinery A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 1	To balance b/d		20,000	2010 Jan 31	By balance c/d		20,000
			20,000				20,000
Feb 1	To balance b/d		20,000				

Furniture A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 1	To balance b/d		5,000	2010 Jan 8	By Cash A/c		300
				Jan 31	By balance c/d		4,700
			5,000				5,000
Feb 1	To balance b/d		4,700				

Roy & Co. A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 1				2010 Jan 5	By Cash A/c		1,900
4	To balance b/d		2,000	Jan 5	By Discount A/c		100
18	To Sales A/c		1,000	Jan 14	By Bank A/c		950
	To Bank A/c		950	Jan 14	By Discount A/c		50
				Jan 31	By balance c/d		950
			3,950				3,950
Feb 1	To balance b/d		950				

Sen & Co. A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 1	To balance b/d		3,000	2010 Jan 11	By Bank A/c		3,000
			3,000				3,000

Loan from SBI A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 31	To balance c/d		10,000	2010 Jan 1	By balance b/d		10,000
			10,000				10,000
				Feb 1	By balance b/d		10,000

Vishwanath & Co. A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 6	To Bank A/c		4,950	2010 Jan 1	By balance b/d		5,000
6	To Discount A/c		50	Jan 13	By Purchases A/c		2,000
17	To Bank A/c		2,000				
			7,000				7,000

Purchases A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 2	To Patel & Co.		2,000	2010			
10	To Cash A/c		1,000				
11	To Vishwanath & Co.		2,000	Jan 31	By balance c/d		5,000
			5,000				5,000
Feb 1	To balance b/d		5,000				

Patel & Co. A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 31	To balance c/d		2,000	2010 Jan 2	By Purchases A/c		2,000
			2,000				2,000
				Feb 1	By balance b/d		2,000

Sales A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan				2010 Jan 3	By Cash A/c		500
				Jan 4	By Roy & Co.		1,000
31	To balance c/d		3,500	Jan 19	By Cash A/c		2,000
			3,500				3,500
				Feb 1	By balance b/d		3,500

Discount A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 5	To Roy & Co.		100	2010 Jan 6	By Vishwanath & Co.		50
14	To Roy & Co.		50	Jan 31	By balance c/d		100
			150				150
Feb 1	To balance b/d		100				

Profit on Sale of Furniture A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 31	To balance c/d		50	2010 Jan 8	By Cash A/c		50
			50				50
				Feb 1	By balance b/d		50

Repairs to Machinery A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 12	To Cash A/c		200	2010 Jan 31	By balance c/d		200
			200				200
Feb 1	To balance b/d		200				

Freight Inward A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 13	To Cash A/c		100	2010 Jan 31	By balance c/d		100
			100				100
Feb 1	To balance b/d		100				

Municipal Taxes A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 22	To Cash A/c		100	2010 Jan 31	By balance c/d		100
			100				100
Feb 1	To balance b/d		100				

Loan from New Age Inv. Co. A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 31	To balance c/d		20,000	2010 Jan 25	By Bank A/c		20,000
			20,000				20,000
				Feb 1	By balance b/d		20,000

Advertisement A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 26	To Cash A/c		500	2010 Jan 31	By balance c/d		500
			500				500
Feb 1	To balance b/d		500				

Sale of newspapers A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 31	To balance c/d		50	2010 Jan 29	By cash c/d		50
			50				50
				Feb.1	By balance b/d		50

Rent A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 31	To bank a/c		500	2010 Jan 31	By balance c/d		500
			500				500
Feb 1	To balance b/d		500				

Salaries A/c

Dr.							Cr.
Date	Particulars	L. F.	Amount (Rs.)	Date	Particulars	L. F.	Amount (Rs.)
2010 Jan 31	To cash a/c		500	2010 Jan 31	By balance c/d		500
			500				500
Feb 1	To balance b/d		500				

7.9 Summary

In the double entry system, it was stated that it is possible to record all types of business transactions in the journal in the chronological order before posting then to the ledger. Now-a-days, the vast majority of transactions are recorded in the special journals such as cash book, purchase day book, sales day book, cash book etc.

The ledger contains in a summarised and a classified form a permanent record of all business transactions in the form of various accounts transferred to it from general journal and other books of original entry.

7.10 Key Words

- **Cash Journal:** A journal meant for recording all cash transactions.
- **Contra Entry:** An accounting entry which is recorded on both the debit and credit sides of Cash Book.
- **Imprest:** The amount advanced to the petty cashier in the beginning of a period.

7.11 Self Assessment Test

1. Prepare proper subsidiary journal (Books) and post to the ledger from the following transactions for the month of Feb 2010:

2010		Rs.
Feb 1	Goods sold to Sachin for	5,000
Feb 4	Purchased from Kushal Traders for	2,480
Feb 6	Sold goods to Manish Traders for	2,100
Feb 7	Sachin returned the goods for	600
Feb 8	Returns to Kushal Traders	280
Feb 10	Sold to Mukesh	3,300
Feb 14	Purchased from Kunal traders for	5,200
Feb 15	Furniture purchased from Tarun for	3,200
Feb 17	Bought of Naresh	4,060
Feb 20	Return to Kunal Traders for	200
Feb 22	Return Inward from Mukesh	250
Feb 24	Purchased goods from Kirti & Co. for list price of Rs. 5,700, Less 10% Trade Discount	
Feb 25	Sold to Shri Chand goods for Rs. 6,600, less 5% trade discount	
Feb 26	Sold to Ramesh Brothers for	4,000
Feb 28	Return Outwards to Kirti & Co. for Rs. 1,000, Less 10% trade discount	
Feb 28	Ramesh Brothers return the goods	500

2. What are the types of accounts? Give two examples of each
3. Write short notes on the following:-
   (i) Narration
   (ii) Petty Cash Book
   (iii) Opening Entry
   (iv) Compound Entry

7.12 Reference Books

1 Grewal, T.S., *Double - Entry Book-Keeping*

2 Paul, S. Kumar, *Book-Keeping and Accountancy*

3 Monga, J.R., *Foundation Accountancy*

Unit -8

Bank Reconciliation Statement

Outline of the unit:

8.0 Objectives

8.1 Introduction

8.2 Importance of Bank Reconciliation Statement

8.3 Techniques of Preparing Bank Reconcitiation Statement

8.4 Cause of difference.

8.5 Where cause of Difference are given.

8.6 Question

8.7 References

8.0 Objectives

After studying this unit you should be able to:

- Explain the meaning and objectives of preparing Bank Reconciliation statements.
- Identify the cause of difference between the balance shown by the Bank pass book and the firm cash book.
- Preparation a Bank Reconciliation Statement.

8.1 Introduction

A Bank Reconciliation Statement is a reconciling the balance as shown by the Bank pass Book and the balance as shown by the cash book. The objective of preparing such a statement is to know the causes of difference between the two balances and pass necessary correcting or adjusting entries in the books of the firm. It should be noted that every reasons of difference does not require an adjusting or correcting entry. Some reasons. For difference are automatically adjusted. For example; if a cheque has been sent for collection, but it has not yet been collected, this is a cause of difference between the balance as shown by the Bank Pass Book and the balance as shown by the Cash Book, but no adjusting entry is required in the Cash Book for such a difference even after it has been found out. This is because the Bank will credit the firm's Account as soon as the cheque is Bank has been returned by the Bank on account of its begins dishonoured, the firm should pass an adjusting entry for return of such cheque if it has not already been passed, Similarly, the firm has also to pass in its books, the entire for bank charges or direct payments received by the Bank on behalf of the firm.

8.2 Importance of Bank Reconciliation Statement

The importance of Bank Reconciliation Statement can be judged on the basis of the following facts:

(i) It highlights the cause of difference between the bank balance as per cash book and the bank balance as per bank pass book. Necessary adjustment or correction can therefore be carried out at the earlier.

(ii) It reduces the chances of fraud by the cash staff. It may be possible that the cashier may not deposit the money in the bank in time through he might have passed the entry in the bank column of the cash

book. The Reconciliation Statement will point out to such discrepancies.

(iii) There is a moral check on the staff of the organization to keep the cash records always up to date.

8.3 Technique of Preparing Bank Reconciliation Statement

A Bank Reconciliation statement is prepared usually at the end of period, i.e.; a quarter, a half year or a year, may be found convenient and necessary by the firm taking into account the number of transaction involved. The following are the step to be taken for preparing a Bank Reconciliation Statement:

(i) The cash Book should be completed and the balance as per the bank column on a particular date should be found out covering the period for which the Bank Reconciliation Statement has to prepared.

(ii) The Bank should be requested to complete and send to the firm the Bank pass Book upto the date mentioned in point (i) above.

(iii) The balance as shown by any book (i.e., the Cash Book and the Bank pass Book) should be taken as the bases. This a matter of fact the starting point for determine the balance as shown by the other book after making suitable adjustment taking into account the causes of difference.

(iv) The effect of the particular cause of difference should be studied on the balance shown by the other book.

(v) In case, the cause has resulted in a increase in the balance shown by the other book, the amount of such increase should be added to the balance as per the former book which has been taken as the base.

(vi) In case, the cause has resulted in decrease in balance shown by the other book, the amount of such decrease should be subtracted from the balance as per the former book which has been taken as the base.

8.4 Causes of Difference

The following are the causes of difference between the balance as shown by the Bank Pass Book and the balance as shown by the Firm's Cash Book.

(i) Cheques issued but not presented for payment.

(ii) Cheques sent for collection but not yet collection.

(iii) Bank charges for collection outstation cheques or Bills.

(iv) Direct collection on behalf of customers.

(v) Errors in account maintained by the customer as well as the bank.

(vi) A wrong credit or debit may be given by the customer or the Bank the tow balances, Therefore, may not tally.

In case, the pass book show an adverse balance (i.e., an overdraft) the amount of the overdraft should be put in the minus column. The Reconciliation Statements should then by prepared on the same pattern as if there is a favourable balance instead of their being an overdraft.

The above technique will be clear with the help of the illustration given in the following pages.

8.5 Where Causes of Difference are Given

Illustration -1 From the following particular prepare a Bank Reconciliation Statement as on 31st December, 1990.

(i) Balance as per Cash Book Rs. 5,800.

(ii) Cheques issued but not presented for payment Rs. 2,000.

(iii) Cheques sent for collection but not collected upto 31st December, 1990 Rs. 1,500.

(iv) The Bank had wrongly debited the account of the firm by Rs. 200 which was rectified by them after 31st December.

Balance as per Pass book is Rs. 6,100.

Solution :

There is a difference of Rs. 300 between the balance as shown by the Cash Book and the balance as shown by the Bank Pass Book. A reconciliation statement can be prepared to reconcile on the following basis the balances shown by the two books;

(i) The Balanace as shown by the Cash Book will be taken as the starting point.

(ii) The cheques issued but not reesented for payment have not been recorded in the Bank Pass Book. The balance as per Pass Book has to be found out. The Bank has not yet passed the entry for the payment of these cheques since they have not been prsented for payment. The balance, therefore, in the Pass Book should be more. The amount of Rs. 2,000 should, therefore, be added to the balance as shown by the Cash Book.

(iii) Cheques sent for collectioin but not yet collected must have been entered in the Cash Book but must not have been credited by the Bank to the firm's account since they have not yet been collected. The balance in Pass Book should therefore, be less as compared to the Cash Book. The amount of Rs. 1,500 should, therefore, be deducted out of the balance as shown by teh Cash Book.

(iv) The Bank has wrongly debited the firm's account. This must have resulted in reducing balance as per the Bank Pass Book. The amount of Rs. 1,500 should, therefore be deducted out of the balance shown as per the Cash Book.

The Bank Reconciliation Statement will now appear as follows :

	Particulars	+ Rs.	- Rs.
(i)	Balance as per Cash Book	5,800	
(ii)	Add: Cheques issued but not presented for payment	2,000	
(iii)	Less: Cheques sent for collection but not yet		1,500
(iv)	collection		200
	Less: Amount wrongly debited by the Bank		
		7,800	1,700
		6,100	

Illustration -2

From the following particulars, prepare a Bank Reconciliation Statement showing the balance as per Cash Bank as on 31st December, 1980.

(i) Out of cheques of Rs. 9,000 paid on 29th December, R. 4,000 appear to have been credited in the Pass Book under date 2nd January, 1991.

(ii) I had issued cheques in December, 1990 amounting in all to Rs. 16,000 of which I find that Rs. 7,000 worth have been cashed in the same month, a cheque of Rs. 5,000 has been cashed on January 3, 1991 and the rest have not been presented at all.

(iii) My Bankders have given me a wrong credit in my Joint Account with wife in respect of a cheque of Rs. 2,000 paid into my personal account.

(iv) Rs. 1,000 for interest on overdraft charged in the Pass Book on 31st December have beenentered in may Cash Book as on 4th January, 1991.

(v) My Pass Book hows a credit of Rs. 1,200 to my account being interest on may securities collected by my Bankers.

(vi) The Bank Balance as per my Pass Book showed an overdraft of Rs. 19,000.

Solution

	Particulars	*+ Rs.*	*- Rs.*
	Overdraft as per Pass Book		19,000
Add :	Cheques not yet credited	4,000	
Less :	Cheques not yet presented		9,000
Add :	Cheques not yet credited to my personal account	2,000	
Add :	Interest on overdraft charged in the Pass Book on 31st December, not entered in Cash Book	1,000	
Less :	Interest on securities collected by bankers not entered in Cash Book		1,200
		7,000	29,200
	Overdraft as per Cash Book		22,200

Illustration -3

Janardan and Co. have bank accounts with two banks, viz., Dena Bank and Bank of India. On 31st December, 1988, his Cash Book (bank columns) shows balance of Rs. 5,000 with Dena bank and overdarft of Rs. 2,250 with Bank of India. On further vrification, the following facts were discovered :

(a) A deposit of Rs. 1,500 made in Dena Bank on 20th December, 1988 has been entered in the column for Bank of India.

(b) A withdrawal of Rs. 500 from Bank of India on 2nd Novermber, 1988 has been entered in the column for Dena Bank.

(c) Two cheques of Rs. 500 and Rs. 750 deposited in Dena Bank on 1st December, 1988 (and entered in the Bank of Indian column) have been dishonoured by the Bankers. The entries for dishonour have been made in the Bank of India column.

(d) Chques were issued on 29th December, 1988 on Dena Bank and Bank of India of Rs. 10,000 and Rs. 1,000 respectively. These have not been chashed till 31st December, 1988.

(e) Incidental charges of Rs. 10 and Rs. 25 charged by Dena Bank and Bank of India respectively have not been entered in the books.

(f) Dena Bank has credited an interest of Rs. 50 and Bank of India has charged interest of Rs. 275. These have not been recorded in the books.

(g) The deposits of Rs. 5,000 and Rs. 3,500 made into Dena Bank and Bank of India respectively have not yet been credited to by them till 31st December, 1988.

Darw up the two Bank Reconciliation Statements.

M/s Janardan and Co.

Reconciliation Statement With Dena Bank

(as on 31st December, 1988)

		Particulars	+ Rs.	- Rs.
		Balance as per Cash Book	5,000	
Add :	(a)	Deposit made on 20.12.1988 but wrongly debited to Bank of India.	1,500	
	(b)	Withdrawal made on 2.11.1988 wrongly entered in the above account instead of Bank of India.	500	
	(c)	These entries have not effect in either account	-	
	(d)	Cheque issued on 29.12.1988 but not yet encashed with the Bank	10,000	
Less :	(e)	Incidental charges not yet credited by us		10
Add :	(f)	Interest credited by Bank but not yet debited by us in our books	50	
Less :	(g)	Cheque deposited but the proceeds of the same not yet credited by Bank		5,000
			17,050	5,010
		Balance as per Bank Pass Book (favourable)	12040	

8.6 Questions

1. What is Bank Reconciliation Statement? How is it prepared? Submit a preforma of a Bank Reconciliation Statement with imaginary figures.

2. Pass/Cash book Favourable Balance:

   From the following particulars prepare a bank reconciliation statement of A showing the balance as per Bank Pass Book on 31march2010

   (i) On march 31,2010 the bank balance as per cash book was Rs. 98000

   (ii) The following cheques were paid into the firm's bank current a/c in March,2010 but were credited by bank in April 2010 : Ram Rs.4000, Shyam Rs.3000 and Mohan RS.2000.

   (iii) The following cheques were issued by the firm in march 2010, but were not cashed in April 2010 : , Gopal 500 and Krishna 2500.

   (iv) The pass book shown a credit of Rs.1800 for interest and a debit of Rs.400 for bank charges.

   (v) The pass book also contains an entry for Rs.2400 being payment made by a customer direct into bank.

   [Ans. Balance as per Pass Book 100,300]

3. On 31st December, 1988, the Pass Book of a merchant shows a credit balance of Rs.3,357. The cheques and draft sent to the bank but not collected and amounted to Rs 790 and three cheques drawn for Rs 300, Rs. 150 and Rs. 200 respectively were not presented for payment till 31st January next year.

   Bank has paid a bill payable amounting to Rs. 1,000 but it has not been entered in the Cash Book and a bill receivable of Rs. 500 which was discounted with the bank was dishonoured by the drawee on due date.

   The bank has charged Rs 13 as its commission for collecting outstation cheques and has allowed interest Rs. 10 on the trader's balance.

Prepare a bank Reconciliation Statement and show the balance as shown by the Cash Book.

[Ans. Balance a per Cash Book Rs. 5,000]

8.7 References

Books Recommended :

1. Financial Accounting : SN Maheshwari, SK Masheshwari.
2. Financial Accounting : Shukla, grewal

Unit - 9

Financial Accounts

Outline of the Unit

9.0 Objectives

9.1 Introduction

9.2 Classification of Capital and Revenue Items

9.3 Distinction between Capital and Revenue Items

9.4 Income Statement- Trading Account

9.5 Income Statement - Profit & Loss Accounts

9.6 Difference between Trading and Profit & Loss Account

9.7 Balance Sheet

9.8 Grouping of Assets and Liabilities

9.9 Classification of Assets and Liabilities

9.10 Distinction between Trial Balance and Balance Sheet

9.11 Methods of Preparing Final Accounts

9.12 Summary

9.13 Key Words

9.14 Self Assessment Test

9.15 Reference Books

9.0 Objectives

After studying this unit you will be able to understand :

- Meaning of financial statements
- Classification and distnction between capital and revenue items
- Meaning and formation process of Trading Account and Profit & Loss Account
- Meaning, importance and Preparation of Balance Sheet
- How grouping, Marshalling of Assets and Liabilities can be done
- Classification of Assets and Liabilities
- Distinction between Trading and Profit & Loss Account
- Methods of Preparing of Final Accounts

9.1 Introduction

Final Accounts refers to such statements which report the profitability and the financial position of the business at the end of the accounting period. These statements are called as "financial Statements" which is prepared to know profit or loss and also the financial position of the business. These statements are prepared for users of accounting information for decision making. Financial statements are prepared from the Trial Balance drawn taking the ledger balances and cash book balances. Final Accounts includes:

(i) Income Statement (Trading and Profit & Loss Account), which shows results of the business operations during an accounting period.

(ii) Statement of Financial Position (or Balance Sheet) which shows final position of the business at a specific point of time.

Objectives of preparing Final Accounts are :

(i) To present a true and fair view of financial performance of a business;

(ii) To present true and fair view of the financial position of the business.

9.2 Classification of Capital and Revenue Items

While preparing final accounts there are certain rules governing the classification of expenditure and receipts between capital and revenue. These are as follows :

9.2.1 Capital Expenditure

An amount spent by an institution on purchase of fixed assets that are used in the business to earn income and are not intended for resale. The benefit yield for over a period extending beyond the accounting period. Examples are: purchase of assets, installation of fixed assets, extension or improvement in fixed assets, expenditure incurred to acquire right to carryout of the business, legal charges for accquiring assets. Capital expenditure is debited to a fixed account which appears in the balance sheet.

9.2.2 Revenue Expenditure

It is an amount spent on running a business. The benefit of these expenditures is exhausted in the accounting period in which it is incurred. Examples : Day to day running expenses for business, expenses incurred for upkeep of fixed assets, expenditure incurred on purchases of goods which are used during the year, depreciation of fixed assets.

Activity 9.1

Can you think of an example which is wrongly treated as revenue expenditure but it is actually Capital expenditure ?

9.2.3 Deferred Revenue Expenditure

Revenue expenditure, which is incurred during an accounting period but the benefit arising out of it extends beyond that accounting period. Example : Large amount spent on advertisement of a new product, which will give benefit over a period. It is charged to profit and loss account in a phased manner, hence balance of such expenses is a fictitious asset and is to be shown in assets side of balance sheet.

9.2.4 Capital Receipts

An amount received in the form of additional capital introduced in the business, loan received and sale proceeds of the fixed assets are examples of Capital receipts. It either increases liabilities or reduce the assets.

9.2.5 Revenue Receipts

An amount received in the regular and normal course of the business i.e. receipts from sale of goods and services. It does not need to return to any one. These are shown in credit side of Income Statement.

9.3 Distinction between Capital and Revenue Items

9.3.1 Distinction between Capital Expenditure and Revenue Expenditure

S.No.	Capital Expenditure	Revenue Expenditure
1.	Its benefit extends to more than one year.	Its benefit extends to only one year.
2.	It is debited to an asset account.	It is debited to an expense account.
3.	It increases the earning capacity of the business	It is incurred for earning profits.
4.	It is incurred for acquisition of fixed assets	It is incurred to carry on the business
5.	It is a real account.	It is a nominal account.
6.	It is shown in the Balance Sheet.	It is part of the Trading or Profit and Loss Account.

9.3.2 Distinction between Capital Receipt and Revenue Receipt

S.No.	Capital Receipt	Revenue Receipt
1.	It is the amount realised by sale of fixed assets or by issue of shares or debentures or by loans taken.	It is the amount realised through sale of goods or rendering of services.
2.	It is an item of Balance Sheet.	It is an item of Trading and Profit and Loss Account.
3.	Capital receipts are normally of non-recurring nature.	Revenue receipts are normally of recurring nature
4.	Capital receipts are the receipts which are not obtained in normal course of business activities	. Revenue receipts are obtained in the course of normal trading operations.
5.	Capital receipts are normally not available for payment as profit to the owner of the business.	Revenue receipts net of revenue expenses and expired portion of capital expenditure/deferred revenue expenditure are available for distribution to the owner of the business.

Activity 9.2
Expenditure to launch a new product in the market, is called .....

9.4 Income Statement - Trading Account

It is a statement which is summary of accounts that affects the profit or loss of an enterprise. It is divided in two parts :

1. Trading Account : It reveals gross profit or gross loss, and
2. Profit and Loss Account : It reveals net profit or net loss.

9.4.1 Trading Account

It is the first phase in the process of preparing final accounts. It is prepared to show the results of manufacturing, buying and selling of goods.

Importance of Trading Account :

(1) It provides information about the direct expenses

(2) It provides information about gross profit or gross loss.

(3) It compares closing stock with that of the previous year.

(4) It provides safety against possible losses.

9.4.2 Preparation of Trading Account

- **Item written on the Dr. side of the Trading Account**

(1) **Opening Stock** The closing stock of the last year becomes the opening stock of the current year. Opening stock will include the following: -

I. Opening Stock of Raw Materials,

II. Opening Stock of Semi-finished goods, and

III. Opening Stock of Finished goods.

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

(3) **Direct Expenses** All expenses incurred in purchasing the goods, bringing them to the godown and manufacturing of goods are called direct expenses, Direct expenses include the following:

(i) Wages Wages are paid to workers who are directly engaged in the loading, unloading and production of goods and as such are debited to the trading account. It should be noted that if the item "Wages and Salaries' is given in the question it will be shown on the trading account. On the contrary, if 'Salaries and Wages' is given it will be shown on the Profit & Loss Account.

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

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

(iv) Import Duty or Custom Duty Custom duty is paid on import as well as on export of goods. Custom duty when paid on the purchase of goods is charged to Trading Account. In the absence of specific instructions, these are debited to trading account.

(v) Octori The amount is levied by the Municipal Committee when the goods enter the city and hence debited to Trading Account.

(vi) Royalty This is the amount paid to the owner of a mine or patent for using his right or patent, Royalty is usually charged to Trading Account because it increases the cost of production. However, if it is specifically stated in the question that the Royalty is based on sales, it will be charged to Profit & Loss Account.

- **Items written on the Cr. Side of the Trading Account**

(1) **Sales and Sales Returns : -** Both Cash and Credit sales will be included in sales. The sales account will be a credit balance whereas, the sales return account or returns inwards account will

be a debit balance. Sales return will be deducted out of Sales on the credit side of the trading account.

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

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

Closing Stock A/c Dr.

To Trading A/c

(Closing Stock transferred to Trading A/c)

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

9.4.3 Closing Entries Relating to Trading Account

(i) Purchases Returns Account is closed by transferring its balance to Purchases Account. Following entry is recorded for this purpose :

Purchases Return A/c Dr.

To Purchases A/c

(Transfer of Purchases Returns Account to purchases account)

(2) Similarly, the Sales Returns Account is closed by transferring its balance to the Sales Account as:

Sales A/c Dr.

To Sales Return

(Transfer of Sales Return Account to Sales Account)

(3) Closing Entry for those accounts which are to be transferred to the Dr. side of the Trading Account:

Trading A/c Dr.

To Opening Stock A/c

To Purchases A/c

To Wages A/c

To Direct Expenses A/c

To Carriage A/c

To Gas, Fuel & Power A/c

To Freight Octroi & Cartage A/c

To Manufacturing Exp. A/c

To Factory Rent & Lighting A/c

To Custom Duty A/c

To Royalty A/c

(The Transfer of above accounts to the Dr. Side of the Trading A/c)

(4) Closing Entry for those accounts which are to be transferred to the Cr. Side of the Trading Account :

Sales A/c Dr.

To Trading A/c

(The Transfer of above accounts to the Cr. Side of the Trading A/c)

(5) Another Closing Entry is needed to close the Trading Account it self. If the credit side of the Trading Account exceeds the debit, the difference will be Gross Profit. The Gross Profit will be transferred to the credit of a newly opened account called Profit & Loss Account -

Trading A/c Dr.

To Profit & Loss A/c

(The transfer of Gross Profit to the Credit Side of P & L A/c)

(6) If the debit side of the Trading Account exceeds the credit, the difference will be Gross Loss, it will be transferred to the debit of P & L A/c by means of the following entry : -.

Profit & Loss A/c Dr.

To Trading A/c

(The Transfer of Gross Loss to the Debit side of P & L A/c)

Format of a Trading Account

Trading A/C

(for the year ended .....)

Dr.		**Cr.**	
Particulars	**Amount**	**Particulars**	**Amount**
	Rs.		Rs.
To Opening Stock		By Sales	
To Purchases		Less: Sales Return or	
Less: Purchases Returns or		Return inwards	
Purchases outward		By Closing Stock	
To Wages		By Gross loss	
To Wages & Salaries		(if any) transferred to	
		Profit	
To Direct Expenses		and Loss A/c	
To Carriage, or		(Balancing figure)	
To Carriage inwards, or			
To Carriage on Purchase			
To Gas, Fuel and Power			
To Freight, octroi and cartage			
To Manufacturing Expenses, or			
Productive Expenses			
To Factory Expenses, such as:			
Factory Lighting			
Factory Rent etc.			
To Import Duty or Custom Duty			
To Royalty			
To Gross Profit Transferred to P & L			
A/c			
(Balancing Figure)			

Illustration 1

Prepare a Trading Account for the year ended 31st March 2010 from the following balances :

	Rs.		Rs.
Opening Stock	30,000	Purchases Return	12,000
Purchases	12,00,000	Sales Return	20,000
Sales	15,00,000	Carriage on Purchases	8,000
Freight and Octroi	6,500	Carriage on Sales	10,000
Wages	30,000	Factory Rent	12,000
Factory Lighting	10,800	Office Rent	7,500
Coal, Gas and Water	2,700	Import Duty	32,000

Closing Stock is valued at Rs. 50,000.

Solution :

Trading A/C

(for the year ended 31 March 2010)

Particulars		Amount	Particulars		Amount
		Rs.			Rs.
To Opening Stock		30,000	By Sales	15,00,000	
To Purchases	12,00,000		Less: Sales Return	20,000	14,80,000
Less : Purchases return	12,000	11,88,000	By Closing Stock		50,000
To Freight and Octroi		6,500			
To Wages		30,000			
To Factory Lighting		10,800			
To Coal, Gas and Water		2,700			
To Carriage on Purchases		8,000			
To Factory Rent		12,000			
To Import Duty		32,000			
To Gross Profit transferred to Profit & Loss A/c		2,10,000			
		15,30,000			15,30,000

- **Cost of Goods sold :**

Cost of Goods sold = Opening Stock + Purchases + Direct Expenses* - Closing Stock * Direc Expenses Means expenses debited to the Trading Account.

9.5 Income Statement - Profit and Loss Account

Trading account discloses the gross profit earned as a result of buying and selling of goods However, a businessman has to incur a number of expenses which are not taken to trading account. Hence

a businessman is more interested in knowing the net profit earned or net loss incurred during the year. As such, a Profit & Loss Account is prepared which contains all the items of losses and gains pertaining to the accounting period.

9.5.1 Importance of Profit & Loss Account

1. To ascertain the Net Profit or Net Loss
2. Comparison with previous years' profits
3. Control over Expenses
4. Helpful in the preparation of Balance Sheet.

9.5.2 Preparation of Profit and Loss Account

A Profit and Loss Account is started with the amount of gross profit or gross loss brought down from the Trading Account all. Those expenses which have not been debited to Trading Account are now debited. It includes administrative expenses, selling expenses, distribution expenses.etc. These are called 'Indirect Expenses.' Profit and Loss Account is a Nominal Account and as such, all the expenses and losses are shown on its debit side and all the incomes and gains are shown on its credit side.

- **Items Written on the Dr. Side of Profit & Loss Account**

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

- **Items Written on the Cr. Side of Profit & Loss Account**

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

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

9.5.3 Closing Entries relating to Profit and Loss Account

The preparation of Profit & Loss Account requires that the balances of all items concerned are transferred to it by posting the following closing entries : -

1. Accounts of various items of expenses and losses are transferred to the debit side of Profit and Loss Account by means of the following entry: -

Profit and Loss A/c Dr.

To Rent, Rates and Taxes A/c

To Printing and Stationery A/c

To Postage and Telegrams A/c

To General Expenses etc.

(The transfer of nominal accounts showing Dr. balances to the Debit of P & L A/c)

2. Balances of all the accounts of incomes and gains will be transferred to the credit side of Profit and Loss Account by means of the following entry : -

Interest Received A/c	Dr.
Commission Received A/c	Dr.
Rent Received A/c	Dr.

To Profit & Loss A/c

(The transfer of nominal accounts showing Cr. balances to the Credit of P & L A/c)

3. For the transfer of credit balance of Profit & Loss A/c, known as net profit: -

Profit and Loss A/c Dr.

To Capital A/c

(The transfer of net profit to Capital A/c)

4. For the transfer of debit balance of Profit & Loss A/c, known as net loss : -

Capital A/c Dr.

To Profit and Loss A/c

(The transfer of net loss to Capital A/c)

Format of a Profit and Loss Account

Profit and Loss A/c

(For the year ending .....)

Dr.			**Cr.**
Particular	**Amount**	**Particular**	**Amount**
	Rs.		**Rs.**
To Gross Loss b/d (Transferred from Trading A/c)		By Gross Profit b/d (Transferred from Trading A/c)	
Office expenses :		By Rent received	
To Salaries		By Discount received	
To Salaries & Wages		By Commission Received	
To Rent, Rates & Taxes		By Interest on Investment	
To Printing & Stationery		By Dividend on Shares	
To Postage & Telegram		By Bad-Debts Recovery	
To lighting		By Apprentice Premium	
To insurance Premium		By Profit on sale of Assets	
To Telephone Charges		By Income from other Sources	
To Legal Charges		By Miscellaneous Receipts	
To Audit Fees		By Net Loss (if any)	
To Traveling Expenses		Transferred to Capital A/c	

To Establishment Expenses			
To Trade Expenses			
To General Expenses			
Selling and Distribution Expenses:			
To Carriage Outwards,			
To Advertisement			
To Commission			
To Brokerage			
To Bad-debts			
To Export duty			
To Packing charges			
To Delivery Van Expenses			
To Stable expenses			
Miscellaneous expenses :			
To Discount			
To Repairs			
To Depreciation			
To Interest Paid			
To Bank Charges			
To Entertainment Expenses			
To Conveyance Expenses			
To Donation and Charity			
To Loss on Sale of Assets			
To Net Profit- Transferred to Capital A/c			

Notes: - (1) Those expenses which are not related to the business are not written in the Profit and Loss Account such as (I) Domestic and household expenses of the proprietor, (II) Income- Tax, and (III) Life Insurance Premium etc. These expenses are known as Drawings and deducted from Capital at the liabilities side of the Balance Sheet.

Illustration 2

From the following particulars, prepare a Profit & Loss Account for the year ending 31st March 2010 : -

	Rs.		Rs.
Gross Profit	2,00,000	Discount allowed	3,000
Trade Expenses	2,000	Lighting	700
Carriage on Sales	10,000	Commission Received	800
Office Salaries	15,800	Bad-debts	,1200
Postage and Telegram	700	Discount (Cr.)	6000
Office Rent	7,500	Interest on Loan	3,600
Legal Charges	400	Stable Expenses	1,400
Audit fee	1,600	Export Duty	2,300
Donation	1,100	Miscellaneous Receipts	500
Sundry Expenses	300	Unproductive Expenses	4,100
Selling Expenses	5,300	Travelling Expenses	2,500

Solution :

Profit & Loss Account

for the year ending on 31st March, 2010

Dr.			Cr.
Particular	**Amount**	**Particular**	**Amount**
	Rs.		**Rs.**
To Trade Expenses	2,000	By Gross Profit	2,00,000
To Carriage on sales	10,000	By Commission received	800
To Office Salaries	15,800	By Discount	6000
To Postage & Telegram	700	By Miscellaneous Receipts	500
To Office Rent	7,500		
To Legal charges	400		
To Audit fee	1,600		
To Donation	1,100		
To Sundry expenses	300		
To Selling expenses	5,300		
To Discount allowed	3,000		
To Lighting	700		
To Bad - Debits	1,200		
To Interest on Loan	3,600		
To Export duty	2,300		
To Unproductive expenses	4,100		
To Travelling expenses	2,500		
To Net Profit transferred to Capital Account	1,45,200		
	2,07,300		2,07,300

9.6 Difference between Trading and Profit & Loss Account

Difference between Trading and Profit & Loss Account

S.No.	Trading Account	Profit and Loss Account
1.	The Gross Profit or Gross Loss is ascertained from the Trading Account.	The Profit and Loss Account is prepared to ascertain the net profit or net loss of the business.
2.	The balance of the Trading Account is transferred to the Profit and Loss Account.	The balance of the Profit and Loss Account is transferred to the Capital Account of the proprietor.
3.	Items shown in the Trading Account are purchases, sales, stock, direct expenses, etc.	Items like indirect expenses related to sales, distribution, administration, finance, etc., are shown in the Profit and Loss Account.

9.7 Balance Sheet

After ascertaining the net Profit or Loss of the business enterprise, the businessman would also like to know the exact financial position of his business. For this purpose a statement is prepared which contains all the Assets and Liabilities of the business enterprise. The statement so prepared is called a Balance Sheet because it is a sheet of balances of ledger accounts which are still open after the transfer of all nominal

accounts to the Trading and Profit & Loss Account. Balances of all the personal and real accounts are grouped as assets and liabilities. Liabilities are shown on the left hand side of the Balance Sheet and Assets on the right hand side. "A Balance Sheet is a statement prepared with a view to measuring the exact financial position of a business on a fixed date."

9.7.1 Importance of Preparing a Balance Sheet

1. To ascertain the true financial position of the business at a particular point of time.
2. To ascertain the nature and cost of various assets of the business.
3. To determine the nature and amount of various liabilities of the business.
4. To know about the exact amount of capital at the end of the year.
5. To prepare the Opening Entries at the beginning of the next year.

9.7.2 Drafting a Balance Sheet

1. A Balance Sheet is a part of the Final Accounts. This is the reason that the Trading and Profit and Loss Account and the Balance Sheet are together called 'Final Accounts'.
2. It is a statement and not an account. It has no debit or credit side and as such the words 'To' and 'By' are not used before the names of the accounts written therein.
3. It is a summary of the Personal and Real Accounts, which are still open and have not been closed by transfer to the Trading and Profit & Loss Account. Debit balances of all Personal and Real Accounts are put on the right hand side known as Assets side, whereas the credit balances are put on the left hand side known as liabilities side.
4. The totals of the two sides of the Balance Sheet must be equal. If the totals are not equal, there will be an error somewhere.
5. It is prepared on a particular date and not for a fixed period.
6. It shows the financial position of the business according to the going concern.

9.8 Grouping of Assets and Liabilities

The Assets and Liabilities shown in the Balance Sheet are properly grouped and presented in a particular order. The term 'grouping means showing the items of similar nature under a common heading.

'Marshalling' is the arrangement of various assets and liabilities in a proper order. Marshalling can be done in any of the following two ways.

9.8.1 In the Order of Liquidity

An asset which is most easily convertible into Cash such as Cash in hand is written first and then will follow those assets which are comparatively less easily convertible, so that the least liquid asset such as goodwill, is shown last.

In the same way, those liabilities which are to be paid at the earliest will be written first. In other words current liabilities are written first of all, then fixed or long-term liabilities and lastly, the proprietor's capital.

Proforma of a Balance Sheet in the order of liquidity will be as follows :

Balance Sheet

as on .....

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Bank Overdraft		Cash in Hand	
Bills Payable		Cash at Bank	
Sundry Creditors		Bills Receivable	
Outstanding Expenses		Short Term Investments	
Unearned Income		Sundry Debtors	
Long term loans		Closing Stock	
Reserves Capital		Prepaid Expenses	
Add : Net Profit		Accrued Income	
Add : Drawings		Long Term Investments	
Less : Income Tax		Furniture	
Less : Life Insurance Premium		Losse Tools	
		Motor Vehicle	
		Plant & Machinery	
		Land and Buildings	
		Patents	
		Goodwill	

9.8.2 In the Order of Permanence

This method is exactly the reverse of the first method. Assets which are most difficult to be converted into cash such as Goodwill are written first and the assets which are most liquid such as Cash in hand are written last. Similarly, those liabilities which are to be paid last, will be written first. In other words, the proprietor's capital is written first of all, then fixed or long term liabilities and lastly, the current liabilities. Joint stock companies are required under the Companies Act to prepare their Balance Sheet in the order of permanence.

9.9 Classification of Assets and Liabilities

9.9.1 Classification of Assets

(i) **Fixed Assets** "Fixed Assets are assets of a relatively permanent nature used in the operations of business and not intended for sale". As the purpose of keeping such assets is not to sell but use them, changes in their market values are ignored and these are always shown in the Balance Sheet at cost less depreciation.

(ii) **Current Assets** Current Assets are those which are either in the form of cash or can be easily converted into cash within one year of the date of the Balance Sheet.

(iii) **Liquid Assets** Liquid Assets are those which are either in the form of Cash or can be quickly converted into cash, such as, Bills Receivable, Short Term Investments, Debtors, Accrued Income etc. In other words, if Prepaid Expenses and Closing Stock are excluded from Current Assets, the balance will be liquid Assets.

(iv) **Fictitious or Nominal Assets** Which cannot be realised in Cash or no further benefit can be derived from these assets. Such assets include Debit balances of P & L A/c and the expnditure not yet written off such as Advertisement Expenses etc. These assets are not really assets but are shown on the Assets side only for the purpose of transferring them to the Profit & Loss Account gradually over a period of time.

(v) **Wasting Assets** Which are exhausted or consumed over a period of time such as mines and oil- wells. Their value reduces through being used. These also include Patents and the properties taken on lease for a definite period of time.

(vi) **Tangible and Intangible Assets** Tangible Assets are those which have a physical existence like Plant and Machinery, Building, Furniture, Stock, Cash etc. Intangible Assets are those which do not have any physical existence such as the Goodwill, Trade Marks, Patents etc.

9.9.2 Classification of Liabilities

(i) **Fixed or Long-term Liabilites :** Those liabilities which are to be repaid after one year or more are termed as long-term liabilities. These include Public Deposits, Long-term Loans, Debentures etc.

(ii) **Current or Short Term Liabilities :** Those liabilities which are expected to be paid within one year of the date of the Balance Sheet are termed as current or short - term liabilities. These include Bank Overdraft, Creditors, Bills Payable. Outstanding expenses etc.

(3) **Contingent Liabilities :** These are the liabilities which will become payable only on the happening some specific event otherwise not such as:

(i) Liabilities for bill discounted

(ii) Liability in respect of a suit pending in a court of law

(iii) Liability in respect of a guarantee given for another person

- **Contingent liabilities are not shown in the Balance Sheet.** They are, however, shown as a footnote just below the Balance Sheet so that their existence may be revealed.

9.10 Distinction between Trial Balance and Balance Sheet

Distinction between Trial Balance and Balance Sheetof

S.No.	Trial Balance	Balance Sheet
1.	It is prepared to check the arithmetical accuracy of the books of accounts.	It is prepared to know the true financial position of the firm.
2.	It is not possible to have information about net profit or net loss from a trial balance.	Since net profit or loss is recorded in the Capital shown in Balance Sheet, it is possible to have the information about net profit or net loss from a Balance Sheet.
3.	The headings of its two columns are debit and credit.	The headings of its two sides are assets and liabilities.
4.	It is normally prepared every month or whenever needed.	It is normally prepared half-yearly or yearly at the end of the accounting period.
5.	All types of accounts whether personal, real or nominal must be written in it.	Only personal and real accounts are included in it.
6.	It can be prepared without making adjustments for outstanding expenses, prepaid expenses, accrued incomes etc.	It cannot be prepared without making adjustments for outstanding expenses, prepaid expenses, accrued incomes etc.

Illustration 3

From the following balances of a businessman, prepare a Balance Sheet as on 31st March, 2010.

	Dr. Rs.	Cr. Rs.
Plant & Machinery	80,000	
Land and Building	60,000	
Furniture	15,000	
Cash in Hand	2,000	
Bank overdraft		18,000
Debtors and Creditors	16,000	8,000
Bills Receivable and Bills Payable	10,000	6,000
Closing Stock	20,000	
Investments (Short-term)	8,000	
Capital		1,30,000
Drawings	10,000	
Net Profit		59,000
	2,21,000	2,21,000

BALANCE SHEET

as on 31st March, 2010

Liabilities		Amount	Assets	Amount
		Rs.		Rs.
Bank overdraft		18,000	Cash in hand	2,000
B/P		6,000	B/R	10,000
Creditors		8,000	Investments (Short-term)	8,000
Capital	1,30,000		Debtors	16,000
Add : Net Profit	59,000		Closing Stock	20,000
	1,89,000		Furniture	15,000
Less Drawings	10,000	1,79,000	Plant & machinery	80,000
			Land & Building	60,000
		2,11,000		2,11,000

Illustration 4

From the following Trial Balance of Shri Ram prepare Trading and Profit and Loss A/c for the year ending 31st March, 2011 and Balance Sheet as on that date. The Closing Stock on 31st March 2011 was value at Rs. 15,000.

	Rs.		Rs.
Stock (1.4.10)	10,000	Sundry Creditors	15,000
Purchases	75,000	Purchases Returns	3,000
Sales Return	8,000	Sales	2,50,000
Freight and Carriage	44,000	Commission	2,000
Salaries	12,000	Capital	1,70,000
Repairs	1,200	Interest on Bank Deposit	2,000
Trade Expenses	4,000	B/P	6,200
Rent and Taxes	24,000		
Cash in Hand	5,000		
B/R	4,000		
Debtors	55,000		
Plant and Machinery	1,60,000		
Withdrawals (Drawings)	16,000		
Bank Deposit	20,000		
	4,38,200		4,38,200

Solution :

Trading and Profit and Loss Account

for the year ending on 31st March, 2011

Dr.					Cr.
Particulars		**Amount**	**Particulars**		**Amount**
		Rs.			Rs.
To Opening Stock		10,000	By Sales	2,50,000	
To Purchases	75,000		Less Sales Return	8,000	2,42,000
Less: Purchase Returns	3,000	72,000	By Closing Stock		15,000
To Freight & Carriage		44,000			
To Gross Profit c/d		1,31,000			
		2,57,000			2,57,000
To Salaries		12,000	By Gross Profit b/d		1,31,000
To Repairs		1,200	By Commission		2,000
To Trade Expenses		4,000	By Interest on Bank Deposit		2,000
To Rent & Taxes		24,000			
To Net Profit transferred to Capital A/c		24,000			
		1,35,000			1,35,000

Balance Sheet

as on 31st March, 2010

Liabilities		**Amount**	**Assets**	**Amount**
		Rs.		Rs.
B/P		6,200	Cash in hand	5,000
Sundry Creditors		15,000	B/R	4,000
Capital	1,70,000		Sundry Debtors	55,000
Add : Net Profit	93,800		Closing Stock	25,000
	2,63,800		Bank Deposit	20,000
Less : Drawings	16,000	2,47,800	Plant & Machinery	1,60,000
		2,69,000		2,69,000

9.11 Methods of Preparing Final Accounts

The Trading and Profit and Loss Account and the Balance Sheet can be presented either in the Horizontal Form or in Vertical Form.

(i) **Horizontal Form:** Under this form of presentation, the items are presented in "T" form, which we have already discussed in this chapter. The final accounts in the above illustrations have been prepared in horizontal form.

(ii) **Vertical Form:** Under this form of presentation, the items are presented in a single column statement in a purposeful sequence.

The Vertical format of a Trading Account is given below.

Trading Account of A

for the year ended 31st March, 2011

Particulars	Rs.	Rs.	Rs.
Sales		200000	
Less: Returns Inwards		2000	198000
Opening Stock		10000	
Purchases	80000		
Less : Purchases Outwards	2000	78000	
Direct Expenses	2000		
Freight and Carriage	15000		
Customs and Insurance	20000		
Wages	20000		
Gas, Water and Fuel	2000		
Lighting and Heating	3000		
Factory Expenses	2000	64000	
		152000	
Less : Closing Stock		2000	
Cost of Goods Sold			150000
Gross Profit			48000

The Vertical format of Profit and Loss Account is given below.

Profit And Loss Account of A

for the year ended 31st March, 2011

Particulars	Rs.	Rs.
Gross Profit		48000
Discount Received	500	
Commission Received	600	
Bank Interest	100	
Rent of Property Let-out	300	
Profit on Sale of Machinery	150	
Profit on Sale of Investments	250	1900
		49900

Cont....

Particulars	Rs.	Rs.
Salaries (Administrative)	17000	
Office Rent, Sales and Taxes	6000	
Printing and Stationery	500	
Telehpone Charges	400	
Insurance	200	
Audit Fees	100	
Legal Fees	150	
Electricity Charges	250	
Repairs and Renewals	120	
Depreciation on Machinery	180	
Salaries (Selling Staff)	140	
Advertisement	160	
Godown Rent	1000	
Carriage Outwards	1500	
Bad Debts	1000	
Provision for Bad Debts	500	
Selling Commission	500	
Bank Charges	500	
Interest on Loans	600	
Discount on Bills	400	
Discount Allowed to Customers	300	
Loss on Sale of Fixed Asset	400	
Loss on Sale of Investment	400	
Loss by Fire or Accident	400	32700
Net Profit transferred to Capital A/c		17200

The Vertical Format merely involves a rearrangement of the information shown by a Balance Sheet presented in the Horizontal Format. The Vertical Format of a Balance Sheet is shown below (using imaginary figures):

Balance Sheet of Z

as at 31st March, 2008

Particulars	Rs.	Rs.	Rs.
Fixed Assets			
Land		2,00,000	
Building		10,00,000	
Plant and Machinery		4,00,000	
Furniture		2,00,000	
Delivery Van		6,00,000	24,00,00
Current Assets			
Stock	5,00,000		
Debtors	3,00,000		

Bills Receivable	1,00,000		
Cash at Bank	30,000		
Cash in Hand	70,000	10,00,000	
Current Liabilities			
Creditors	3,00,000		
Bills Payable	80,000		
Outstanding Expenses	20,000	4,00,000	
Working Capital (Current Assets - Current Liabilites)			6.00,000
Net Assets Employed			30,00,000
Financed by			
Capital		25,00,000	
Add: Net Profit		5,00,000	
			30,00,000

9.12 Summary

The term financial statements as used to denote 'Final Accounts' consists of two basic statements : **(1)** Trading and Profit and Loss Account (Income statement) **(2)** Balance Sheet. The users of financial statements are present and potential investors, lenders, short terms creditors employees, customers, government, tax authorities, providers of loan, which satisfy their specific needs. Trading account contains the revenue incomes and expenditures which are related to purchases or goods manufactured i.e. direct expenses related to production. This account shows gorss profit or loss. Profit & Loss account contains all indirect expenses related to business and all indirect incomes related to enterprise. It shows net profit or loss. The Balance Sheet is a statement, which depicts the financial position of a business on a particular date. Income statements is a period statement whereas Balance Sheet is a point statement. Grouping & marshalling refers to collect same nature of items in one group and arrange them in a particular order. Vertical presentation is a system of presentation of information of trading, profit and loss Account and Balance Sheet instead of side by side, in such a way that important information are revealed to the readers a a glance.

9.13 Key Words

- **Final Accounts -** Financial statement which includes Trading Account, Profit and Loss Account and Balance Sheet. It is prepared to know profit earned in a particular period and to know the financial position of a particular date.
- **Contingent Liabilities-** A liability that becomes payable on the happening of an event. If the event does not happen, no amount is payable examples : Liabilities in respect of bills discounted, disputed loans etc.
- **Wasting Assets -** Which are exhausted over a period of time. Their value reduces through being used. Examples : Patents taken on a lease for a definite period, mines & oil wells.

- **Intangible Assets** - Those which do not have any physical extistence like, goodwill, Trade mark, Patents. These assets are valuable as tangible assets.
- **Fictitious Assets** - Which cannot be realised in cash or no further benefit can be derived from these assets. These are like deferred revenue expenditure of which benefit is derived over a period of more than one year. Such assets are advertisement expenses. Debit balance of Profit and Loss Account.

9.14 Self Assessment Test

1. Explain the following terms :

   (a) Capital Expenditure (b) Revenue Expenditure (c) Contingent Liabilities (d) Wasting assets

2. Distinguish between :

   (1) Capital Receipts and Revenue Receipts (2) Capital Expenditure and Revenue Expenditure

   (3) Trial Balance and Balance Sheet.

3. Give five examples of each of the following :

   (a) Direct Expenses (b) Indirect Expenses

4. What do you mean by "Grouping and Marshalling a Balance Sheet ?

5. List out the 4 examples of each of the following :

   (i) Fixed Assets

   (ii) Current Assets

   (iii) Contingent Liabilities

6. Prepare the Trading and Profit & Loss Account and Balance Sheet of Jagat Shah as on 31st March, 2008 from the following balances :

	Rs.		Rs.
Capital (Cr.)	3,600	Salaries	600
Machinery	700	General Expenses	200
Sales	8,200	Rent	500
Purchases	4,000	Purchases Returns	50
Sales Returns	100	Debtors	3,000
Stock on April 1, 2010	1,000	Cash	400
Drawings	400	Carriage Outward	200
Wages	1,000	Advertising	200
Carriage Inward	50	Creditors	500

Closing Stock was valued at Rs. 2,000

7. From the following Trial Balance, prepare a Trading and Profit and Loss Account for the year ending March 31, 2010 and the Balance Sheet as on that date:

	Rs.	Rs.
Capital		5,00,000
Plant & Machinery	1,00,000	
Land and Buildings	1,20,000	
Sales		8,00,000
Furniture and other Equipment	60,000	
Trade Expenses	30,000	
Cash at Bank	2,50,000	
Wages and Salaries	60,000	
Repairs	10,000	
Purchases	5,00,000	
Opening Stock	2,00,000	
Sundry Creditors/Sundry Debtors	1,00,000	1,30,000
Purchases Returns		10,000
Rent		12,000
Discount	8,000	
Drawings		35,000
Bills Receivable/Bills Payable	10,000	10,000
Bad Debts	45,000	
Interest	4,000	
	14,97,000	15,82,000

The Stock on 31st March, 2010 was valued at Rs. 1,40,000.

9.15 Reference Books

1 Paul S. Kr., *Book-Keeping and Accountancy*

2 Grewal Shukla, *Accountancy*

3 Monga J.R., *Foundation Accountancy*

4 Grewal T.S., *Double Entry Book-Keeping*

UNIT – 10

Inventory Configuration and Inventory Masters

Outline of the Unit

10.0 Objectives

10.1 Meaning of Inventory

10.2 Features of Inventory

10.3 Meaning of Inventory Management/Control

10.4 Objectives of Inventory Management and control

10.5 Importance or Functions of Inventory Management

10.6 Factors Affecting Level of Inventory:

10.7 Dangers of Excess Inventory

10.8 Risk and Costs Associated with Inventory

10.9 Techniques of Inventory Control

10.10 Summary

101.11 Abbreviations

10.12 Key Terms

10.13 Self-Assessment Questions

10.14 Reference/Suggested Books

10.0 Objectives

After completing this unit, you will be able to:

- Define Inventory, Features of Inventory
- Define the Nature of Inventory Management Control and objectives of Inventory Management Control systems.
- Define importance and functions of Inventory management.
- Define factors affecting the level of inventory, risks and costs associated with inventory.
- Define various techniques of inventory management systems.
- Define inventory configuration and inventory master.

10.1 Meaning of Inventory

Inventory which comprises stock of raw material, work in progress and finished goods is an important element of the current assets of a business enterprise. The research studies conducted on the management of inventory have revealed the facts that inventories, generally, constitute the second largest item next to fixed assets in the financial statements of manufacturing enterprises. Mismanagement of inventory reduces the long-term profitability of the firm, as the shortage of inventory interrupts production and timely supply of

goods to the customers. On the other hand, capital of the firm is tied-up in holding excessive inventory resulting in an increase in interest and storage costs.

An efficient inventory management ensures continuous production by maintaining inventory at a satisfactory level. It also minimises capital investment and cost of inventory by avoiding stock-pile of products. Thus, to some extent, a firm can control the volume of inventory using different methods and techniques of inventory control without affecting the production and sales.

The dictionary meaning of the word 'inventory' is stock of goods. But, inventory means such types of assets which will be disposed of in future in the ordinary course of business. Bolten S.E. has defined it as, "inventory refers to the stock-pile of the product a firm is offering for sale and the components that make up the product". In other words, the inventory is used to represent the aggregate of those items of tangible assets which are –

(i) Held for sale in the ordinary course of business;

(ii) In the process of production for such sale;

(iii) To be currently consumed in the production of goods or services to be available for sale.

Thus inventory means and includes any one or all of the following:

1. Raw materials and suppliers: These are goods that have to be used in the production of finished goods such as iron ore in steel or oils seeds/groundnut in oil industry. The purpose of holding raw material is to ensure uninterrupted production in the event of delay in delivery and to take advantage of bulk or other favourable terms of purchase.

2. Work in Progress: Those raw materials which have been used in production process but have not been completed into the final product are work-in-progress. Such inventory helps to stabilise the rate of output at successive stages in the face of fluctuations of demand for the product.

3. Finished goods: These represent final or completed product which are available for sale in ordinary course of business. Such inventory serves as a buffer against fluctuations in demand for a product. It helps to reduce the risk associated with stoppage or reduction in output on account of strikes, break downs, shortage of materials or power etc.

The above may considered to be the operational definition of inventory. In financial parlance, inventory is defined as the sum total of value of raw materials, work-in-progress and finished goods, though it depends largely upon the type of business. For example, in case of manufacturing firms, inventory will mean and include all the three groups stated above, while in case of trading firms, it will represent only the finished goods. Raw material and work in-progress inventories make the production process convenient, while with the help of inventory of finished goods marketing activities are carried on successfully. Thus, inventory works as a link between production and consumption of goods.

Activity 10.1

Q1.Define Inventory?

Q2. State three reasons for holding inventory?

10.2 Features of Inventory

A comparison of inventory with other components of working capital reveals that it has some special features of its own. These features are:

- On an average, it accounts for the lion's share of a firm's investment in working capital. For example, in India, inventory generally accounts for more than 60 percent of current assets in the manufacturing industries.
- The risk factor in holding inventory is generally higher than that of holding other items of current assets.
- Though holding of more and more inventory may be desirable from the point of view of functional managers, it adversely affects profitability.
- It involves many types of costs associated with it viz. acquisition cost, carrying cost, short-out cost etc.
- It is the only item of current assets which has direct influence on the prices and the income of a firm.
- It involves almost all the functional areas of management, viz, purchasing, production, marketing and finance.

Why Business Firm Have Inventories:

In holding different types of inventories, the capital of the firm is tied-up and it has to incur some expenditure in the form of storage and transportation costs. In spite of it, every business enterprise holds adequate inventories. By holding inventories, the firm is able to separate the process of purchasing, producing and selling. If firms were not willing to hold adequate raw materials and finished goods, purchasing would take place only when immediate production and sales have anticipated. In brief, holding of inventory has many purposes that are explained as under.

1. **To Stabilise Production and Production Process**: In the absence of adequate stock of raw materials, production would be hampered. It is not possible for a firm to procure raw material whenever it is needed. There exists a time lag between placing an order and receiving the goods. Sometimes, it becomes difficult to procure raw material due to strike, transport disruption and shortage of material. Therefore, a firm has to hold adequate quantity of raw material in stock for a continuous supply to the factory for an uninterrupted production.
2. **Reducing Order cost:** Every time a firm places an order, it incurs certain costs. Forms must be typed, checked, approved and mailed. When goods arrive, they must be accepted, inspected and counted. The invoice must be checked with the goods and then sent to the accounting department so that payment may be made to the supplier. The costs which vary with the individual order can be reduced if the firm places larger than numerous small orders.
3. **Gaining Quantity Discount:** If a firm is willing to hold large inventories in selected product lines, it may be able to make bulk purchases of goods at large quantity discount. Suppliers usually offer a substantially reduced price if the firm will order double or triple its normal requirements. By availing this discount, the firm will be able to increase its profits as long as the costs of maintaining inventories are less than the amount of discount.
4. **Avoiding Losses of Sales:** If the firm does not have goods for sale, it will lose sales. Customers requiring immediate delivery will purchase their goods from the firm's competitors or will decide not to purchase goods at all instead of waiting for delivery. At any, rate, the customer is to be maintained because a satisfied customer creates a new class of customer for selling and therefore producing.
5. **Full Utilization of Capacity**: The firm has also to hold adequate quantity of stock of raw material to use its unutilised production capacity. If the production capacity is not being fully utilised due to shortage of raw material, it causes an increase in cost of production because some elements of

costs are meant for production capacity. Partial utilization of capacity does not result in reducing such costs. Therefore, to protect the firm from such losses, holding of an adequate inventory is inevitable.

6. **Lower Prices**: Raw materials, spares and other components may be purchased in bulk to take the advantage of a special offer at low prices or a temporary recession in prices. Similarly, if it is anticipated that there will be large price increase in future, bulk purchases may be made at current market prices to take the advantage of low costs in future. In both the cases of bulk purchases, the purpose are to reduce the cost of materials input and thereby increases the profitability. However, this is possible only when carrying costs of inventory do not exceed the benefits from lower prices.

All the aforementioned purposes of holding inventories can be grouped, like keeping cash, into the three categories viz.

(i) Transaction motive

(ii) Precautionary motive and

(iii) Speculative motive.

Inventories kept with transaction motive help smooth production and sales. Inventories held with precautionary motive protect the firm against the risk of uncertainty about demand and supply and other related factors. Inventories held with speculative motive benefits the firm due to price fluctuations and changes in demand and supply.

Activity 10.2

Q1. Discuss the features of inventory?

Q2. What is meant by precautionary motive?

10.3 Meaning of Inventory Management/Control

In broad sense, inventory management is inventory planning which covers the task of development and administration of policies, systems and procedures which minimize total costs relating to inventory decisions, and related functions such as customer service requirements, production scheduling, purchasing and so on. On the other hand, inventory control in a narrows sense, primarily covers the areas of administration of established policies, systems and procedures. *Professor G.B. Carson* in Production Hand Book edited by him defines inventory control as the "process where by the investment in materials and parts carried in stock is regulated within predetermined limits set in accordance with the inventory policy established by management". The *American Production and Inventory Control society* has also defined inventory control as, "the technique of maintaining stock, keeping items at desired level whether they are raw material, work-in-progress or finished goods". In this way, inventory control is an integral part of inventory management.

Thus, *inventory management means efficient control and management of capital invested in raw materials and supplies, work-in-progress and finished goods for the purpose of obtaining maximum return from the investment.*

Activity 10.3

Q1. What is meant by inventory management?

Q2. What is ordering costs?

10.4 Objectives of Inventory Management and control

The objective of inventory management is to minimise the investment in inventories keeping in view the production, sales and financial resources of the firm. In brief, the different objectives of inventory management may be summarised as follows:

Operating Objectives

(1) **Regular Flow of Materials**: The inventory management has to ensure the maintaining of required quantity of material of the required quality at the required time so that the regular flow of work should not hinder or hurt. Hence, there should be proper control from the time orders are place with the suppliers till the materials have been effectively utilised in production. This requires efficient purchasing, storing, consumption and accounting of materials.

(2) **Risk Minimisation:** The firm should try, to the extent possible, to minimise the possibility of risk and losses due to : (i) stock out (not holding inventories), (ii) obsolescence of stores with the change in demand such as fashions, design, technology, likes and dislikes or style, (iii) deterioration, (iv) pilferage, (v) theft, (v) waste and unauthorised use etc.

(3) **Avoiding of Stock-out Danger**: Information about availability of materials or finished goods should be made available to the management so that planning for procurement at right time can be done by it. If inventories are maintained at the optimum level keeping in view the operational requirements, the danger of stock out is eliminated.

Financial Objectives

(4) **Making Possible Minimum Investment:** Over-stocking of raw material and finished goods results in unnecessary tied-up of the firm's funds and loss of profit. Investment of funds in inventory costs in the form of opportunity cost and carrying cost. It reduces the firm's profitability. Moreover, holding assets in the form of excessive inventories for a long period results in decrease in the liquidity of the firm. The objective of inventory control system in a manufacturing firm is, therefore, to minimise the funds tied-up in inventories.

(5) **Minimisation of Inventory Costs:** The investment can be minimised when a perfect match is brought between two sets of inventory costs viz. procurement costs and inventory carrying costs. This requires purchase of material at such quantities where purchasing and carrying costs are minimum. This is possible by taking quantity discount in bulk purchases or by taking advantages of favourable market conditions.

Activity 10.4

Q1. Discuss the objectives of inventory and control?

Q2. Explain the operating objectives of inventory management?

Q3. Discuss the financial objectives of inventory management?

10.5 Importance or Functions of Inventory Management

The significance of inventory management and control is the function it performs. When one speaks of functions of inventory control, it is implied that one speaks of its importance. The functions performed are identified as follows:

(1) **Effective Use of Financial Resources**: Effective inventory control system and its use lessen the investment in inventories, inventory carrying costs and procurement costs. This encourages healthy

practice of wise spending or investment. It is worth emphasizing that it is a rupee saved is rupee earned.

(2) **Economy in Purchasing**: A proper inventory control brings certain economies in purchasing by taking quantity discount in bulk purchases or taking advantages of favourable market conditions. But, while purchasing materials, it should be noted that quality is not to be sacrificed at the cost of lower price.

(3) **Uninterrupted Production**: Inventory control, like a balancing wheel in a watch or a clock with spring acts as agent to supply adequate materials, stores spares, supplies, reducing stock outs and shortages and avoiding costly hurdles in operations. It acts as a pumping station. What is heart to a human body or an animal that is inventory control system to production organisation?

(4) **Protection against material Losses**: A firm might acquire the requisite quantity of material at quite reasonable cost, in adequate quantities, from reliable sources, and at an opportune time; yet the materials in various forms are subject to losses caused by natural and human factors. A good inventory system develops a policy or set of policies where these man-made and natural factors are made splashed by developing a immunity within limits.

(5) **Ascertainment of Results**: The final accounts can be prepared at any movement of time as ready valuation stock is there because perpetual inventory system is followed. This helps taking many valuable decisions which would have been otherwise post-mortem decisions. This facilitates quick decisions and prompt actions.

(6) **Prompt Delivery to Customers**: In today's highly competitive and racing marketing system the customers are not prepared to wait for you, in case you say that it is not possible for you to supply in time. A firm which has thorough scheduling system, the order can be met well in time which is quite a plus point in favour of company. It is because a company can not afford to lose a customer, for loss of one customer leads loss of one by one as competitors are waiting to grab the opportunity.

(7) **Eliminates Redundant Inventory**: Good inventory system eliminates duplication in ordering by centralising the source from which the purchase requisitions are sent. Scientific inventory control system eliminates the dead inventory, surplus and movable surplus stock as far as practicable. These are the materials which are no longer needed or demanded and which valuable money blocked but can not be realised in full because these items are surplus, deteriorated, scrap and waste materials.

(8) **Provides Information**: A well developed inventory system cares to provide the management detailed and up-to-date information that helps in production planning and control. Even distribution logistics can be determined. Dependable information can make impossible things possible.

Activity 10.5

Q1. Discuss the important functions of Inventory management?

Q2. "There are two dangerous situations that management should usually avoid in controlling inventories". Explain.

10.6 Factors Affecting Level of Inventory

A firm should maintain its inventory of raw materials, work-in-progress and finished goods at a reasonable level. The level of inventory depends upon several factors; the important among them are as under:

(1) **Nature of Business**: The levels of inventories of raw material, work-in-progress and finished goods for a firm depends on the nature of its business. A Manufacturing firm will have a high level of all kinds of inventories, while a trading firm will have very high level of finished goods inventories and no inventory of raw material and work-in-progress..

(2) **Inventory Turnover**: The rate of inventory turnover i.e. the time period within which inventory completes the cycle of production and sales affects the level of inventory. When the turnover rate is high, investment in inventories tends to be low and vice-versa.

(3) **Nature and Type of Product**: Durable products are more sensitive to inventory holding as the risk of perishablility and obsolescence is less. Perishable and fashion goods are not stocked in large quantities. The firms dealing in seasonal products have to hold large stock of finished goods during peak season to meet customers' demand.

(4) **Market Structure**: Under conditions of imperfect competition demand is uncertain. In such a case, stock must be held if the firm wants to take advantage of profitable selling opportunities. The optimum level of inventory will depend upon the variability of cost-volume-profit relationship. The level of inventory rises with the increase in the contribution margin.

(5) **Economics of Production:** Economies of production also determine the inventory level. Modern manufacturing process is very costly and cost of idle machine time is considerable. Therefore, every business firm likes to maintain sufficient stocks of raw material to ensure uninterrupted production.

(6) **Inventory Cost:** There are certain costs of carrying stock. Some of these costs like storage costs, set-up costs, ordering costs, spoilage and obsolescence costs are directly measurable. On the other hand, certain costs such as opportunity cost of capital, cost of loss of sale due to shortage of stock, cost caused by price level changes are not measurable. All these costs influence the level of inventories.

(7) **Financial Position:** A financially sound firm may buy material in bulk and hold them for future use. A firm short of funds cannot maintain large stocks. Thus, financial position of the firm exercises significant influence on inventory level.

(8) **Period of Operating Cycle:** Investment in work-in-progress is dependent on duration of production cycle i.e. time lag between the feeding raw materials in production process and completing the finished products. The longer the time required for inventories to pass through the various processes, the greater would be the amount of work-in-progress inventory or vice-versa. Normally, the duration of operating cycle is greater where production process is complex and complicated.

(9) **Attitude of Management:** Dynamic management estimates precisely the future changes in demand with the help of advanced techniques of fore-casting. As against this, conservative management does not bother much in forecasting demand and consider it safer to carry on large stock of goods in hand. Thus, inventory requirements in the former case would be less.

Activity 10.6

Q1. Describe the various factors affecting the inventory?

Q2. What is meant by inventory costs? Q3. Discuss the period of operating cycle?

10.7 Dangers of Excess Inventory

Inventory is the life blood of a concern and as both the high blood pressure and low blood pressure is equally dangerous to the life of a person, likewise excessive inventory and under inventory both are

harmful to the economic life and health of the concern. Therefore, the purpose of inventory management is to keep the stock in such a way that neither there is over-stocking nor under-stocking. In case, under-stocking or shortage of inventory, the firm will be deprived of the above mentioned advantages and will face difficulties. If, there is over-stocking or excessive inventory, the firm will suffer from the following losses:

- Unnecessary investment of funds and reduction in profits.
- Increase in holding costs which include interest on capital, rent of warehouse, insurance etc.
- Loss of liquidity because inventory is the most illiquid asset.
- Deterioration in the quality and quantity of inventories due to mishandling or lack of proper storage facilities.

Activity 10.7

Q1. Why inventory is called the life blood of an organization?

Q2. Discuss the under-stocking or shortage of inventory?

10.8 Risk and Costs Associated with Inventory

Inventory Risks

The risk in inventory management signifies the chance that inventories cannot be turned over into cash through normal sale without a loss. These risks are due to three factors:

(1) Price Decline: may result from an increase in the market supply of products, introduction of a new competitive product and price reduction by competitors.

(2) Product Deterioration: may result due to holding a product too long or it may occur when inventories are held under improper conditions of light, heat, humidity and pressure.

(3) Obsolescence: is due to changes in customer taste, new production techniques, improvement in the product design, specification etc.

Inventory Costs

The objective of inventory management is to maintain the optimum level of inventory. The optimum level depends on the following costs of inventory:

(1) Material Costs: These are the cost of purchasing the goods plus transportation and handling charges. It may be calculated by adding the purchase price (less any discount), the delivery charges and the sales tax, if any.

(2) Ordering Costs: When order are place by the firm with suppliers to replenish inventory of raw material certain costs are involved which are known as ordering costs. Thus, ordering costs refer to the costs incurred in placing an order for goods and receiving the supplies. Such costs vary in proportion to the number of orders placed and the number of items ordered. The more frequent the orders are place and fewer the quantities purchased on each order, the greater will be the ordering costs. Similarly, the fewer the order, the lower will be the ordering cost for the firm. Thus, ordering costs are inversely related to the level of inventory. These costs are generally classified under the following heads.

(i) **Purchasing:** The clerical and administrative costs such as staff salaries, postage, stationary, telephone etc. associated with the purchasing, the cost of requisitioning material, placing an order, follow up, receiving and evaluation quotations.

(ii) **Transportation and Inspection:** The cost of transportation and checking material for quality and quantity when they are received.

(iii) **Accounting:** The costs of checking supplies against each order, making payments and maintaining records of purchases.

(iv) **Set-up Costs:** When goods are manufactured internally instead of purchasing from outside, the set up and tooling costs associated with each production runs.

(3) Inventory Carrying Costs: Once the goods have been receive and inspected, they are not immediately used for production or sale, but stored for some time. The expenses incurred in storing these goods are called carrying costs or holding costs. In other words, the costs associated with holding a given level of inventory on hand are called inventory carrying costs and vary with the level and length of time, inventory is held. These costs include the following:

- Storage costs such as rent, lighting, heating, refrigeration etc.
- Handling costs associated with the movement of stock such as cost of labour, overhead cranes etc.
- Stores staffing, equipment maintenance and running costs.
- Taxes, depreciation and insurance.
- Spoilage, breakage, pilferage and loss due to perishable nature.
- Audit and accounting costs.
- Interest on capital (opportunity costs on investment tied-up in inventory).

The level of inventory and the carrying costs are positively related and move in the same direction. In other words, if inventory level decreases, the carrying costs also decrease and vice-versa. For a certain period, carrying costs are assumed per unit fixed. But, in practice, these costs are calculated on an annual basis and are expressed as a percentage of average inventory value.

(4) Stock-out Costs or Shortage Costs: Whenever the firm faces shortages of material or products. It incurs costs. If the firm is unable to fill an order it loses its sale. If the firm runs out of raw material, it may be forced to shut down the production process. Thus, the costs associated with the shortage of inventory are known as stock out or shortage costs. It may be considered as an opportunity cost since the firm would be deprived of certain benefits due to shortage of inventory. The avoidance of these costs is the basic reason of holding inventories. These costs include the following:

- Loss of profit due to lost sales
- Loss of future sales because customers may go elsewhere
- Loss of customer goodwill
- Loss of man and machine hours

These costs cannot be estimated easily as they differ from one firm to another firm, but these can be controlled by safety stock.

Activity 10.8

Q1. What is meant by Inventory Risks?

Q2. What is meant by Inventory costs?

Q3. What do you mean by safety stock?

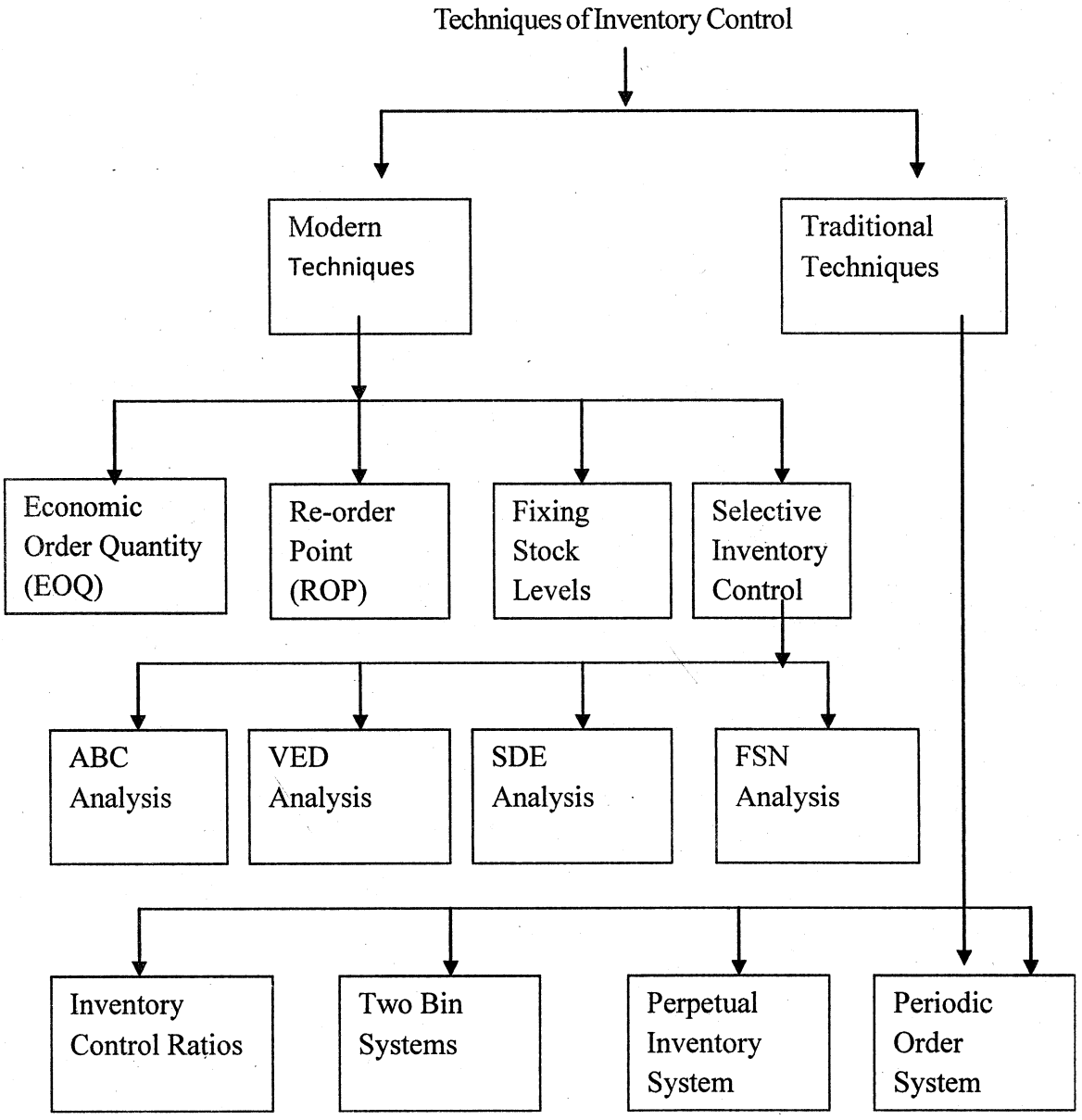
Q4! What is meant by re-order point? Discuss.

10.9 Techniques of Inventory Control

Inventory control signifies a planned approach of ascertaining when to indent, what to indent, how much to indent and how much to stock so that costs involving buying and storing are optimally minimum without interrupting production or affecting sales. To solve these problems of inventory management various techniques have bee evolved by business firms. These techniques are divided into two categories.

(1) Modern Techniques

(2) Traditional Techniques



Economic Order Quantity (EOQ)

The optimal size of an order for replenishment of an item of inventory is called economic order quantity. If a firm orders for its total annual requirements of material in one lot and keeps it in stock, its ordering costs will be low but carrying cost will rise. On the other hand, in case the firm orders small quantities at different times in more than one order, its carrying costs would be low but ordering cost will increase. Thus, there is an inverse relationship between carrying costs and ordering costs of inventory.

Therefore, a firm should place an order for that quantity where there is a trade-off between ordering costs and carrying costs, because at this point the total cost of inventory would be minimum This size of an order is known as the 'Economic Order Quantity EOQ" or 'Economic Lot Size' Or 'Optimum Order Quantity'. Thus, economic order quantity (EOQ) or optimum order quantity is that size of the order where total inventory costs (ordering costs + carrying cost) are minimised. At this size the ordering costs and carrying costs are balanced. In the words of John J. Hampton "the economic order quantity means the size of an order that will results in the lowest total of order cost and carrying cost for an item of inventory.". Economic order quantity can be calculated from any of the following three methods –

(1) Trial and Error Method: Under this method, annual requirements of goods or material are divided into different lot sizes and total inventory cost (carrying cost + ordering cost0 for each lot size is calculated. In the last, the lot size where total inventory cost is minimum is chosen as EOQ or mort profitable quantity to be purchased.

(2) Formula Method: This method is used to avoid the computational difficulties of trial and error method. It is also known as 'Square Root Formula' or 'Wilson Formula' as given below –

$$EOQ = SQRT(2RO/C)$$

Where EOQ = Economic Order Quantity

R = Annual Requirement or consumption in units

O = Ordering Cost per order

C = Carrying cost per unit per year

(3) Graphic Method: The economic order quantity can also be determined with the help of graph. Under this method, ordering costs, carrying costs and total inventory costs according to different lot sizes are plotted on the graph. The point at which the line of inventory carrying cost and the line of ordering cost intersect each other is the economic order quantity. At this point the total cost line is also minimum.

Activity 10.9

Q1. Discuss the various methods of inventory?

Q2. What is Economic Order Quantity? Give Formula

Q3. Differentiate between the traditional and modern method of inventory control?

10.10 Summary

Inventory is assets of the, and as such they represent an investment. Because such investment requires commitment of funds, managers must ensure that the firms maintain inventories at the correct level. If they become too large, the firm loses the opportunity to employ those funds more effectively. Similarly, if they are too small, the firm may loose sales. Thus, there is an optimal level of inventories and there is an economic order quantity model for determining the correct level of inventory.

Inventory includes and refers to raw material, work in progress and finished goods. Inventory management refers to management of level of these components.

Inventory has cost and benefits associated with it. The cost of inventory includes the cost of storage, cost of financing, cost of ordering and cost of stock costs.

The benefits of inventory are available in terms of independent production and sales activities.

Inventory management involves a trade off between cost and benefits inventory. In a systematic approach to inventory management, a financial manager has to identify (i) the items that are more important than others (ii) the size of each order for different items.

Two important techniques to deal with the inventory management are ABC Analysis and the EOQ Model.

The EOQ model attempts to find out the numbers of units to be ordered every tiem in order to minimise the total cost of ordering and carrying the inventory.

The EOQ may be adjusted to take care of the lag period, minimum inventory level and the quantity discount if offered by the supplier.

10.11 Abbreviations

EOQ	–	Economic Order Quantity
ABC Analysis	–	Always Better Control Analysis
VED Analysis	–	Vital, Essential and Desirable Analysis
SDE Analysis	–	Secure, Difficult and Essay Analysis
FSN Analysis	–	Fast, Slow and Non-moving Analysis

10.12 Key Terms

- **Inventory** is the stock-pile of the product a firm is offering for sale and the components that make up the product.
- **The objective of inventory management** is to keep the stock in such a way that neither there is over-stocking nor under-stocking.
- **Ordering costs** are the costs incurred in placing an order for goods and receiving the supplies.
- **Inventory carrying** costs are the costs associated with holding a given level of inventory on hand and vary with the level and length of time, the inventory is held.
- **Economic order quantity** is the optimal size of an order for replenishment of an item of inventory.
- **Maximum level** indicates the maximum quantity of an item of inventory which can be hold in store at any time.
- **Re-order level** is that level of inventory at which an order should be placed for replenishment the current stock of inventory.
- **Lead time** is the time between ordering a replenishment of an item of inventory and actually receiving the item into store.
- **Safety Stock** is the minimum quantity of inventory which a firm decides to keep always protecting itself against the risks and losses of stoppage in production and sale due to non-availability of inventory.
- **ABC analysis** is a technique where inventories are analysed according to their value so that costly items are given greater attention and care by the management.
- **Perpetual Inventory System** is the method of recording stores balance after each receipt and issue to facilitate regular checking and obviate closing down for stock taking.

10.13 Self-Assessment Questions

1. What is meant by inventory control? Discuss as why inventory control is important explaining the need to hold inventory in a manufacturing concern.
2. Describe the objectives of inventory management?
3. Define ABC Analysis?
4. What is meant by inventory management and ABC analysis? Describe their advantages.
5. What is EOQ? Give its assumptions.
6. What is meant by inventory carrying costs?
7. What is minimum and maximum level? Give formula.
8. What is meant by inventory? Explain different techniques used for inventory control.
9. Write short notes on –
   (i) EOQ
   (ii) Safety Stock
   (iii) Re-order point
   (iv) ABC Analysis
   (v) Ordering Cost
10. Define perpetual inventory system.
11. Explain the meaning of lead time.

10.14 Reference/Suggested Books

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Unit - 7 Cost Accounting

Unit Structure

7.0 Objectives

7.1 Introduction

7.2 Terminology of Cost Accounting

7.3 Objectives of Cost Accounting

7.4 Cost Accounting vs. Financial Accounting

7.5 Cost Accounting vs. Management Accounting

7.6 Advantages of Cost Accounting

7.7 Limitations of Cost Accounting

7.8 Types of Costing

7.9 Methods of Costing

7.10 Cost, Expenses and Losses

7.11 Classification of Costs

7.12 Codification of Costs

7.13 Elements of Costs

7.14 Determination of Total Cost

7.15 Summary

7.16 Key Words

7.17 Self Assessment Test

7.18 Reference Books

7.0 Objectives

After studying this unit you should be able to understand :

- Terminology of Cost Accounting
- Objectives and Advantages of Cost Accounting
- Cost Accounting differentiated from Financial Accounting and Management Accounting
- Limitations of Cost Accounting
- Types of Costing
- Classification of Costs
- Codification of Costs
- Elements of Cost
- Determination of Total Cost

7.1 Introduction

Priror to industiral revolution, there was a need of book-keeping, because business were small and it is characterised between individuals. By the seventeenth century in France and eighteenth century in

England, the cost accounting information gathered by one or two manufacturing organisation. During world war I and II the importance of cost accounting grew due to high defence expenditure of each country. The emphasis of industry in general has very rightly turned to reduction in costs while improving internal efficiencies and product quality. In the current scenario it has become difficult in the industry to sustain and survive unless the costs are correctly accounted for, controlled and reduced so as to sustain and remain in the industry. In the period of severe competition, financial accounting has failed to meet the exeptations of owners in this regard. Issues such as cost determination, cost control, cost reduction and product pricing paved the way for the emergence of cost accounting.

7.2 Terminology of Cost Accounting

- **Cost:** It may defined as the amount of expenditure either actual or notional incurred on or attributable to a given thing or to ascertain to cost of a given thing. Hence cost is the amount of resources used for something, which can be measured in terms of money.
- **Costing:** It is defined as "the techniques and process of ascertaining costs. Weldon defines "costing as the classifying, recording and appropriate allocation of expenditure for the determination of cost of products or services and for the presentation of suitably arranged data for purposes of control and guidance of management. It deals with the cost of production, selling and distribution."
- **Cost Accounting:** Weldon defines it as "the classifying, recording and appropriate allocation of expenditure for determination of costs of products or services, the relation of these costs to sales values, and the ascertainment of profitability. It deals with collection, analysis of relevant cost data for interpretation and presentation for various problem of management."
- **Cost Accountancy:** CIMA defines Cost Accountancy as "the application of costing and cost accounting principles, methods and techniques to the science art and practice of cost control and the ascertainment of profitability as-well-as presentation of information for the purpose of managerial decision making."

7.3 Objectives of Cost Accounting

The important objectives of cost accounting are as follows:

1. To ascertain of cost per unit.
2. To determine the selling price.
3. To control over cost and to minimise cost.
4. To ascertain cost of each division/unit/activity/centre.
5. To help the management in decision making.
6. To provide a base for operating policies.
7. To provide basis for comparative analysis.
8. To facilitate cost estimation.
9. To facilitate continuous review and help in speedy preparation of reports.

7.4 Cost Accounting vs. Financial Accounting

1. Transcations are identified with cost units whereas in financial accounting transcations are recorded for a definite period.

2. It is an internal reporting system for an organisactions's own management for decision making whereas, it is more attached with reporting the results and position of business to persons and authorities.
3. It is concerned with short term planning and reporting period is much better than financial accounting.
4. Items of costs are analysed, classified in order to acertain the cost per unit of product or service, but in financial accounting the items of costs are expressed in totals.
5. It is use with both monetary and notional items, but in financial accounting only monetary information is used.
6. It gives more importance to control aspect whereas, financial accounting does not give importance to control aspect.
7. Cost accounting is concerned with the ascertainment, allocation, distribution and accounting aspects of costs but financial accounting is concerned with determination of overall performance and position of the enterprise.
8. Cost accounting system can be installed with proper financial accounting system but financial accounting system can be installed without proper cost accounting system.
9. It needs reconciliation of its profit with that of financial records to findout correct profit, but financial accounting does not need any such reconciliation.
10. Cost accounting is not obligatory but financial accounting is obligatory as required by companies Act, Income Tax Act etc..
11. Cost accounting deals with estimates also but in financial accounting there is no room for estimates.

7.5 Cost Accounting vs. Management Accounting

1. Cost Accounting serves as a base to which the tools and techniques of management accounting can be applied to make it more purposeful, the management accounting data is derived from financial and cost accounts.
2. The scope of cost accounting is narrower than management accounting, but scope of management accounting is broder, because the management accountant places the data in a wider perspective than the cost accountant.
3. Cost Accounting is not dependent on management accounting but management accounting can not be installed without proper cost accounting system.
4. Cost accounting emphasizes collection, analysis, interpretation and presentation of cost data, the main thrust in management accounting is towards corporate planning and strategy effective and meaning ful.
5. Cost accounting is concerned with assisting in management function and does not provide for evaluation and performance of management but management accounting is concerned with evaluation and performance of management.
6. Cost accounting is mostly historical in its approach but management accounting is futuristic in its approach.
7. Cost accouting deals with collection, classification and analysis of cost data whereas, management accounting deals with various divisions, departments of the business and report about profitability and performance of each of them.

7.6 Advantages of Cost Accounting

A good cost accounting system serves the needs of a large section viz:

- **To Management :**
  1. It helps in identifying unprofitable activities and losses.
  2. It is useful for identifiying exact causes for decrease or increase in profit or loss of the business.
  3. It provides data to the management, which are helpful for them to take business decisions.
  4. It plays an important role to assist the management in price fixing.
  5. It enables the management to make inter-firm comparison or intra-firm comparison.
  6. Cost comparison help in cost control.
  7. It is helpful for cost reduction and also provides information for value analysis and for other efforts.
  8. It points out deviation in pre-determined cost and actual cost, thus suitable action may be taken to eliminate such deviation in future.
- **To Employees :**
  1. Cost accounting provides information to distinguish between efficient and inefficient workers. Through this efficiency can be recoginsed and rewarded.
  2. Cost accounting provides a system for sound wages policy, it aids the management in devising suitable wage policy.
  3. Cost accounting provides the information with regard to productivity, it helps the management to serve it with workers in the form of bonus.
- **To Lenders :**
  1. It gives correct picture of business, so lenders can judge the soundness.
  2. Cost information is helpful for them, while taking decisions of merger, takeover etc..
- **To Government:**
  1. Cost information can help the government for the preparation of the national plan.
  2. Cost accounting is useful to government in so many ways like making the policies for taxation, export, import and subsidy decisions.
- **To Society :**
  1. Cost accounting facilitates customers to get goods at fair prices and of better quality.
  2. Cost accounting paves a vital role in development and prosperity of industries, hence it is beneficial to all section of society.

7.7 Limitations of Cost Accounting

1. It does not give the outright solution, it gives only base for taking best decisions.
2. It is a time consuming system and also expensive.
3. There are different views for inclusion of an item to ascertain the cost.
4. Cost data varies with purpose. Hence cost called for certain purpose will not be suitable for the other.

5. It is not exact science. It involves elements of judgement.
6. There are so many methods for apportionment and absorption of overheads, valuation of stock, segregation of fixed and semi-fixed cost, provision for deprectiation etc. that may lead to cost difference.
7. There is no uniform procedure.

7.8 Types of Costing

The important types of costing systems are discussed below:

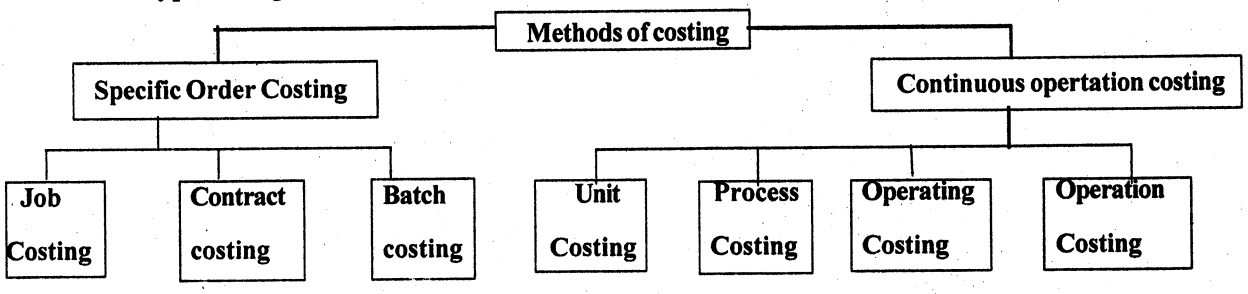
1. **Historical costing:** The cost actually incurred are recorded and then the costs are ascertained, it is useful for post mortem examination of actual costs incurred. These data are available at the end of the accounting period hence it is too late to use these data for control purpose.
2. **Absorption costing:** In this system also costs are charged either fixed or variable. It is allocated to cost units and total overheads are absorbed according to activity level. It is a traditional form of cost ascertainment. In this system costs are absorbed on the basis of the benefit received from these costs.
3. **Marginal costing:** Under this method, variable cost are charged to unit cost and fixed costs are treated as period costs and it is deducted from the contribution (excess of sales over variable cost) to arrive the profit. The techniques is widely used for managerial decisions.
4. **Standard costing:** The cost which is computed in advance on basis of factors affecting costs. It provides base for control through variance analysis. It is helpful for management to take corrective action.
5. **Uniform costing:** A common method of costing is used by similar units of the same industry known as uniform costing. It facilitates valid comparisons between the same type of units and help in elimination of inefficiencies.
6. **Life-Cycle costing:** It is a system, which accumulates costs for all activities occuring over the entire life cycle of a product. It includes all costs either of capital nature or of revenue nature.
7. **Activity Based costing:** Cost of indirect activites are charged to cost units on the basis of benefits received from such activity. Cost of each activity is ascertained seperately.

Activity- 7.1

For the comparison of cost between the same type of units, which type of costing should be adopted by similar concerns?

7.9 Methods of Costing

There are a number of costing methods of cost ascertainment depending upon the nature of business and the type of its products. The methods are given in the chart below :



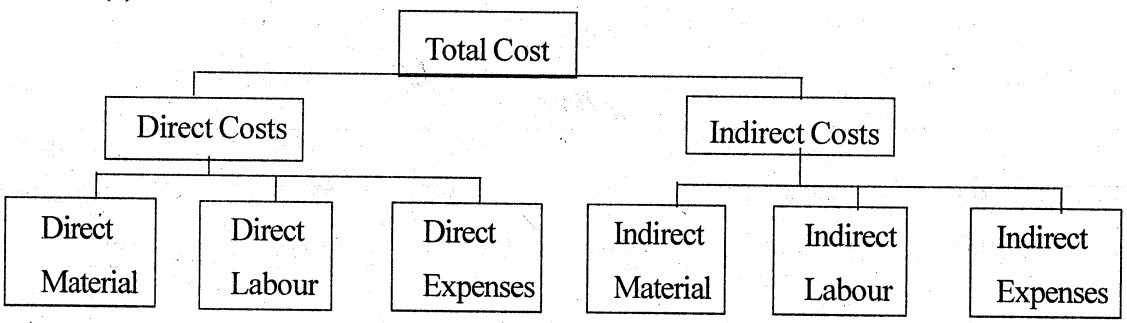
1. **Job costing** It refers to a system of costing in which costs are ascertained in terms of special requirement, which is not comparable with each other. It is a method which is used in such industries, where production is carried on demand or order of a customer like a printing press, interior decorator, repair shop and automobile garage.
2. **Contract costing** Contract costing is "that form of specific order costing which is applied where work is undertaken to customer's special requirement and each order is of long term duration. It is an agreement between two parties to complete a special nature of job at the fixed price known as "control Price". This method is suitable for industries engaged in the construction of bridges, buildings on a contract basis.
3. **Batch costing** Where a customer orders certain quantity of identical items or a production which can be completed in a specific quantum of production. The cost can be ascertained on the basis of units produced in a batch. It is used in readymade garments, toys, backery items etc.
4. **Unit costing** It is applicable to all such industries where there is a production of single article on a large scale by a continuous process of manufacture. This method is adopted in industries like cement, steel, breweries etc. It is also called as single or output costing:
5. **Process costing** Where material is passed through various operations to obtain a final product, in this case, it is desired to calculate the cost of each operation seperately for a given period of time. It is applicable to industries like chemicals, textiles, paper, oil manufacturing etc.
6. **Operating costing** Cost of services rendered by a unit is calculated and cost per unit of the service is arrived at. This method is used by the undertakers who render services like transportation, electricity companies. This systems is also known as service costing.
7 **Operation costing** A manufacturing process may sometimes be sub-divided into a number of operations, each production process is considered as a separate cost centre. It is applicable to such industries where there is mass and repetitive production conducted through different operations.
8. **Composite costing** In this method, two or more methods of costing are used to determine the cost of a product. Total cost can be ascertained by computing costs through job/process costing and then aggregating costs with the use of output costing. It is applicable to motor cars, computers industries.

7.10 Cost, Expenses and Losses

Cost refers to the amount of expenditure incurred for an economic benefit. It includes deferred as well as expired cost. **Expenses** includes expired cost with a matching economic benefit. **Loss** refers to the amount which has been spent without any matching economic benefit.

7.11 Classification of Costs

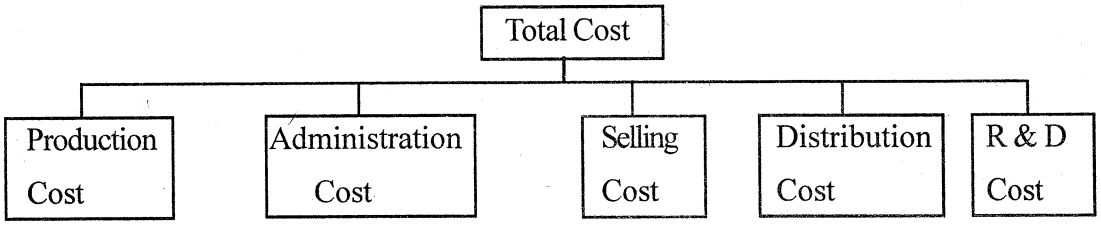
It is a process of grouping costs according to their common characteristics. The different bases are as follows: - **(a)Element-wise classification:**



Direct costs are those which can be identified easily with a costing unit or cost centre. These costs can be directly allocated to a particular cost unit. These costs are also called as traceable costs.

Indirect costs can be approtioned to cost centres or cost units but it can not be allocated directly, hence these are called as "common costs" or "untraceable costs."

(b) Functional Classification :



The production cost includes all direct costs plus indirect costs related to manufacturing operations. The Administration cost is the sum of these costs associated with administrative functions. Selling cost is cost of marketing a produce or service like advertisement. Distribution cost includeds the costs which are incurred on goods or service made available to the customers. Research cost includes cost of searching new ideas/products/process, improvement of exisitng products.Development cost is the cost which is incurred for putting the research results on commercial basis.

(c) Classification of Costs for Decision Making:

(i) Product and Periods costs It is aggregate of costs that are associated with a unit of product. It includes an element of overheads depending upon the types of costing system in force like absorption or direct. Period costs are the costs which are associated with a time period rather than level of activity. These are in the nature of fixed costs.

(ii) Explicit and Implicit costs Explicit costs involves payment to other parties, hence it is called as "outof pocket cost. Implicit costs are the costs which do not require current cash payments like depreciation. It is also called as 'imputed' or 'book cost' or economic costs".

(iii) Sunk costs and Pre-determined cost Sunk cost is a past cost. Investment in plant, is a sunk costs, which will not relevant for decisions. Pre-production costs are incurred at the time of trial run production. These are generally treated as deferred revenue expenditure, except to the extent of capitalised portion of such costs.

(iv) Opportunity cost It is a value of benefit forgone of an alternative course of action. Notional rent of own-building is an example. It is used in decision making but not entered into books of accounts.

(v) Shut down cost It refers to the minimum fixed costs which are incurred even at the temporary closure of dept., division. It is irrelevant for decision making.

(vi) Conversion cost The cost which is attributable for converting raw material into finished product. Hence, it is production cost excluding direct material cost.

(vii) Replacement cost It is the cost of replacing existing capital asset with new one, which is usually identical.

Activity - 7.2

Depreciation is an example of ..... cost, while rent is an example of .....cost.

12. From the following information prepare statement of equivalent production, statement of cost and also prepare process account by using FIFO method.

(i) Opening WIP 2000 units

Materials	(100 % complete)	Rs. 7,500
Wages	(60 % complete)	Rs. 3,000
Overhead	(60 % complete)	Rs. 1,500

(ii) Units introduced into this process 8,000 and process costs for the period are materials Rs. 1,00,000, wages Rs. 78,000, overheads Rs. 39,000.

(iii) Closing WIP 2,000 units which are completed 100% for materials, 50% for wages and overhead.

(iv) 8,000 units are transferred to next process.

10.14 Reference Books

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3 Gorden Shillinglaw, *Cost Accounting Analysis and control.*

Unit - 11

Tax application : Value Added Tax

Outline of the unit:

11.0 Objectives

11.1 Introduction

11.2 Value added tax system in Rajasthan

11.3 Characterstics of Rajasthan value added tax

11.4 Input Tax

11.5 Output Tax

11.6 Exempyion of Tax

11.7 Rates of value Value Added Tax

11.8 Taxable Turnovwe [Section 2(40)]

11.9 Determination of Taxable Turnover

11.10 Computation of Tax

11.11 Questions

11.12 Reference

11.0 Objectives

After complecting this unit you will be able to:

- Understand the meaning of value added tax
- Calculation of Taxable Turnover.
- Tax payable by an assessee under VAT

11.1 Introduction

Value added tax is an indrect tax , the incidence of which ultimately lies on the consumers.

Value Added Tax is a form of Sales Tax System in which tax is imposed at a prescribed rate on the value added at every stage of production and distribution and tax paid previously is set off or adjusted at every stage. In simple words, the main characteristic of this sytem is to impose tax at every point of sale and to set off or adjust the tax paid on purchase against output tax. In this way it is a payment of tax on net value addition.

The value added tax is ascertained or computed by deducting tax payable on purchases from the tax payable on sales i.e. by deducting the input tax from the output tax.

11.2 Value Added Tax System in Rajasthan

The Government of Rajasthan also had given its consent to introduce Value Added Tax on sales in principle from 1st April, 2003. It also prepared a draft Act and presented it before the public for amendments and suggestions. But in order to resolve various problems and difficulties coming before the government and the public, a number of rounds of talks were held with the Central Government and every time the date of its introduction was extended. At last, the Value Added Tax was introduced in Rajasthan

with effect from 1st April, 2006. Neighbouring states like, Madhya Pradesh, Gujrat etc. also introduced this system from 1st April, 2006.

Brief introduction of Rajasthan Value Added Tax :

The Value Added Tax system has been introduced in Rajasthan from 1st April, 2006. The Act enacted for this purpose has been named as Rajasthan Value Added Tax Act, 2003. It contains 11 Chapters, 100 Sections and 6 Schedules. In order to implement the Act smoothly, Rajasthan Value Added Tax Rules, 2006 have also been framed. In this way at present the Rajasthan Value Added Tax Act, 2003 and the Rajasthan Value Added Tax Rules, 2006 provide proper and smooth administration of Value Added Tax throughout the State of Rajasthan.

11.3 Characteristics of Rajasthan Value Added Tax

In order to understand the provisions of any Act clearly, it is always advantageous to study its characteristics. The main characteristics of Rajasthan Value Added Tax are as follows :

(1) An easy and transparent form of sales tax system :-

Value Added Tax (VAT) is an easy and transparent form of sales tax system in which tax is levied at the prescribed rate on the value added at every stage of production and distribution and tax paid previously at every stage is set off or adjusted. In simple words the main characteristic of this system is to impose tax at every point of sale and to set off the tax paid on purchase of goods against the output tax immediately. In this way in fact it is a tax on valued added on each stage.

(2) Based on Multiple point tax system :-

It is a multiple point tax i.e. tax is imposed at every point of sale. The number of times an article is sold either in its original form or after doing any process on it, the same number of times the tax is realised from the respecting seller but as stated previously, the tax paid by each seller at the time of purchase of the goods is deducted while colculating tax payable by each seller.

11.4 Input Tax [Section 2(17)]

Input tax means tax paid or payable by a registered dealer in the course of business, on the purchase of any goods from a registered dealer.

In Value Added Tax system, input tax has special importance. Out of the total tax realised from the customers and payable to the Govt. by the dealer, input tax (tax paid by the dealer) is deducted or set off and the balance of the realised tax is paid to the Government. In real sense the basis of Value Added Tax is the set off of input tax. For example a dealer purchased goods and paid Rs. 100 by way of tax. After incurring certain expenditure on such goods and after adding his margin of profit, he sold the goods to a customer and charged Rs. 1 80 as tax. Out of Rs. 1 80 realised as tax by the dealer, a sum of Rs. 100 will be deducted and the balance of only Rs. 80 will be paid to the Government.

11.5 Output Tax [Section 2(24)]

Output tax means tax charged or chargeable under this Act by a registered aealer in respect of the sale of goods in the course of business. In other words, when a registered dealer sells goods, the tax which he realises from the buyer on the sale of such goods, is called output tax under value added tax system.

11.6 Exemption of Tax [Section-8]

Provision of Section 8 of Rajasthan Value Added Tax in respect of exempted goods are as follows :

(1) The goods specified in Schedule - 1 of Rajasthan Value Added Tax Act, 2003 are fully exempted subject to the fulfilment of any condition specified for any goods. On 1 st April, 2006, when Value Added Tax came into force, this Schedule contained 58 items. At present there are 111 items in this Schedule. Some of the goods have been removed from this Schedule by the subsequent amendments. At present they are not exempted goods.

Some of the important exempted goods are as follows :

(i) Ordinary Agricultural implements such as khurpa, spade, Gandasa, Kudali, Axe, Belcha etc.

(ii) Animal driven agricultural implements such as plough, cart, Land levelers etc.

(iii) Power driven agricultural implements such as Thrasher, cultivator, Trolley of tractor etc.

(iv) Aids and implements used by handicapped persons—such as Braille Typewriter, Artificial Hearing aids, Braille watch etc.

(v) Poultry and cattle feed which includes grass, hay and straw, Gwar Churi, husk etc.

(vi) Books and peridicals and journals including maps, charts and globe.

(vii) Charkha, Amber Charkha, Handlooms and their parts and accessories.

(viii) Maize, Jawar, Bajra and flour thereof.

(ix) Electrical energy.

(x) Earthen pot.

(xi) Fresh vegetables and fruits.

(xii) Slate and Slate Pencile.

(xiii) Salt.

(xiv) Bura and Mishri.

(xv) Helmet.

(xvi) Tilpatti

(xvii) Gulkand and gulabjal

(xviii) Domestic solar cooker

(xix) Newsprint

(xx) L.P.G. for domestic use.

(2) The State Government may, if it considers necessary so to do in the public interest, by notification in the Official Gazette, add to or omit from this schedule any goods or amend or modify the schedule prospectively or retropectively and then the schedule shall be deemed to have been amended accordingly. The Government may, however impose certain conditions as deemed suitable in this behalf.

(3) The State Government in the pulic interest by notification in the Official Gazette, may exempt whether prospectively or retrospectively from tax the sales or purchase by any person or class of persons as mentioned in schedule-II without any condition or with such condition as may be specified in the notification.

If the state Government consider necessary in the public interest so to do, may by notification in the

official Gazette add to or omit from,or otherwise amend or modify the Schedule II. It can be done either prospectively or retrospectively . The state Government may, however, impose certain conditions while doing such amendment. After this the Schedule shall be deemed to have been amended. The state Government has given exemption from payment of tex to a number of persons or class of persons from time to time under this sub-section by issuing notifications.

(4) If the state Government considers necessary in the public interest so to do, may by notification in the official Gazette, grant exemption from payment of whole of tax payable under this Act in respect of any class of sales or purchases for the purpose of promoting export.It may,however, impose certain conditions and to get the benefit of exemption under this sub-section compliance of those conditions shsll be essential.

(5) Every notification issued under this section shall be laid ,as soon as possible after its issuance before the Houses of State Legislature, while it is in session for a period of not less than 30 days, which may comprised in one session or in two successive sessions and if before the exipiry of the session in which it is so laid or of the session immediately following the House of the State Legislature makes any modification in such notification or resolves that any such notification should not be issued, then such notification will have effect in suich modified form or will have no effect as the case may be, but any such mkodification or annulment shall not effect anything done previously on the basis of such notification.

11.7 Rates of Value Added Tax [Section 4(1)]

General rates of Value Added Tax :

The State Government has prescribed mainly three rates of Value Added Tax which are as follows:

(1) Rate of 1% : Rate of 1% is levied on such goods, names of which are given in Schedule-III. Such goods are as follows :

(i) Gold,

(ii) Silver,

(iii) Ornaments made of Gold, Silver and Platinum and Vark of Gold and Silver,

(iv) Precious and semi-precious stones including kharad,

(v) Jewellery,

(vi) Pearls whether real or cultured,

(vii) Agate and Diamond,

(viii) All types of pulses - whole or in pieces,

(ix) Wheat bran,

(x) De-oiled cake.

(2) Rate of 5% : This rate is leviable on all essential goods and basic raw materials names of which are mentioned in Schedule-IV, Schedule-IV Part A and Part 'B'.

At present Schedule-IV contains 187 commodities. Schedule IV Part A contains 28 commodities pertaining to Information and Technology products and Schedule IV Part B contains 277 commodities pertaining to industrial

inputs. The State Government is empowered to amend these Schedules by issuing notification in the public interest.

(3) Rate of 14% : All other goods not mentioned in Schedule III, Schedule IV, Schedule IV Part A, Schedule IV Part B and Schedule VI are liable to be taxed @ 14%.

11.8 Taxable Turnover [Section 2(40)]

In general terms taxable turnover meanslhat part of total turnover of a dealer on which tax is actually payable or on which tax is computed. According to Section 2(4) 'taxable turnover' means that part of the turnover as determined after making such deductions from the total turnover as may be prescribed on whiqh a dealer shall be liable to pay tax under this Act.

11.9 Determination of Taxable Turnover

(1) According to Rule-22 of the Rajasthan Value Added Tax Rules, 2006 the following amounts are deducted from the turnover in the determination of taxable turnover for the purpose of levying tax

(i) The amount of sales of those goods on which no tax is leviable under this Act i.e. on which no tax can be imposed under this Act. They include the following sales :

(a) Sale outside the State,

(b) Sale in the course of inter-state trade and commerce,

(c) Sale in the course of export trade,

(d) Sale to the exporters within the State for exports, on submission of declaration form VAT-1 5.

(ii) Sale of those goods which have been declared exempted from tax.

(iii) Sale price of the goods-returned to the dealer by the purchaser within 6 months from the date of VAT invoice, but during the Return Period.

(iv) Sale price of the goods consigned by the principal to the agent provided form No. VAT-35, VAT-36 and VAT-36A have been issued in respect of such sales. It shall be deducted in computing the taxable turnover of the Agent.

(2) In case of a works contract while determining the taxable turnover apart from the deductions provided under sub-rule (1), the amount of labour shall also be deducted from the total value of the contract.

Where the amount of labour is not determinable from the account of a contractor or is considered unreasonably high in view of the nature of the contract, the deduction towards labour charges, shall be allowed by the assessing authority according to the limits laid down in column 3 for the type of contract specified in column 2 of the table under Rule 22. In this table the amount of labour has been determined in the form of percentage of the gross value of different type of contracts. There are 20 items in all in this table. In the first 19 items special rates are determined for special contracts. In the last item it has been given that in all other items which are not covered in items from 1 to 19, the rate is 25%.

(3) The computation of purchase price for the purposes of levying tax under Section 4(2) shall be made in accordance with the provisions of Section 2(28) and the same amount shall be added to the turnover.

(4) The sale price of the goods sold by the commission agent on behalf of his principal registered under the Act, shall be added in the taxable turnover of the principal.

(5) The amount of cess levied by the State Government for specific purposes, shall be deducted for determination of taxable turnover.

Computation of Turnover and Taxable Turnover

	Total of Sale Price Given			xxxx
Less :	(1) Trade discount and cash discount if not deducted previously		xxxx	
	(2) Sale of goods having purchased after paying full tax on M.R.P.		xxxx	xxxx
				xxxx
Add :	Purchases Price of goods purchased under section 4(2)			xxxx
	Turnover			xxxx
Add :	Sale price of goods sold by Agent			xxxx
				xxxx
Less :	(1) Sale of Exempted goods		xxxx	
	(2) Sale outside the State		xxxx	
	(3) Sale in the course of Inter-state Trade and Commerce		xxxx	
	(4) Sale in the course of export trade		xxxx	
	(5) Sale of goods to expeorters		xxxx	
	(6) Sales return within 6 months within the ruturn period		xxxx	
	(7) Sale of goods taxable at first point or tax paid goods		xxxx	
	(8) Amount of labour, in case of Works Contract		xxxx	
	(9) Amount of Cess levied by the State Govt. for specific purposes		xxxx	xxxx
	Taxable Turnover			xxxx

Some Other Important Provisions

1. If the total of sale prices includes sale of such articles or commodities which are not covered by the definition of goods, then the sale price of such articles or commodities shall be deducted first from the given sale prices in order to ascertain the correct total of sale prices.
2. Sale of goods purchased after paying tax at full rate of Maximum retail price will be deducted only in those cases where such sale was included in the total of sale prices.
3. Sales of raw material or of manufactured goods to registered dealers or to manufacturers or sales to unregistered dealers or to consumers are taxable. Hence while computing taxable turnover, such sales shall not be deducted from the total of sale prices.
4. If in any question rebate is to be given for trade discount and cash discount both, from the sale prices, then, trade discount is deducted first. After that rebate for cash discount is given on the balance of sale prices.
5. If any such goods are sold on which tax has been paid on first point i .e. which are tax paid goods, then input tax credit shall not be allowed on such goods. Such goods are also not taxable. Hence sale of such goods is deducted while computing taxable turnover.

Illustration 1.

The account book of M/s Gopal Brothers shows a turnover of Rs. 48 lakhs for the quarter ending on 30th June, 2010 which includes turnover of Rs. 10 lakhs in respect of tax paid goods and turnover of Rs. 6 lakhs in respect of exempted goods. Total sales return as per sales return account during this period is of Rs. 1,20,000. The ratio of taxable sales, tax paid sales and exempted sales in the amount of sales return is 5 : 2 : 1 respectively. All returns were made within 15 days from the date of VAT-Invoice.

Ascertain the amount of turnover and taxable turnover of M/s Gopal Brothers under the Rajasthan Value Added Tax Act.

Solution :

		Rs.	Rs.
	Sale of tax paid goods		10,00,000
	Sale of exempted goods		6,00,000
	Sale of taxable goods		32,00,000
	Turnover		48,00,000
Less :	1. Sale of tax paid goods	10,00,000	
	2. Sale of exempted goods	6,00,000	
	3. Sales return within return period (related to taxable goods only)	75,000	16,75,000
	Taxable Turnover		31,25,000

Working Note :

(i) Rs. 1,20,000 being the amount of sales return shall be apportioned in different types of sales according to ratios of different types of sales return and only that portion of sales return which relates to the taxable turnover shall be deducted in determining the amount of taxable turnover. It has been computed as under:

$1,20,000 \times \frac{5}{8}$ = Rs. 75,000

(ii) The whole amount of Rs, 1,20,000 may be deducted in an alternate solution of the question. In that case the amount of sales return would increase but the amount of exempted goods and tax paid goods shall be reduced by the amount of their respective returns and the alternate solution would not affect the result of the question.

11.10 Computation of Tax

(1) The net tax payable by registered dealers, other than the dealers covered by Section *3(2) or* Section 5, for a tax period shall be calculated by the following formula :

$T = (O + R + P) - I$

The denotations used in the formula means as under :

T = Net tax payable under this Act

O = Output tax i.e. the tax collected by the dealer

R = Reverse tax i.e. Amount of tax for which input tax credit availed of illegally by the dealer

I = Input tax i.e. tax paid at the time of purchase of goods (including capital goods) from registered dealers.

In this way, in order to compute the net tax payable by a dealer, first of all, the following three amount of tax are added together :

(i) Tax realised by the dealer on sale of goods,

(ii) Input tax credit illegally availed of,

(iii) Tax payable on purchase price under Section 4(2).

From the total of aforesaid three items of tax, the tax paid by the dealer at the time of purchase of goods or capital goods is deducted and thus the net tax payable by the deel?' for the tax period is as certained.

(2) In case the net tax payable under sub-section (1) above has a negative value i.e. the input tax credit available to the dealer is more than the tax payable by him, then the dealer becomes entitled to refund of such excess amount. But the refund is not granted immediately. The amount refundable to the dealer is first set off or adjusted against the following amounts of tax payable by the dealer -

(i) any tax payable or any amount outstanding under the Central Sales Tax Act, 1956, or

(ii) any amount of tax payable or outstanding under thia Act i.e. Rajasthan Value Added Tax Act, 2003, or

(iii) any amount of tax payable or outstanding under the repealed Act i.e. Rajasthan Sales Tax Act, 1994.

Even after making aforesaid set off or adjustment if there remains any amount in balance to which the dealer is entitle to refund, then such amount of refund shall be carried forward to next tax period for further set off. After making such further set off still there remains any balance refundable to the dealer at the end of the year and the dealer claims for the refund of such amount, the sam& shall be granted only after the end of the immediately succeeding year. But the Commissioner, after recording reasons in writing may direct to refund the balance even earlier by a general specific order.

Illustration : 2

M/s Pawan Brothers are the manufacturers of Lime Stone and a istered dealer in Rajasthan. Their total sales during the quarter ending on 30th June, 2010 was Rs. 36,90,000, the details of which are as follows:

(i) Sales to registered dealers exempted Rs. 8,40,000.

(ii) Sales to unregistered dealers Rs. 2,50,000

(iii) Sales during export trade Rs. 5,00,000

(iv) Sales to consumers Rs. 21,00,000

M/s Pawan Brothers purchased raw material of Rs. 14,00,000 by submitting declaration form without making payment of tax. Out of it, they used some material worth Rs. 2,80,000 for the purposes other than those declared or referred to in sub-clause (a) to (g) of section 18(1). General rate of tax on such raw material is 5%.

The dealer has paid VAT of Rs. 80,000 on its purchases.

M/s Pawan Brothers collected separately the price of the bags given with the Lime Stone which has not been included in the above mentioned sale prices. The sale price of bag can be assumed to be 1 % of the sale price of Lime Stone kept in the bag.

Assuming that the general rate of Rajasthan VAT on Lime Stone is 5%, ascertain the Taxable Turnover and the amount of tax payable by M/s Pawan Brothers for the quarter ending 30th June, 2010 under the Rajasthan Value Added Tax Act, 2003.

Solution :

Computation of Taxable Turnover of

M/s Pawan Bros. for the quarter ending on 30th June, 2010

			Rs.	Rs.
		Total of sales price given		36,90,000
Add :	(i)	Sale price of bags given with lime stone @ 1% of goods not included previously	36,900	
	(ii)	Purchases price of goods purchased under declaration but not used for specified purposes, have been included in sale price u/s 4(2)	2,80,000	3,16,900
		Turnover		40,06,900
Less :	(i)	Sale during export trade (Rs. 5,00,000 + Rs. 5,000)	5,05,000	
	(ii)	Sale of exempted goods (Rs. 8,40,000 + Rs. 8,400)	8,48,400	13,53,400
		Taxable Turnover		26,53,500

Computation of Tax Payable

by M/s Pawan Bros.

		Rs.
Output Tax		
	Tax on Taxable Turnover @ 5% (Rs. 23,73,500 × 5%	1,18,675
	Purchase Tax u/s 4(2) (Rs. 2,80,000 × 5%)	14,000
		1,32,675
Less :	Input Tax Credit Tax paid on purchases	80,000
	Net tax payable	52,675

Working Note : While deducting sale price of goods sold in the course of exported goods and the price of exempted goods, the price of bardana given with such goods shall also be deducted.

11.11 Questions

1. What do you mean by Rajasthan Value Added Tax Act 2003 ?
2. What is Input Tax?
3. What is Output Tax?
4. What do you mean by erempyion of tax under VAT (Section8). Given name of 10 articles?
5. What is Taxable Turnover (Sec.2(40)?
6. How will you determine taxable turnover.Give a simple example?
7. M/s Shri Govind and Sons submitted their return of Sales of Rs. 16,00,000 for the End quarter ending on 30th September, 2010 Sales includes the following items :

	Rs.
(i) Sale of exempted goods	1,50,000
(ii) Sale of Tax paid goods	1,80,000

(iii)	Goods supplied outside the State	1,30,000
(iv)	Safe of Taxable Goods to consumers	2,00,000
(v)	Sales in the course of export trade	80,000
(vi)	Sales in the course of inter-state trade and commerce	60,000
(vii)	Sale of bardana (packing material) received with the goods purchased	20,000
(viii)	Sale of goods to registered dealers for resale in the State	2,50,000
(ix)	Sale of goods on the package of which maximum retail sale price is printed, purchased having paid tax at full rate	4,00,000

The aggregate of sale prices of the goods returned by the customers was Rs. 40,000. Out of it, goods worth Rs. 10,000 was returned after 6 months from the date of sales. 75% of the returns were in respect of the taxable goods.

Compute the amount of turnover and taxable turnover of M/s Shri Govind & Sons.

11.12 References

1. Patel, Choudhry, Choudry Prakashan Jaipur.
2. Singhaniya, Taxman Publication. Indirect Tax.

Unit-12

Techniques of Financial Analysis - Ratio Analysis

Outline of the Unit

12.0 Objectives

12.1 Introduction

12.2 Meaning

12.3 Importance

12.4 Classification of Ratios

12.5 Limitations

12.6 Summary

12.7 Key Words

12.8 Self Assessment Test

12.9 Reference Books

12.0 Objectives

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

- The concept of Ratio anaylsis.
- Importance of Ratio anaylsis.
- The various types of Ratio anaylsis and their calculations.
- The various limitations associated with Ratio anaylsis.

12.1 Introduction

To make rational decisions in keeping with the objectives of the firm, the financial manager must have analytical tools. The firm itself and outside providers of capital-creditors and investors-all undertake financial statement analysis. The type of analysis varies according to the specific interests of the party involved. Trade creditors (suppliers owed money for goods and services) are primarily interested in the liquidity of a firm. The claims of bondholders, on the other hand, are long term. Accordingly, bondholders are more interested in the cash-flow ability of the firm to service debt over a long period of time. They may evaluate this ability by analyzing the capital structure of the firm, the major sources and uses of funds, the firm's profitability over time, and projections of future profitability.

Investors in a company's common stock are principally concerned with present and expected future earnings as well as with the stability of these earnings about a trend line. As a result, investors usually focus on analyzing profitability. They would also be concerned with the firm's financial condition in so far as it affects the ability of the firm to pay dividends and avoid bankruptcy.

Internally, management also employs financial analysis for the purpose of internal contol and to better provide what capital suppliers seek in financial condition and performance from the firm. From an internal control standpoint, the management needs to undertake financial analysis in order to plan and control effectively. To plan for the future, the financial manager must assess the firm's present financial position and evaluate opportunities in relation to this current position. With respect to internal control, the

financial manager is particularly concerned with the return on investments provided by the various assets of the company and in the efficiency of asset management. Finally, to bargain effectively for outside funds, the financial manager needs to discuss all aspects of financial analysis that outside suppliers of capital use in evaluating the firm. We see, then, that the type of financial analysis undertaken varies according to the particular interests of the analyst.

12.2 Meaning

Ratio analysis is a widely used tool of financial analysis. It is defined as the systematic use of ratio to interpret the financial statements so that the strengths and weaknesses of a firm as well as its historical performance and current financial condition can be determined. The term ratio refers to the numerical or quantitative relationship between two variables.

12.3 Importance

1. **Helps in evaluating the firm's performance:** With the help of ratio analysis conclusion can be drawn regarding several aspects such as financial health, profitability and operational efficiency of the undertaking. Ratio points out the operating efficiency of the firm i.e. whether the management has utilized the firm's assets correctly to increase the investor's wealth. It ensures a fair return to its owners and secures optimum utilization of firm's assets.
2. **Helps in inter-firm comparison:** Ratio analysis helps in inter-firm comparison by providing necessary data. An inter-firm comparison indicates relative position. It provides the relevant data for the comparison of the performance of different departments. If comparison shows a variance, the possible reasons of variations may be identified and if results are negative, the action may be initiated immediately to bring them in line.
3. **Simplifies financial statement:** The information given in the basic financial statements serves no useful purpose unless it is interrupted and analyzed in some comparable terms. The ratio analysis is one of the tools in the hands of those who want to know something more from the financial statements in the simplified manner.
4. **Helps in determining the financial position of the concern:** Ratio analysis facilitates the management to know whether the firm's financial position is improving or deteriorating or is constant over the years by setting a trend with the help of ratios. The analysis with the help of ratio analysis can know the direction of the trend of strategic ratio may help the management in the task of planning, forecasting and controlling.
5. **Helpful in budgeting and forecasting:** Accounting ratios provide a reliable data, which can be compared, studied and analyzed. These ratios provide sound footing for the future. The ratios can also serve as a basis for preparing budgeting future line of action.
6. **Helps in analyzing liquidity position:** With the help of ratio analysis conclusions can be drawn regarding the liquidity position of a firm. The liquidity position of a firm would be satisfactory if it is able to meet its current obligation when they become due. The ability to meet short term liabilities is reflected in the liquidity ratio of a firm.
7. **Helps in assessing long term solvency position:** Ratio analysis is equally useful for assessing the long term financial ability of the firm. The long term solvency is measured by the leverage or capital structure and profitability ratio which shows the earning power and operating efficiency. Solvency ratio shows relationship between total liability and total assets.

8. **Helps in measuring operational efficiency:** Yet another dimension of usefulness of ratio analysis, relevant from the view point of management is that it throws light on the degree of efficiency in the various activity. Ratios measures this kind of operational efficiency.

12.4 Classification of Ratios

Different ratios are used for different purposes. These ratios can be grouped into various classes according to the financial activity. Ratios are classified into four broad categories.

12.4.1 Liquidity Ratio

Liquidity ratio measures the firm's ability to meet its current obligations i.e. ability to pay its obligations when they become due. They compare short-term obligations to short-term (or current) resources available to meet these obligations. From these ratios, much insight can be obtained into the present cash solvency of the firm and the firm's ability to remain solvent in the event of adversity. Commonly used liquidity ratios are:

(A) **Current ratio:** Current ratio is the ratio, which expresses relationship between current asset and current liabilities. It shows a firm's ability to cover its current liabilities with its current assets. Current assets are those which can be converted into cash within a short period of time, normally not exceeding one year. The current liabilities are of short- term maturity.

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current liabilities}}$$

Ideal Ratio is 2:1

(B) **Quick/ Liquid Ratio:** Quick Ratio is the measure of the instant debt paying ability of the business enterprise, hence it is also called 'quick ratio' or 'acid test ratio'. It measures the ability of the firm to meet its short term obligations as and when due without relying upon the realization of stock.

Quick ratio is considered to be superior to current ratio in evaluating the liquidity position of the firm. Sometimes, a situation arises when the firm has to meet its current liabilities immediately. In such cases, it can pay off these liabilities out of its quick assets of equal value without any difficulty. Thus, quick ratio is an indication of a firm's ability to meet unexpected demand for working capital.

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Quick Liabilities}} = \frac{\text{Current Assets} - (\text{Stock} + \text{prepaid expenses})}{\text{Current Liabilities} - \text{Bank overdraft}}$$

Ideal Ratio is 1:1

(C) **Absolute Liquidity Ratio:** The absolute liquidity ratio is the relationship between the absolute liquid or super quick assets to liquid or quick liabilities. This is variation of quick ratio and is even called, 'super quick ratio'.

$$\text{Absolute liquidity Ratio} = \frac{\text{Cash} + \text{Bank} + \text{Marketable Securities}}{\text{Quick Liabilities}}$$

A standard of 0.5:1 in absolute liquidity ratio is an acceptable norm, because fifty paisa worth of absolute liquid assets are considered sufficient for one rupee worth of current liabilities.

Activity
Which ratio indicates the ability to meet unexpected demand of working capital?

Illustration 1:

Following is the Balance Sheet of SUN Ltd. as on 31st March 2010:

Liabilities	Rs.	Assets	Rs.
Share Capital:		Fixed Assets:	
4,000 Equity Shares of Rs. 100/-each.	4,00,000	Buildings	1,70,000
Reserve & Surplus:		Furniture	1,14,000
General Reserve	20,000	Machinery	1,10,000
Capital Reserve	8,000	Investments	20,000
Current Liabilities:		Current Assets:	
Creditors	6,000	Stock	10,000
Bills Payables	4,000	Debtors	7,000
Outstanding Expenses	2,000	Bills Receivable	5,000
		Cash & Bank Balance	2,000
		Marketable Securities	2,000
	4,40,000		4,40,000

Calculate the following ratios:

(a) Current Ratio,

(b) Quick Ratio,

(c) Absolute Liquidity Ratio

Solution:

(a) $$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{26,000}{12,000} = 2.17:1$$

Current Assets = 10,000+7,000+5,000+2,000+2,000 = Rs. 26,000

Current Liabilities = 6,000+4,000+2,000 = Rs. 12,000

(b) $$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Quick Liabilities}} = \frac{16,000}{12,000} = 1.33:1$$

Quick Assets = Current Assets – Stock = 26,000 – 10,000 = Rs. 16,000

Quick Liabilities = Current Liabilities – Bank overdraft = Rs. 12,000

(c) $$\text{Absolute Liquid Ratio} = \frac{\text{Absolute Liquid Assets}}{\text{Quick Liabilities}} = \frac{4,000}{12,000} = 0.33:1$$

Absolute Liquid Assets = Cash & Bank Balance + Marketable Securities

= 2,000 + 2,000

= Rs. 4,000

12.4.2 Leverage or Capital Structure Ratio

Leverage or capital structure ratios are the ratios, which indicate the relative interest of the owners and the creditors in an enterprise. These ratios indicate efficiency of the funds provided by the long-term creditors and owners. To judge the long term financial position of the firm, following ratios are applied.

(A) Debt–Equity Ratio: Debt-Equity ratio expresses the relationship between debt and equity. This ratio explains how far owned funds are sufficient to pay outside liabilities. It is calculated by the following formula:

$$\text{Debt - Equity Ratio} = \frac{\text{Debt or External liabilities}}{\text{Equity or Net worth}}$$

Debt = Long-term and Short-term loans + Current Liabilities

Net worth = Share Capital + Reserves & Surpluses

A high Debt-Equity ratio shows that the claims of creditors are greater than those of the owners. A very high ratio is unfavorable from the owner's point of view. This causes hindrance in the firm's operations due to the increasing pressure and interference of creditors in the management. A high debt company finds difficulty in raising additional debt.

A low Debt-Equity ratio shows a greater claim of owners than creditors. From the creditor's point of view, it represents a larger margin of safety since owners equity is treated as margin of safety by creditors.

(B) Proprietary Ratio: This ratio is also known as 'Net Worth to Total Assets Ratio' or 'Shareholders Equities to Total Equities Ratio' or 'Equity Ratio'.

This ratio establishes relationship between Net Worth and Total Tangible Assets.

$$\text{Proprietary Ratio} = \frac{\text{Proprietor's Fund}}{\text{Total tangible Assets}}$$

This ratio shows how much capital is introduced by the owner in business. Higher ratio means a sound position of business, because it shows that the organization is not running through outside funds which mean less interference and pressure of outsiders.

(C) Interest Coverage Ratio: This ratio indicates the relationship between net profits before interests and taxes on long term debt. The objective of calculating this ratio is to measure the debt servicing capacity of a firm so far as fixed interest on long term debt is concerned.

$$\text{Interest Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest payable on Long - term debt}}$$

Interest Coverage ratio shows the number of times the interest charges are covered by the income out of which they will be paid. Higher the ratio the more beneficial for the lenders, because this ratio measures the margin of safety for the lenders.

Illustration 2:

From the following statement, calculate: (a) Debt-Equity Ratio, (b) Proprietary Ratio.

Balance Sheet As on 31st March, 2010

Liabilities	Rs.	Assets	Rs.
Share Capital	1,00,000	Fixed Assets	2,70,000
Reserves & Surplus	50,000	Stock	80,000
Debentures	2,00,000	Debtors	30,000
Creditors	30,000	Cash at Bank	20,000
Bills Payable	20,000		
	4,00,000		4,00,000

Solution:

(a) $$\text{Debt - Equity Ratio} = \frac{\text{Debt or External Liabilities}}{\text{Equity or Net Worth}}$$

$$= \frac{\text{Rs. } 2,50,000}{\text{Rs. } 1,50,000} = 1.67 : 1$$

(b) $$\text{Proprietary Ratio} = \frac{\text{Proprietary Funds or Net Worth}}{\text{Total Tangible Assets}}$$

$$= \frac{\text{Rs. } 1,50,000}{\text{Rs. } 4,00,000} = 0.38 : 1$$

Working notes:

1. External Liabilities = Debentures + Creditors + Bills Payable
   = Rs. (2,00,000+30,000+20,000)
   = Rs. 2,50,000
2. Net Worth = Share Capital + Reserve & Surplus
   = Rs. (1,00,000+50,000)
   = Rs. 1,50,000
3. Tangible Assets = Fixed Assets + Stock + Debtors + Cash at Bank
   = Rs. (2,70,000+80,000+30,000+20,000)
   = Rs. 4,00,000

Illustration 3:

From the following information, calculate interest coverage ratio:

	Rs.
Net Profit after Tax	4,00,000
Rate of Income tax	50%
Fixed Interest Charges	60,000

Solution:

$$\text{Interest Coverage Ratio} = \frac{\text{Net Profit before interest and tax}}{\text{Fixed interest charges}}$$

$$= \frac{\text{Net profit after tax + Tax + Interest}}{\text{Fixed interest charges}}$$

$$= \frac{\text{Rs. } 4,00,000 + \text{Rs. } 4,00,000 + \text{Rs. } 60,000}{\text{Rs. } 60,000}$$

$$= \frac{\text{Rs. } 8,60,000}{\text{Rs. } 60,000} = 14.33 \text{ Times}$$

Working Notes:	Rs.
Net profit before tax	8,00,000
$\frac{(4,00,000 \times 100)}{50}$	
Less: Tax @ 50%	4,00,000
Net profit after tax	4,00,000

12.4.3 Profitability ratio

Profitability ratios are the best indicators of overall efficiency of the business concern, because they compare return of value over and above the value put into business with sales or service carried on by the firm with the help of assets employed. Profitability ratio can be determined on the basis of:

- Sales
- Investment

I. Profitability Ratios related to Sales:

(A) Gross Profit Ratio: The gross profit to sales ratio establishes relationship between gross profit and sales to measure the relative operating efficiency of the firm to reflect pricing policy. Gross profit ratio indicates the average margin on the goods sold. It shows whether the selling prices are adequate or not. It also indicates the extent to which selling prices may be reduced without resulting in losses.

A low gross profit ratio may indicate a higher cost of goods sold due to higher cost of production. It may also be due to low selling prices. A high gross profit ratio, on the other hand, indicates relatively low cost and is a sign of good management.

$$\text{Gross profit to sales ratio} = \frac{\text{Sales - cost of goods sold}}{\text{Sales}} \times 100$$

(B) Net Profit Ratio: The net margin indicates the management's ability to earn sufficient profit on sales not only to cover all revenue operating expenses of the business, the cost of borrowed funds and the cost of goods or servicing, but also to have sufficient margin to pay reasonable compensation to shareholders on their contributions to the firm.

$$\text{Net profit Ratio} = \frac{\text{Net profit after interest and taxes}}{\text{Sales}} \times 100$$

Illustration 4:

Following is the Trading and Profit & Loss A/c of A Ltd. for the year ending 31st March 2010:

Trading and Profit & Loss A/c For the year ended 31st March, 2010

Items	Rs.	Items	Rs.
To Opening Stock	1,10,000	By Sales	6,50,000
To Purchases	4,00,000	By Closing Stock	1,60,000
To Wages	1,00,000		
To Gross Profit c/f	2,00,000		
	8,10,000		8,10,000
To Interest	3,000	By Gross Profit b/f	2,00,000
To Administrative Expenses	60,000		
To Net Profit	1,37,000		
	2,00,000		2,00,000

From the above information, calculate the following ratios:

1. Gross Profit Ratio 2. Net Profit Ratio

Solution:

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

$$= \frac{2,00,000}{6,50,000} \times 100 = 30.77\%$$

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

$$= \frac{1,37,000}{6,50,000} \times 100 = 21.07\%$$

II. Profitability Ratios related to Investments:

(A) Return on Equity or Return on Shareholder's Fund: This ratio measures the return on the total equity of the shareholders. This ratio is also known as 'Return on Shareholder's Fund'.

$$\text{Return on assets} = \frac{\text{Net profit after interest and taxes}}{\text{Shareholder's Fund}} \times 100$$

Net profit for the purpose of this ratio is calculated after charging interest on long term liabilities and payment of taxes. Shareholder's funds include equity capital, preference capital, capital reserve, general reserve and other undistributed profits.

(B) Return on Capital Employed (ROCE) or Return on Investment (ROI):

This is most important test to measure overall profitability of a business. It is ascertained by comparing profit earned and capital (or funds) employed to earn it.

$$\text{Return on capital employed} = \frac{\text{Net profit after interest and taxes}}{\text{Total capital employed}} \times 100$$

Capital Employed = (Share capital + Reserves & Surpluses + Long term loans) - Fictitious assets

ROI is the only ratio which measures the overall performance of the business from the view point of profitability. This ratio indicates how well the management has utilized the funds supplied by the owners and creditors. In other words, this ratio is intended to measure the earning power of the net assets of the business. The higher the ROI, the more efficient the management is considered to be in using the funds available.

Illustration 5:

	Rs.
Net Worth or Shareholders fund	8,25,000
Capital Employed	13,10,000
Net Profit after Tax	2,25,000

From the above information, calculate the following ratios

1. Return on Capital Employed
2. Return on Shareholders Fund

Solution:

1. Return on Capital Employed $= \frac{\text{Net Profit after Interest \& Taxes}}{\text{Capital Employed}} \times 100$

$$= \frac{2,25,000}{13,10,000} \times 100 = 17.18\%$$

2. Return on Shareholders Fund $= \frac{\text{Net Profit after Interest \& Taxes}}{\text{Shareholders Fund}} \times 100$

$$= \frac{2,25,000}{8,25,000} \times 100 = 24.85\%$$

> Activity
> By which ratio can overall profitability be determined?

12.4.4 Activity Ratio or Efficiency Ratio

Activity ratios are sometimes called efficiency ratios. Activity ratios are concerned with how efficiency of the assets of the firm are managed. These ratios are also known as turnover ratios because they indicate the speed with which assets are being converted or turned into sales. These ratios express relationship between level of sales and the investment in various assets investors, receivables, fixed assets etc.

The important activity ratios are as follows:

(A) Inventory Turnover Ratio: This ratio establishes a relationship between cost of goods sold and average stock. This ratio tells the rate at which stock is converted into sales.

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

Cost of goods sold = Opening Stock + Purchase + Direct expenses – Closing Stock

Or

Net Sales – Gross profit

* If cost of goods sold and average stock can not be calculated, then sales and closing stock can be used, and in that condition:-

$$\text{Inventory Turnover Ratio} = \frac{\text{Net Sales}}{\text{Closing Stock}}$$

This ratio provides how many times purchases are made during the year. Higher ratio shows that more sales are being produced by a unit of investment in stocks. Companies in which stock turnover ratio is high generally work on comparatively low margin of profit.

(B) Debtors Turnover Ratio: This ratio shows how quickly debtors are converted into cash. The objective of calculating this ratio is to determine the efficiency with which the trade debtors are managed.

$$\text{Debtors turnover ratio} = \frac{\text{Net credit Sales}}{\text{Average Receivables}}$$

$$\text{Average Receivables} = \frac{\text{(Opening debtors \& B/R) + (Closing Debtors \& B/R)}}{2}$$

(C) Average Collection Period Ratio or Debtor's Velocity: This period indicates an average period for which the credit sales remain outstanding and measures the quality of debtors. It indicates the speed with which the money is collected from debtors.

$$\text{Average Collection Period} = \frac{\text{Average receivables}}{\text{Average Credit Sales}} \times 365/52/12$$

Activity
By which ratio can we judge the period for which the credit sales remain outstanding?

(D) Working Capital Turnover Ratio: This ratio shows the number of times the working capital turns in trading transaction. If it has an increasing trend over the previous year it shows that the working capital is being used efficiently.

The higher the ratio the less is the investment in working capital and the greater are the profits. A very high ratio is a sign of over trading and a low ratio indicates under trading, i.e., working capital is not effectively used.

$$\text{Working Capital Turnover Ratio} = \frac{\text{Cost of Good Sold or Sales}}{\text{Net Working Capital}}$$

Illustration 6:

	Rs.
Opening Stock	40,000
Closing Stock	30,000
Purchases	80,000
Carriage Inwards	10,000
Sales	1,50,000
Opening Debtors	36,000
Closing Debtors	24,000

Calculate the following ratios from the above information:

1. Stock Turnover Ratio
2. Debtor's Turnover Ratio
3. Average Collection Period

Solution:

1. $$\text{Stock Turnover Ratio} = \frac{\text{Cost of Good Sold}}{\text{Average Stock}}$$

$$= \frac{\text{Rs.}1,00,000}{\text{Rs.}35,000} = 2.86 \text{ Times}$$

Working notes:

Cost of Good Sold = Opening Stock + Purchases + Carriage Inwards - Closing Stock

= Rs. (40,000+80,000+10,000-30,000)

= Rs. 1, 00,000

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

$$= \frac{\text{Rs.}(40{,}000 + 30{,}000)}{2} = \text{Rs. } 35{,}000$$

2. $$\text{Debtor's Turnover Ratio} = \frac{\text{Net Credit Sales}}{\text{Average Receivables}}$$

$$= \frac{\text{Rs. } 1{,}50{,}000}{\text{Rs. } 30{,}000} = \text{Rs. } 5 \text{ Times}$$

Working notes:

$$\text{Average Receivables} = \frac{\text{Rs.}(36{,}000 + 24{,}000)}{2} = \text{Rs. } 30{,}000$$

3. $$\text{Average Collection Period} = \frac{\text{Average Receivables}}{\text{Net Credit Sales}} \times 365$$

$$= \frac{\text{Rs. } 30{,}000}{\text{Rs. } 1{,}50{,}000} \times 365 = 73 \text{ days}$$

Illustration 7:

From the following information given below, calculate Working Capital Turnover Ratio:

Particulars	Rs.
(A) Current Assets	
Stock	15,000
Debtors	10,000
Bills Receivables	4,000
Cash at Bank	12,000
Cash in hand	4,000
	45,000
(B) Current Liabilities	
Sundry Creditors	10,000
Bills Payable	5,000
Tax Payable	4,000
Proposed Dividend	4,000
Interest Payable	2,000
	25,000

Net Sales during the year was Rs. 6, 00,000

Solution:

1. Working Capital Turnover Ratio $= \frac{\text{Sales}}{\text{Working Capital}}$

$$= \frac{\text{Rs.6,00,000}}{\text{Rs.20,000}}$$

Working notes:

1. Working Capital = Current Assets - Current Liabilities
   = Rs. (45,000-25,000)
   = Rs. 20,000

12.5 Limitations

Inspite of many advantages, there are certain limitations of the ratio analysis techniques and they should be kept in mind while using them in interpreting financial statements. The following are the main limitations of accounting ratios:

1. **Limited Comparability:** Different firms apply different accounting policies. Therefore the ratio of one firm can not always be compared with the ratio of the other firm. Some firms may value the closing stock on LIFO basis while some other firms may value on FIFO basis. Similarly there may be difference in providing depreciation of fixed assets or certain provisions for doubtful debts etc.
2. **False Results:** Accounting ratios are based on data drawn from accounting records. In case that data is correct, then only the ratios will be correct. For example, valuation of stock is based on very high price, the profits of the concern will be inflated and it will indicate a wrong financial position. The data therefore must be absolutely correct.
3. **Effect of Price Level Changes:** Price level changes often make the comparison of figures difficult over a period of time. Changes in price affects the cost of production, sales and also the value of assets. Therefore, it is necessary to make proper adjustment for price-level changes before any comparison.
4. **Qualitative factors are ignored:** Ratio analysis is a technique of quantitative analysis and thus, ignores qualitative factors, which may be important in decision making. For example, average collection period may be equal to standard credit period, but some debtors may be in the list of doubtful debts, which is not disclosed by ratio analysis.
5. **Effect of window-dressing:** In order to cover up their bad financial position some companies resort to window dressing. They may record the accounting data according to the convenience to show the financial position of the company in a better way.
6. **Costly Technique:** Ratio analysis is a costly technique and can be used only by big business houses. Small business units are not able to afford it.
7. **Misleading Results:** In the absence of absolute data, the result may be misleading. For example, the gross profit of two firms is 25%. Whereas the profit earned by one is just Rs. 5,000 and sales are Rs. 20,000 and profit earned by the other one is Rs. 10,00,000 and sales are Rs. 40,00,000. Although the profitability of the two firms is same yet the magnitude of their business is quite different.
8. **Absence of standard universally accepted terminology:** There are no standard ratios, which are universally accepted for comparison purposes. As such, the significance of ratio analysis technique is reduced.

12.6 Summary

Financial analysis, though varying according to the particular interests of the analyst, always involves the use of various financial statements – primarily the balance sheet and income statement. The Balance sheet summarizes the assets, liabilities and owner's equity of a business at a point in time, and the income statement summarizes revenues and expenses of a firm over a particular period of time.

A conceptual framework of Ratio analysis provides the analyst with an interlocking means for structuring the analysis. For example, in the analysis of external financing, one is concerned with the firm's funds needs, its financial condition and performance, and its business risk. Upon analysis of these factors, one is able to determine the firm's financing needs and to negotiate with outside suppliers of capital.

Financial Ratios are the tools used to analyze financial condition and performance. We calculate ratios because in this way we get a comparison that may prove more useful than the raw numbers by themselves.

Financial ratios can be divided into five basic types: liquidity, leverage(debt), coverage, activity and profitability. No one ratio is itself sufficient for realistic assessment of the financial condition and assessment of the financial condition and performance of the firm. With a group of ratios, however, reasonable judgments can be made. The number of key ratios needed for this purpose is not particularly large – about a dozen or so.

The usefulness of ratios depends on the ingenuity and experience of the financial analyst who employs them. By themselves, financial ratios are fairly meaningless; they must be analyzed on a comparative basis. Comparing one company to similar companies and industry standards over time is crucial. Such a comparison uncovers leading clues in evaluating changes and trends in the firm's financial condition and profitability. This comparison may be historical, but it may also include an analysis of the future based on projected financial statements.

12.7 Key Words

- **Liquidity Ratios :** Liquidity ratios are used to measure the ability of the firm to meet its short-term obligations out of its short-term resources.
- **Leverage Ratios :** Leverage ratios help in measuring the long-term solvency of the business.
- **Efficiency Ratios :** Efficiency ratios helps the management to measure the effectiveness of the resources for the command of the firm.
- **Profitability Ratios:** Profitability ratios are used to measure the end result of business operations.
- **Return on Capital Employed:** This ratio expresses the relationship between profit and capital employed.
- **Gross Capital Employed :** Total assets used in business.
- **Net Capital Employed:** Total assets minus current liabilities.

12.8 Self-Assessment Test

1. What do you understand by 'RATIO ANALYSIS'? What are its limitations?
2. What is the importance of ratio analysis? Explain any two ratios each for measuring Liquidity and Profitability?
3. What are Capital Structure Ratios and Activity Ratios? Explain with illustration.
4. Following is the Balance Sheet of B Ltd. as on 31st March, 2010:

Liabilities	Rs.	Assets	Rs.
Equity Share Capital	2,00,000	Plant & Machinery	2,50,000
Profit & Loss A/c	20,000	Stock	40,000
Debentures	80,000	Sundry Debtors	30,000
Sundry Creditors	50,000	Cash in hand	25,000
Provision for Taxation	10,000	Cash at Bank	10,000
		Prepaid Expenses	5,000
	3,60,000		**3,60,000**

Calculate the following ratios:

(a) Current Ratio

(b) Quick Ratio

(c) Absolute Liquidity Ratio

5. From the following Balance Sheet, calculate:

(a) Debt-Equity Ratio (b) Proprietary Ratio

Balance Sheet

As on 31st March, 2010

Liabilities	Rs.	Assets	Rs.
Equity Share Capital	4,00,000	Fixed Assets	5,00,000
Preference Share Capital	2,00,000	Investments	1,00,000
General Reserve	1,00,000	Stock	2,00,000
Profit & Loss A/c	50,000	Debtors	1,00,000
10% Debentures	1,00,000	Cash in Bank	50,000
Creditors	80,000		
Proposed Dividend	20,000		
	9,50,000		**9,50,000**

6. From the following information, calculate Interest Coverage Ratio:

Particulars	Rs.
Net Profit after Tax	7,00,000
Income Tax	3,00,000
Interest Charges	2,00,000

7. Trading and Profit & Loss A/c

For the year ended 31st March, 2010

Particulars	Rs.	Particulars	Rs.
To Opening Stock	1,00,000	By Sales	9,00,000
To Purchases	4,00,000	By Closing Stock	1,20,000
To Carriage	50,000		
To Wages	2,50,000		
To Gross Profit c/d	2,20,000		
	10,20,000		**10,20,000**
To Adm. Expenses	1,00,000	By Gross Profit b/d	2,20,000
To Selling Expenses	20,000		
To Net Profit	1,00,000		
	2,20,000		**2,20,000**

You are required to calculate:

(a) Gross Profit Ratio (b) Net Profit Ratio.

8. From the following information, calculate:

(a) Return on Capital Employed (b) Return on Shareholder's Fund.

Equity Share Capital	2,00,000
8% Preference Share Capital	1,00,000
General Reserve	1,00,000
10% Debentures	1,25,000
Current Liabilities	1,75,000
Fixed Assets	4,00,000
Current Assets	3,00,000
Net Profit after Tax	78,000

9. From the following information, calculate:

(a) Stock Turnover Ratio

(b) Debtors Turnover Ratio

(c) Average Collection Period.

Particulars	**Rs.**
Opening Stock	1,45,000
Closing Stock	1,55,000
Opening Debtors	1,00,000
Closing Debtors	80,000
Purchases	6,10,000
Sales	7,50,000

10. From the following information, calculate Working Capital Turnover Ratio:

Particulars	**Rs.**
(A) Current Assets	
Inventories	40,000
Debtors	27,000
Bills Receivables	15,000
Cash in hand	20,000
	1,02,000
(B) Current Liabilities	
Creditors	26,000
Bills Payables	14,000
Outstanding Expenses	10,000
	50,000

12.9 Reference Books

1 Agarwal M. R., *Financial Management*

2 Agarwal & Agarwal, *Management Accounting*

3 Maheshwari S.N., *Management Accounting*

Unit -13

Funds Flow and Cash Flow Statements

Outline of the Unit

13.0 Objectives

13.1 Introduction

13.2 Meaning of Fund

13.3 Funds Flow Statement

13.4 Importance of Funds Flow Statement

13.5 Limitations of Funds Flow Statement

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13.7 Sources of Funds

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13.12 Distinction between Funds Flow and Cash Flow Statement

13.13 Distinction between Funds Flow Statement and Balance Sheet

13.14 Format of Cash Flow Statement

13.15 Method of Cash Flow Statement

13.16 Preparation of Cash Flow Statement

13.17 Summary

13.18 Key Words

13.19 Self Assessment Test

13.20 Reference Books

13.0 Objectives

After studying this unit you should be able to understand:

- The concept of funds flow and cash flow statements.
- Objectives behind preparing funds flow and cash flow statements.
- The various limitations associated with funds flow and cash flow statements.
- The various sources and uses of funds.
- Difference between fund flow, cash flow statements and balance sheet.
- Preparing funds flow and cash flow statements.

13.1 Introduction

The second portion of the tools of financial analysis and planning deals with the analysis of funds flows and cash flows. A flow of funds statement (also known as a sources and used of funds statement or

a statement of changes in financial position) is a valuable aid to a financial manager or a creditor in evaluating the uses of funds by a firm and in determining how the firm finances those uses. The purpose of the cash flow statement is to report a firm's cash inflows and outflows. Flow of funds is segregated into three categories: operating, investing and financing activities. Although this statement certainly serves as an aid for analyzing cash receipts and disbursements, important current period investing and financing noncash transactions are omitted. Therefore, the analyst will still want to prepare a flow of funds statement in order to fully understand the firm's funds flows.

Every business concern prepares two basic financial statements at the end of accounting period, namely, Balance Sheet or Position Statement and Profit and Loss Account or Income Statement. Balance Sheet reveals the financial position of the business concern at a certain point of time. It reveals the financial status of the business concern. The Profit and Loss Account reveals the net results of operations over a period of time i.e., how much profit was earned (or loss sustained) by the business enterprise during the accounting period.

The Balance Sheet provides only a static view of the business. It does not show the movement of funds. In business concerns, funds flow from different sources and similarly funds are invested in various sources of investment. The study and control of this fund flow process is the main objective of financial management to assess the soundness and solvency of a business and little about its flow of funds, i.e., financing and investing activities over a related period. Like Balance Sheet, even Profit and Loss Account does not depict the changes that have taken place in financial condition of a business concern between two dates. Hence, there is a need to prepare additional statement to know the changes in assets, liabilities and owner's equity between dates of two Balance Sheets. Such a statement is called Funds Flow Statement or Statement of Sources and Uses of funds.

13.2 Meaning of Funds

Funds Flow Statement is widely used tool in the hands of financial executives for analyzing the financial performance of a business concern. The term Funds has a variety of meanings:

(a) **In a narrow sense-** In a narrow sense funds means only cash. Funds Flow Statement prepared on this basis is called Cash Flow Statement. In this type of Statement, only inflow and outflow of cash is taken into account.

(b) **In a broader sense -** In a broader sense, the term fund refers to money value in whatever form it may exist. Here fund means all financial resources in the form of men, money, materials, and machines, etc.

(c) **Popular Sense -** In a Popular Sense, the term fund means Working Capital i.e., the excess of current assets over current liabilities.

13.3 Meaning and Definition of Funds Flow Statement

Funds Flow Statement is prepared to study the changes in the financial position of a business over a period of time, generally one year. Funds Flow Statement reveals both inflow and outflow of funds. The inflow of funds is known as sources of funds and the outflow of funds means uses or application of funds. Funds Flow Statement highlights changes in the financial structure of an undertaking. It determines the financial consequences of business operations.Funds Flow Statement gives detailed analysis of changes in distribution of resources between two Balance Sheet dates.

Definitions:-

According to Foulke a statement of sources and application of funds is a technical device designed

to analyze the changes in the financial condition of a business enterprise between two dates.

According to Anthony Funds Flow Statement describes the sources from which additional funds were derived and the use to which these sources were put.

A Statement is either prospective or retrospective, setting out the sources and applications of the funds of an enterprise. The purpose of the statement is to indicate clearly the requirements of funds and how they are proposed to be raised and the efficient utilization and application of the same.

13.4 Importance of Funds Flow Statement

Funds Flow Statement is an analytical tool in the hands of financial manager. The basic purpose of this statement is to indicate on historical basis the changes in the working capital i.e., where funds came from and if they are used during a given period.

The utility of this statement can be measured on the basis of its contributions to the financial management. It generally serves the following purposes:-

(1) **Analysis of Financial Position** The basic purpose of preparing the statement is to have a rich into the financial operations of the concern. It analyses how the funds were obtained and used in the past. In this sense, it is a valuable tool for the finance manager for analyzing the past and future plans of the firm and their impact on the liquidity. He can identify the reasons for the imbalances in uses of funds in the past and take necessary corrective actions. In analyzing the financial position of the firm, the Funds Flow Statement answers such questions as-

1. Why were the net current assets of the firm down, though the net income was up or vice versa?
2. How was it possible to distribute dividends in absence of or in excess of current income for the period?
3. How was the sale proceeds of plant and machinery used?
4. How was the sale proceeds of plant and machinery used?
5. How were the debts retired?
6. What became to the proceeds of share issue or debenture issue?
7. How was the increase in working capital financed?
8. Where did the profits go?

Though it is not an easy job to find the definite answers to such questions because funds derived from a particular source are rarely used for a particular purpose. However, certain useful assumptions can often be made and reasonable conclusions are usually not difficult to arrive at.

(2) **Evaluation of the Firm's Financing** One important use of the statement is that it evaluates the firm' financing capacity. The analysis of sources of funds reveals how the firm financed its development projects in the past i.e., from internal sources or from external sources. It also reveals the rate of growth of the firm.

(3) **An Instrument for Allocation of Resources** In modern large scale business, available funds are always short for expansion programmes and there is always a problem of allocation of resources. It is, therefore, a need of evolving an order of priorities for putting through their expansion programmes which are phased accordingly, and funds have to be arranged as different phases of programmes get into their stride. The amount of funds to be available for these projects shall be estimated by the finance with the help of Funds Flow Statement. This prevents the business

from becoming a helpless victim of unplanned action.

(4) **A Tool of Communication to Outside World** Funds Flow Statement helps in gathering the financial status of the Business. It gives an insight into the evolution of the present financial position and gives answer to the problem 'where have our resources been moving'? In the present world of credit financing, it provides a useful information to bankers, creditors, finance, and government etc. regarding amount of loan required, its proposes, the terms of repayment an sources for repayment of loan etc. the financial manager gains a confidence born out of a study of Funds Flow Statement. In fact, it carries information regarding firm's financial policies to the outside world.

(5) **Future Guide** An analysis of Funds Flow Statements of several years reveals certain valuable information for the financial manager for planning the future financial requirements of the firm and their nature too i.e. Short term, long-term or mid term. The management can formulate its financial policies based on information gathered from the analysis of such statements. Financial manager can rearrange the firm's financing more effectively on the basis of such information along with the expected changes in trade of payables and the various accruals. In this way, it guides the management in arranging its financing more effectively.

(6) **Control device** It serves as a measure of control for the management. If actual figures are compared with budgeted/projected figures, management can take remedial action, if there are any deviations.

13.5 Limitations of Funds Flow Statement

The following are the important limitations of Funds Flow Statement:

1. Funds Flow Statement is not a substitute of Income Statement or a Balance Sheet. It furnishes only some additional information as regards changes in the working capital.
2. This statement lacks originality. It is rearrangement of data appearing in account books.
3. It indicates only past changes. It can not reveal continuous changes.
4. Some management accountants are of the opinion that Funds Flow Statement is not an ideal tool for financial analysis.

13.6 Steps for Funds Flow Statement

The objective of funds flow statement is to analyse the causes for net increase or decrease in the working capital as shown by the schedule of working capital changes. This statement is prepared on the basis of changes in fixed assets, long-term liabilities and capital. Funds flow statement has two parts (i) Sources of funds and (ii) uses or application of funds. The difference between these two parts represents net changes is working capital. The amount of net increase or decrease as shown in funds flow statement should be equal to the amount shown by the schedule of working capital changes. The following steps should be taken to prepare funds flow statement:

I Step

From the current assets and current liabilities shown in the balance sheet. prepare a schedule of working capital changes. This will result in either an increase or decrease in net worming captial.

- Increase in current assets increases working capital.
- Decrease in current assets decreases working capital.
- Increase in current liabilities decreases working capital.
- Decrease in current liabilities increases working capital.

II Step

Open respective accounts for all other non-current assets and non-current liabilities taking their opening and closing balances.

III Step

Journalise the adjustments using double entry system and post them in respective accounts.

IV Step

Close the accounts which will result either as an item of source of funds or an item of use or application of funds or close the remaining accounts by transferring to adjustment profit and loss acounts. The balance of adjusted profit and loss account will be profit or loss from operation, that is to be shown in funds flow statement following accounts are open for these calculations.

1. Funds From Operation The major source of working capital is the net profit from operations. The net profit from operations is the source of funds and net loss from operations is the use or application fo funds. The net profit or loss disclosed by profit and loss account is not treated profit or loss from operations for the purpose of funds flow statement, because profit and loss account contains such items which do not effect working capital. So the appripriate adjustments are to be made in the profit disclosed by the profit and loss account to arrive at the fund from operation.

(a) Item to be added in Net Profit The non-funds items which do not affect current assets or current liabilities and non-trading expenses and losses are added in the profit to arrive at funds from operation. These are:

- Depreciation
- Loss on sale of fixed assets or long term investment.
- discount on issue of share and debentures.
- Premium on redemption of debentures.
- Prelimising expenses written off.
- Deferred revenue expenses.
- Goodwill written of.
- Patents; Trade marks written off.
- Provision for tax.
- Proposed dividend.
- Transfer to reserves.

(b) Items to be deducted from net profit

Items which do not affect current assets or current liabilities and non trading incomes and gains will be deducted from the net profit to arrive at fund from operations. These are:

- Profit or gain on sale of fixed assets.
- Dividend received or receivable (not being trading income).
- Interest received on investments. Compensation received.
- Refund of tax.
- Profit on revaluation of assets.

- Increase in value of goodwill and patents.
- Transfer from reserves to profit and loss account.

- **Calculation of Non-cash expenses and Non-trading losses.**

Information regarding non-cash expenses and non-trading losses is not generally explicity provided. When the amount of intangible and factious assets are written off like goodwill preliminary expenses etc. are less in the current year's balance sheet than previous years balance sheet, then it is presumed that the deficiency is written off in the profit and loss account.

Sometime information regarding current year's depreciation is provided but sometimes it has to be calculated. If the amount of accumulated depreciation is given, than it is ascertained by preparing accumulated depreciation account. If the amount of accumulated depreciation is not given, then it should be calculated as follows:

		Rs.
Book value of fixed assets in last year's	B/S	.....
Add: Fixed assets purchased during the yeas		.....
Less : Book value of fixed assets in current year's	B/S/	.....
Current year's depreciation		.....

If the information regarding profit or loss on sale of fixed assets and long term investments is not given, then difference between sale proceeds and book value of the assets should be presumed as profit or loss.

- **Purchase/Sale of Fixed Assets**

The amount of source or use of funds from purchase or sale of fixed assets can be ascertained by opening an account for the concerned assets as it appears in the ledger. The opening balance of the assets is posted on the debit side and closing balance on the credit side of the assets account. Then the additional information is journalised by double entry system and the entry is posted in the concerned assets account. The balancin figure of the assets account may be either purchase or sale. If the balance falls short in the debit side, it represents purchase of the assets, on the contrary, if the balance falls short in the credit side, it is sale of the assets.

- **Purchase/Sale of Investment**

In a business concern, investment may be treated as current assets or as fixed assets. Investment in marketable securities or government securities representing temporary investment or short term investments are treated as current assets. Any change in the figures of such investments between the two balance sheet dates is automatically adjusted through the schedule of changes in working capital.

Investment in shares or debentures of other companies or subsidiary companies i.e. long term or trade investment are treated as fixed assets. Any sale of such investments is a source of funds while purchase represents use of funds.

- **Increase/Decrease in Share Capital and Long Term Liabilities**

Between the two balance sheet dates, increase in share capital or long term liabilities during the year arising on account of fresh issue of shares or debentures result in a source of funds. The redemption of preference shares or buy back of equity shares or debentures is an application or use of funds as it reduces the value of these instruments. If these share or debentures are issued at premium the account of premium is also treated an increase in share or debenture capital.

- **Provision for Taxation**

As a current liability - When the provision for taxation is treated as current liability, it is shown as the statement of changes in working capital and any tax paid by the firm during the year is ignored. The amount paid not shown is the fund flow statement and it will not be added back to the net profit for ascertaining funds from operations.

As an appropriation of Profits - When provision for taxation is treated as an appropriation of profits, the amount of tax paid will be shown as an application or use of funds in the funds flow statement. The amount of provision for taxation charged from the profit and loss account during the year is added back to the net profit for the year while calculating funds from operations.

Proposed Dividend - Proposed devidend prior to the approval of the annual financial statement in the annual general meeting represents only an appropriation of profits. When it is approved by the shareholders in the annual general meeting, it becomes a current liability for the company. According to the circumstances in each case, proposed dividend can be treated as provision for Taxation.

Interim Dividend - Dividend paid in advance against current year's profit is known as 'interim dividend'. The amount interim dividend paid during the year is shown as an application or use of funds in funds flow statement and in the debit side of adjusted profit and loss account or added back to net profit for calculating the funds from operation.

In the end, the balances of funds flow statement will be equal to the increase or decrease is net working capital as shown in the schedule of working capital changes.

13.7 Sources of Funds

Transactions that increase Working Capital are sources of funds. Some of them are:-

1. Funds from issue of Share Capital
2. Funds from issue of Debentures, Acceptance of Public Deposits, and other Long-term Loans.
3. Sale of Fixed Assets or Long-term Investments such as Land, Building, Machinery, Furniture, etc.
4. Non-trading income such as dividend, rent, interest, etc.
5. Fund from Operations.
6. Decrease in Working Capital.

Note- Share or Debentures issued and allotted for other than cash considerations, do not generate fund.

13.8 Application of Funds

1. Redemption of Equity & Preference Share Capital.
2. Redemption of Debentures.
3. Repayment of Long-Term Loans
4. Purchase of Fixed Assets or Long Term Investments.
5. Non-trading payment.
6. Funds lost in operations.

Note- If any fixed asset is purchased for a consideration of issue of shares or debentures, it does not involve any funds and hence it is not an application of funds.

Activity
Write any four items which can be treated as sources of funds.

Illustration 1

The balance sheets of Ram & Company as on 31st march 2008 and 2009 were as follows:

Liabilities	2008 Rs.	2009 Rs.	Assets	2008 Rs.	2009 Rs.
Creditors	37,400	42,000	Bank	4,000	5,000
P&L A/c	20,000	30,000	Debtors	36,000	39,000
9% debentures	-	20,000	Stock	22,000	26,000
General reserve	10,000	15,000	Fixed Assets	93,400	1,66,000
Equity share capital	90,000	1,30,000	Preliminary Expenses	2,000	1,000
	1,57,400	2,37,000		1,57,400	2,37,000

Additional Information

(1) Depreciation written off against Fixed Assets was Rs. 23,400.

(2) Dividend of Rs. 20,000 was paid on Share Capital.

Prepare Schedule of Changes in Working Capital and Fund Flow Statement.

Solution

Statement of Changes in Working Capital

Particulars	31 March 2008	31 March 2009	Changes in Working Capital	
			Increase	Decrease
	Rs.	Rs.	Rs.	Rs.
Current Assets:				
Bank	4,000	5,000	1,000	-
Debtors	36,000	39,000	3,000	-
Stock	22,000	26,000	4,000	-
Total (A)	62,000	70,000		
Current Liabilities:				
Creditors	37,400	42,000	-	4,600
Total (B)	37,400	42,000		
Net Working Capital (A-B)	24,600	28,000	8,000	4,600
Increase in Working Capital	3,400	-	-	3,400
	28,000	**28,000**	**8,000**	**8,000**

Funds Flow Statement

Sources of Funds	Amount Rs.	Uses of Funds	Amount Rs.
Issue of Share Capital	40,000	Dividend Paid	20,000
Issue of Debentures	20,000	Purchase of Fixed Assets	96,000
Funds from Operations	59,400	Increase in Working Capital	3,400
	1,19,400		1,19,400

Working Notes

Particulars	Rs.	Particulars	Rs.
To Balance b/d	93,400	By Depreciation	23,400
To Cash (Purchase of Fixed Assets)	96,000	By Balance c/d	1,66,000
	1,89,400		1,89,400

Dr. **Profit & Loss Adjustment A/c** **Cr.**

Particulars	Rs.	Particulars	Rs.
To Dividend	20,000	By Balance b/d	20,000
To Depreciation	23,400	By Funds from Operations	59,400
To Written off Preliminary Expenses	1,000		
To General Reserve	5,000		
To Balance c/d	30,000		
	79,400		79,400

Illustration 2

From the following balance sheets of X Ltd. on 31st march 2009 and 2010, you are required to prepare:

(a) A Statement of changes in Working capital;

(b) A Funds Flow Statement.

Liabilities	2009	2010	Assets	2009	2010
	Rs.	Rs.		Rs.	Rs.
Share Capital	1,00,000	1,00,000	Goodwill	12,000	12,000
General Reserve	14,000	18,000	Building	40,000	36,000
P&L A/c	16,000	13,000	Plant	37,000	36,000
Sundry Creditors	8,000	5,400	Investment	10,000	11,000
Bills Payable	1,200	800	Stock	30,000	23,400
Provision for Taxation	16,000	18,000	Bills Receivable	2,000	3,200
			Debtors	18,000	19,000
Provision for Doubtful debts	400	600	Cash at Bank	6,600	15,200
	1,55,600	1,55,800		1,55,600	1,55,800

The following additional information have also been given:

(a) Depreciation charged on Plant was Rs.4,000 and on Building Rs.4,000

(b) Provision for Taxation of Rs.19,000 was made during the year.

(c) Interim Dividend of Rs.8,000 was paid during the year.

Solution:

Funds Flow Statement

For the year ended 31st March, 2010

Sources	Rs.	Applications	Rs.
Funds from Operations	36,000	Purchase of Plant	3,000
		Purchase of Investment	1,000
		Payment of Interim Dividend	8,000
		Payment of Tax	17,000
		Increase in Working Capital	7,000
	36,000		36,000

Statement of Changes in Working Capital

Items	31st March 2009 Rs.	31st March 2010 Rs.	Increase Rs.	Decrease Rs.
(A)Current Assets:				
Debtors	18,000	19,000		
Less: Provision for Doubtful debts	400	600		
	17,600	18,400	800	-
	30,000	23,400	-	6,600
Stock	2,000	3,200	1,200	-
Bills Receivable	6,600	15,200	8,600	-
Cash at Bank				
	56,200	60,200		
Total(A)				
(B)Current Liabilities:	8,000	5,400	2,600	-
Sundry Creditors	1,200	800	400	-
Bills Payable				
	9,200	6,200		
Total (B)				
	47,000	54,000	13,600	6,600
Net Working Capital(A-B)	7,000	-	-	**7,000**
Increase in W.C.				
	54,000	**54,000**	**13,600**	**13,600**

Working Notes:

Dr. **Adjusted Profit & Loss A/c** **Cr.**

Particulars	Rs.	Particulars	Rs.
To General Reserve	4,000	By Balance b/d	16,000
To Provision for Taxation	19,000	By Funds from Operations	36,000
To Interim Dividend	8,000		
To Depreciation:			
Building	4,000		
Plant	4,000		
To Balance c/d	13,000		
	52,000		52,000

Dr. **Provision for Taxation A/c** **Cr.**

Particulars	Rs.	Particulars	Rs.
To Bank A/c	17,000	By Balance b/d	16,000
To Balance c/d	18,000	By Adjusted P&L A/c	19,000
	35,000		35,000

Dr. **Building A/c** **Cr.**

Particulars	Rs.	Particulars	Rs.
To Balance b/d	40,000	To Depreciation	4,000
		To Balance c/d	36,000
	40,000		40,000

Dr. **Plant A/c** **Cr.**

Particulars	Rs.	Particulars	Rs.
To Balance b/d	37,000	By Depreciation	4,000
To Bank A/c		By Balance c/d	36,000
(Balancing Figure)	3,000		
	40,000		40,000

13.9 Cash Flow Statement

Three major financial statements that are ordinarily required for external reports are an income statement, a balance sheet, and a statement of cash flows. The purpose of the statement of cash flow is to highlight the major activities that directly and indirectly impact cash flows and hence affect the overall cash balance. The manager focuses on cash for a very good reason. Without sufficient cash balance at the right time, a company may miss golden opportunities or may even fall into bankruptcy. The cash flow statement answers questions that cannot be answered by the income statement and a balance sheet.

The statement of cash flows is a valuable analytical tool for managers as well as for investors and creditors, although managers tend to be more concerned with forecasted statements of cash flows that are prepared as a part of the budgeting process. The statement of cash flows can be used to answer crucial questions such as the following:

1. Is the company generating sufficient positive cash flows from its ongoing operations to remain viable?
2. Will the company be able to repay its debts?
3. Will the company be able to pay its usual dividends?
4. Why is there a difference between net income and net cash flow for the year?
5. To what extent will the company have to borrow money in order to make needed investments?

For the statement of cash flows to be useful to managers and others, it is important that companies employ a common definition of cash. It is also important that a statement be constructed using consistent guidelines for identifying activities that are sources of cash and uses of cash. The proper definition of cash and the guidelines to use in identifying sources are discussed in coming paragraphs.

Definition of Cash:

In preparing a statement of cash flows, the term cash is broadly defined to include both cash and cash equivalents. Cash equivalents consist of short term, highly liquid investments such as treasury bills, commercial paper, and money market funds that are made solely for the purpose of generating a return on temporary idle funds. Instead of simply holding cash, most companies invest their excess cash reserves in these types of interest bearing assets that can be easily converted into cash. These short term liquid investments are usually included in marketable securities on the balance sheet. Since such assets are equivalent to cash, they are included with cash in preparing a statement of cash flows.

13.10 Uses of Cash Flow Statement

Its main advantages are as follows:

(i) **Planning and Co-ordination of Financial Operations:** Cash Flow Statement is useful for evaluating Financial policies and current cash position. Since cash is the basis for carrying on

operations, the Cash Flow Statement prepared on an estimated basis for the next accounting period will enable the management to plan and co-ordinate the financial operations. It is especially useful in preparing cash budgets.

(ii) **A Control Device :** Cash Flow statement is also a control device for the management. A comparison of cash flow statement of previous year with the budget for that year would indicate to what extent the resources of the enterprise were raised and applied according to the plan. Thus a comparison of original forecast with actual results may highlight trends of movement that might otherwise go undetected.

(iii) **Useful to internal Financial Management :** Since it gives a clear picture of cash inflow from operations (and not income flow of operation), it is, therefore, very useful to internal financial management in considering the possibility of retiring long-term debts, in planning replacement of plant facilities or in formulating dividend policies.

(iv) **Profit and Cash Positions:** It enables the management to account for situation when business has earned huge profits yet run without money or when it has suffered a loss and still has plenty of money at the bank.

(v) **Short-term Financial Decisions :** Cash Flow Statement helps the management in taking short-term financial decisions. Suppose, a firm wants to know its state of solvency after one month, it is possible only from Cash Flow analysis and not from Funds Flow Statement. Shorter the period, greater is the importance of Cash Flow Statement.

13.11 Limitations of Cash Flow Statement

Cash flow statement suffers from the following limitations:

(1) A Cash Flow Statement only reveals the inflow and outflow of cash. The cash balance disclosed by the cash flow statement may not represent the real liquid position of the concern.

(2) Cash Flow Statement is not suitable for judging the profitability of a firm as non-cash changes are ignored while calculating cash flows from operating activities

(3) Cash Flow Statement is based on cash accounting. It ignores the basic accounting concept of the accrual basis.

Cash Flow Statement does not give a complete picture of financial position of the concern.

13.12 Distinction between Funds Flow and Cash Flow Statements

A distinction between these two statements may be briefed as under:

(i) Funds Flow Statement is concerned with all items constituting funds (Working Capital) for the business while Cash Flow Statement deals only with cash transactions. In other words, a transaction affecting working capital other than cash will affect Funds statement, and not the Cash Flow Statement.

(ii) In Funds Flow Statement, net increase or decrease in working capital is recorded while in Cash Flow Statement, individual item involving cash is taken into account.

(iii) Cash Flow Statement is started with the opening cash balance and closed with the closing cash balance while there are no opening or closing balances in Funds Flow Statement.

13.13 Distinction between Funds Flow Statement and Balance Sheet

A summary of main points of differences between these two is give below:

(i) Balance sheet is a statement showing the financial position of the concern on a particular date. The asset side portrays the development of resources in various types of properties and liabilities side indicates the manner in which these resources are obtained. It shows all assets and liabilities whether current or fixed, tangible or intangible etc., while Funds Flow Statement shows the changes in current assets and current liabilities during a particular period of time.

(ii) Balance Sheet shows the total financial position on a particular date and in this way, it is of a historical nature and therefore, its utility is very limited for the management. On the other hand, Funds Flow Statement is a comparative statement of assets and liabilities and depicts the changes in working capital during the period of two Balance sheets.

(iii) Funds Flow Statement is an analysis and control device for the management. Management can ensure the long term and the short term solvency of the firm by studying the internal funds flow cycles. It is a modern technique of knowing the inflows and outflows of funds during a particular period. Balance Sheet represents the balance of various assets and liabilities and does not present analysis of any kind.

(iv) There are two views of the financial position of the firm-long term and short-term. Short-term financial position means the technical solvency of the firm in the near future while on the other hand, long-term financial position means future financial structure of the firm. Both are inter-related but there is a differences in their analysis. The short-term view of the financial position of the firm cannot be obtained from the Balance Sheet.

13.14 Format of Cash Flow Statement

The cash flow statement is divided into three sections:

1. **Cash flow from Operating Activities:** Shows the results of cash inflows and outflows related to the fundamental operations of the basic line or lines of business in which the company engages. (Example: cash receipts from the sale of goods or services and cash outflows for purchasing inventory and paying rent and taxes).
2. **Cash flow from Investing Activities :** Associated with purchases and sales of non-current assets (Example: building and equipment purchases or sales of investments or subsidiaries).
3. **Cash flow from Financing Activities :** Associated with financing the firm (Example: selling and paying off bonds and issuing stock and paying dividends).

13.15 Methods of Cash Flow Statement

There are two methods of preparing the Cash Flow Statement. Both methods give the same results in respect of the final total as well as sub-totals of the three sections - operating, investing and financing. They differ only in the manner the information regarding cash flow from operating activities is presented.

(1) Indirect Method

Format of Cash Flow Statement for the year ended.....

As per Accounting Standard - 3 (Revised)

Particulars	Rs.	Rs.
(i) Cash flows from operating Activities		
Net Profit as per Profit and Loss A/c or difference between closing balance and opening balance of Profit and Loss A/c	xxx	xxx

Add : Transfer to reserve	xxx	
Proposed dividend for current year	xxx	
Interim dividend paid during the year	xxx	
Provision for tax made during the current year	xxx	
Extraordinary items, if any, debited to Profit and Loss A/c	xxx	xxx
Less: Extraordinary Items, if any, credited to Profit and Loss A/c	xxx	
Refund of Tax credited to Profit and Loss A/c	xxx	(xxx)
A. Net profit before taxation and Extra-Ordinary items		**Xxxx**
(Adjustment for Non-Cash and Non-Operating Items)		
B. Add :		
– Depreciation	xxx	
– Preliminary expenses	xxx	
– Discount on issue of shares and debentures written off	xxx	
– Interest on borrowings and debentures	xxx	
– Loss on sale of fixed assets	xxx	xxx
C. Less :		
– Interest income/received	xxx	
– Dividend income received	xxx	
– Rental income received	xxx	
– Profit on sale of fixed asset	xxx	xxx
D. Operating profits before working capital changes (A + B – C)		xxxx
E. Decrease in current assets and increase in current liabilities		xxx
F. Less: Increase in current assets and decrease in current liabilities		xxx
G. Cash generated from operations (D + E – F)		xxx
H. Less: Income tax paid (Net tax refund received)		xxx
I. Cash flow from before extraordinary items		xxx
Adjusted extraordinary items (+/–)		xxx
Net cash flow from operating activities		xxxx
(ii) Cash Flow from Investing Activities		
Add:		
– Proceeds from sale of fixed assets	xxx	
– Proceeds from sale of investments	xxx	
– Proceeds from sale of intangible assets	xxx	
– Interest and dividend received	xxx	xxx
Less:		
– Rent income	xxx	
– Purchase of fixed assets	xxx	
– Purchase of investment	xxx	
– Purchase of intangible assets like goodwill	xxx	(xxx)
Net cash from (or used in) investing activities		Xxxx
(iii) Cash Flow from Financing Activities		
Add:		
Proceeds from issue of shares and debentures	xxx	
Proceeds from other long term borrowings	xxx	xxx
Less:		
Final dividend fund	xxx	
Interim dividend fund	xxx	
Interest on debentures and loans paid	xxx	
Repayment of loans	xxx	
Redemption of debenture preference shares	xxx	(xxx)

Net cash flow from (or used in) financing activities		**xxxx**
(iv) Net increase/Decrease in cash and cash equivalent (i + ii + iii)		**xxxx**
(v) **Add:** Cash and Cash equivalents in the beginning of the year		
– Cash in hand	xxx	
– Cash at bank overdraft	xxx	
– Short term deposit	xxx	
– Marketable securities	xxx	**xxxx**
(vi) **Less:** Cash and Cash equivalents in the end of the year		
– Cash in hand	xxx	
– Cash at Bank (by bank overdraft)	xxx	
– Short term deposits	xxx	
– Cash flow from operation	xxx	(xxx)
		Nil

(2) Direct Method

Format for Cash flow Statement for the year ended...
As per Accounting Standard-3 (Revised)

Particulars	Rs.	Rs.
(i) Cash Flow from Operating Activities		
A. Operating Cash Receipts		
– Cash sales	xxx	
– Cash received from customers	xxx	
– Trading commission received	xxx	
– Royalties received	xxx	xxx
B. Less: Operating cash payment		
– Cash purchase	xxx	
– Cash paid to the supplier	xxx	
– Cash paid for business expenses like office expenses, Manufacturing expenses, selling and distribution expenses	xxx	(xxx)
C. Cash generated from operation (A – B)		xxxx
D. Less: Income tax paid (Net of tax refund received)		(xxx)
E. Cash flow before extraordinary items		xxx
F. Adjusted extraordinary items (+/–)/Receipt/payment		xxx
G. Net Cash Flow from (or used in) Operating Activities		**xxxx**
(ii) Cash Flow from Investing Activities (calculation same as under indirect method)		**xxxx**
(iii) Cash Flow from Financing Activities (Calculation same as under indirect method)		**xxxx**
(iv) Net increase/decrease in cash and cash equivalents (i + ii + iii)		**xxxx**
(v) Add: cash and cash equivalent in the beginning of the year (calculated same as under indirect method)		xxx
(vi) Less: Cash and Cash equivalent in the end of the year		(xxx)
		Nil

Activity

What are the main headings while preparing cash flow statement by indirect method.

13.16 Preparation of Cash Flow Statement

13.16.1 Operating Activities

Cash flow from operating activities are primarily derived from the principal revenue generating activities of the enterprise. A few items of cash flows from operating activities are:

(i) Cash receipt from the sale of goods and rendering services.

(ii) Cash receipts from royalties, fee, Commissions and other revenue.

(iii) Cash payments to suppliers for goods and services.

(iv) Cash payment to employees

(vi) Cash payment or refund of Income tax.

Determination of cash flow from operating activities:-

There are two stages for arriving at the Cash Flow from Operating Activities:-

Stage-I

Calculation of operating profit before working capital changes, it can be calculated in the following manner:-

Net profit before Tax and extra-ordinary Items		xxx
Add: Non-cash and non-operating Items (Which have already been debited to profit and Loss Account)		
- Depreciation	xxx	
- Amortization of intangible assets	xxx	
- Loss on the sale of Fixed assets	xxx	
- Loss on the sale of Long term Investments	xxx	
- Provision for tax	xxx	
- Dividend paid	xxx	xxx
		xxxx
Less: Non-cash and Non-operating Items (Which have already been credited to profit & loss Account)		
- Profit on sale of fixed assets	xxx	
- Profit on sale of Long term investment	xxx	(xxx)
Operating profit before working Capital changes		**xxxx**

Stage-II

After getting operating profit before working capital changes as per stage I, adjust increase or decrease in the current assets and current liabilities.

The following general rules may be applied at the time of adjusting current assets and current liabilities.

A. Current assets

(i) An increase in an item of current assets causes a decrease in cash inflow because cash is blocked in current assets.

(ii) A decrease in an item of current assets causes an increase in cash inflow because cash is released from the sale of current assets.

B. Current liabilities

(i) An increase in an item of current liability causes a decrease in cash outflow because cash is saved.

(ii) A decrease in an item of current liability causes increase in cash out flow because of payment of liability.

13.16.2 Investing Activities

Investing Activities refer to transactions that affect the purchase and sale of fixed or long term assets and investments.

Examples of cash flow arising from Investing activities are:-

1. Cash payments to acquire fixed Assets.
2. Cash receipts from disposal of fixed assets.
3. Cash payments to acquire shares, or debenture investment.
4. Cash receipts from the repayment of advances and loans made to third parties.

Thus, Cash Inflow from Investing activities is:-

- Cash sale of plant and machinery, land and Building, furniture, goodwill etc.
- Cash sale of investments made in the shares and debentures of other companies.
- Cash receipts from collecting the Principal amount of loans made to third parties.

Cash Outflow from Investing Activities is:

- Purchase of fixed assets i.e. land, building, furniture, machinery etc.
- Purchase of Intangible assets i.e. goodwill, trade mark etc.
- Purchase of shares and debentures
- Purchase of Government Bonds
- Loan made to third parties

13.16.3 Financing Activities

The third section of the cash flow statement reports the cash paid and received from activities with non-current or long term liabilities and shareholders Capital. Examples of cash flow arising from financing activities are:

- Cash proceeds from issue of shares or other similar instruments.
- Cash proceeds from issue of debentures, loans, notes, bonds, and other short-term borrowings.
- Cash repayment of amount borrowed.

Cash Inflow from financing activities is:

- Issue of Equity and preference share capital for cash only.
- Issue of Debentures, Bonds and long-term note for cash only

Cash Outflow from financing activities is:

- Payment of dividends to shareholders.
- Redemption or repayment of loans i.e. debentures and bonds.
- Redemption of preference share capital.
- Buy back of equity shares.

13.16.4 Treatement of Special Items

(i) **Payment of Interim Dividends** The following procedure is followed:

- The amount of interim dividend paid during the year is shown as outflow of cash in cash flow statement.
- It will be added back to the profits for the purpose of calculating cash provided from operating activities.
- No adjustment is necessary if the cash provided from operating activities is calculated on the basis of revised figure of net profit.

(ii) **Proposed dividend** The dividend is always declared in the general meeting after the preparation of Balance Sheet. It is therefore, a non-operating item which should not be permitted to affect the calculation of cash generated by operating activities. Thus, the amount of proposed dividends would be added back to current year's profit and payments made during the year in respect of dividends would be shown as an outflow of cash.

(iii) **Share Capital** The increase in share capital is regarded as inflow of cash only when there is a increase in share capital. For example, if a company issues 10000 equity shares of Rs.10 each for cash only, Rs. 100,000 would be shown as inflow of cash from financing activities. Similarly, the redemption of preference share is an outflow of cash. But where the share capital is issued to finance the purchase of fixed assets or the debentures are converted into equity shares there is no cash flow. Further, the issue of bonus shares does not cause any cash flows.

(iv) **Purchase or sale of fixed Assets** The figures appearing in the comparative balance sheets at two dates in respect of fixed assets might indicate whether a particular fixed asset has been purchased or sold during the year. This would enable to determine the inflows or outflows of cash. For example, If the plant and machinery appears at Rs 60,000 in the current year and Rs.50,000 in the previous year, the only conclusion, in the absence of any other information is that there is a purchase of fixed assets for Rs.10000 during the year. Hence, Rs.10000 would be shown as outflow of cash.

(v) **Provision for Taxation** It is a non-operating expense or an item of appropriation in the Income statement/Profit and Loss Account and therefore should not be allowed to reduce the cash provided from operating activities. Hence, if the profit is given after tax and the amount of the provision for tax made during the year is given, the same would be added back to the current year profit figure. In the cash flow statement, the tax paid would be recorded separately as an outflow of cash. The item of provision for taxation would not be treated as current assets.

Sometimes, the only information available about provision for taxation is two figures appearing in the opening balance sheet and closing balance sheet. In such a case the figure in the opening balance sheet is treated as an outflow of cash while the figure in the closing balance sheet is treated as a non-cash and non-operating expense and thus is added back to net Income figure to find out the cash provided from operating activities.

Illustration 3

From the summarized cash account of ABC Limited (Ltd.) prepare cash flow statement for the year ended 31st December 2006 in accordance with AS-3 (Revised) using the direct method and indirect method. The company does not have any cash equivalents:

Summarized Cash A/c

Particulars	Amount (Rs. 000)	Particulars	Amount (Rs. 000)
Balance on 1.1.2006	50	Payment to Suppliers	2000
Issue of equity shares	300	Purchase of fixed assets	200
Receipts from customers	2800	Overhead expenses	200
Sale of fixed assets	100	Wages and salaries	100
		Taxation	250
		Dividend	50
		Repayment of Bank Loan	300
		Balance on 31.12.2006	150
	3250		3250

Additional information: Net profit before tax for the year 2006 was Rs 5,00,000.

Solution:

Cash Flow Statement of ABC Ltd

for the year ended 31st December 2006 (Indirect method)

	Rs '000	Rs '000
A. Cash flow from operating activities		
Net profit before tax		500
Income tax paid		(250)
Net cash from operating activities		250
B. Cash flow from investing activities		
Purchase of fixed assets	(200)	
Sale of fixed assets	100	
Net cash used in investing activities		(100)
C. Cash flow from financing activities		
Issue of equity shares	300	
Repayment of bank loan	(300)	
Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash (A+B+C)		100
Add: Cash at the beginning of the year		50
Cash at the end of the year		150

Cash Flow Statement (Direct Method) of ABC Ltd.

for the year ended 31st December 2006

	Rs '000	Rs '000
A. Cash flows from Operating Activities		
Cash receipts from customers	2800	
Cash payments to suppliers	(2000)	
Cash paid for wages and salaries	(100)	
Cash paid for overhead expenses	(200)	
Income tax paid	(250)	
Net cash from operating activities		250

B. Cash flows from Investing Activities		
Purchase of fixed assets for cash	(200)	
Proceeds from sale of fixed assets	100	
Net cash used in investing activities		(100)
C. Cash Flows from Financing Activities		
Proceeds from issue of equity shares	300	
Payment of bank loan	(300)	
Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash (A+B+C) i.e. Net cash from activities		100
Cash at the beginning		50
Cash at the end		150

Illustration 4

From the following information, you are required to prepare the cash flow statement of Classic Ltd. for the year ended 31st March (both methods):

Balance Sheet
as at 31st March 2006

Liabilities	2005	2006	Assets	2005	2006
	Rs.	Rs.		Rs.	Rs.
Share Capital	70,000	70,000	Fixed Assets	50,000	91,000
Secured Loans	-	40,000	Inventory	15,000	40,000
Creditors	14,000	39,000	Debtors	5,000	20,000
Tax payable	1,000	3,000	Cash	20,000	7,000
Profit & Loss A/c	7,000	10,000	Prepaid expenses	2,000	4,000
	92,000	**162,000**		**92,000**	**162,000**

Profit and Loss Account
for the year ended 31st March 06

Dr. **Cr.**

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
Opening Stock	15,000	Sales	100,000
Purchases	98,000	Closing Inventory	40,000
Gross profit c/d	27,000		
	1,40,000		**1,40,000**
General Expenses	11,000	Gross profit b/d	27,000
Depreciation	8,000		
Provision for tax	4,000		
Net Profit c/d	4,000		
	27,000		27,000
Dividend (interim)	1,000	balance b/d	7,000
balance c/d	10,000	Net profit b/d	4,000
	11,000		**11,000**

Solution:

Cash Flow Statement (Direct Method)
for the year ended, March 31, 2006

Particular	Amount Rs.	Amount Rs.
(A) Cash Flow from Operating Activities		
Cash receipts from Debtors (see Debtors A/c)		85,000
Cash payment for :		
Cash paid to suppliers (see creditors A/c) (73,000)	(73,000)	
General expenses	(13,000)	(86,000)
Cash from operating activities		(1,000)
Taxes paid		(2000)
Net Cash outflow from operating activities		(3,000)
(B) Cash flow from Investing Activities		
Purchase of fixed Assets	(49,000)	
Net cash used in investing Activities		(49,000)
(C) Cash flow from Financing Activities		
Proceeds from Raising secured loans	40,000	
Dividend paid	(1,000)	
Net cash from Financing Activities		39,000
Net Decrease in cash (– 3000 – 49000 + 39000)		(13,000)
[A + B + C]		

Working Notes:

Dr. **Debtors A/c** **Cr.**

Particulars	Amount	Particulars	Amount
	Rs		Rs
To Balance b/d	5,000	By Cash A/c (Received)	85,000
(Bal. Fig.)			
To Sales A/c (Credit)	1,00,000	By Balance c/d	20,000
	1,05,000		1,05,000

Dr. **Creditors A/c** **Cr.**

Particulars	Amount	Particulars	Amount
	Rs		Rs
To Cash A/c	73,000	By Balance b/d	14,000
(Bal. Fig.)			
To Balance c/d	39,000	By Purchases A/c	98,000
	1,12,000		1,12,000

Dr. **Fixed Assets A/c** **Cr.**

Particulars	Amount	Particulars	Amount
	Rs		Rs
To Balance b/d	50,000	By Depreciation	8,000
To Purchase of fixed asset	49,000	By Balance c/d	91,000
	99,000		99,000

Cash flow Statement (Indirect Method)
For the year ended March, 31, 2006

Particulars	Rs.	Rs.
(A) Cash flow from Operating Activities :		
Net profit as per Profit and Loss A/c		4,000
Add : Provision for Tax (See provision for Tax Account)		4,000
Net profit be fore Tax		8,000
Add : Depreciation		8,000

Operating profit before working		
Capital Changes		16,000
Add : Decrease in Current Assets or		
Increase in Current liabilities		
Increase in Creditors	25000	
Less : Increase in current assets or Decrease in Current liabilities		
Increase in Debtors	(15000)	
Increase in Inventory	(25000)	
Increase in prepaid expenses	(2,000)	(17000)
Cash from Operating Activities		(1,000)
Taxes paid		(2,000)
Net cash from Operating Activities		(3,000)
(B) Cash flow from Investing Activities :		
Purchase of Fixed Assets (See fixed assets)	(49000)	
Net cash used in Investing Activities		(49000)
(C) Cash Flow from financing Activities		
Proceeds from Raising Secured loan	40000	
Dividend paid	(1000)	
Net Cash flow from Financing Activities		39000
Net Decrease in Cash a Cash equivalent		(13000)

Working Notes:

1. Fixed Assets A/c

Dr.			Cr.
Particulars	**Amount**	**Particulars**	**Amount**
	Rs.		**Rs.**
To Balance b/d	50,000	By Depreciation A/c (Given)	8,000
To Cash A/c (Purchases) (Bal. fig.)	49,000	By Balance C/d	91,000
	99,000		99,000

2. Provision for Tax Account (Tax Payable A/c)

Dr.			Cr.
Particulars	**Amount**	**Particulars**	**Amount**
	Rs		**Rs**
To Cash A/c (Tax paid)	2,000	By Balance c/d	1,000
(Bal Fig) To Balance c/d (Given) (Provision made during the year)	3,000	By Profit & loss A/c	4,000
	5,000		5,000

13.17 Summary

Funds flow statement is an analytical tool in the hands of financial manager. The basic purpose of this statement is to indicate on historical basis the changes in the working capital i.e. where funds came from and where they are used during a given period.

Cash flow statement is a statement of sources and use of cash and cash equivalents in an enterprise during a specified period of time. A cash flow statement, summarises the causes of changes in cash position of a business enterprise between dates of two balance sheets.

13.18 Key Words

- **Net Working Capital** Net working capital means difference between current assets and current liabilities.
- **Flow of Funds** Flow of funds refers to increase or decrease in net working capital.
- **Cash Flow** Inflows and outflows of cash and cash equivalents.

- **Cash Equivalents** Cash equivalents are short term highly liquid investments that are readily convetible into cash and their maturity so near that they present insignificant risk of changes in value and interest rates.

13.19 Self Assessment Test

1. Explain the meaning of funds flow statement. What are its main objectives?
2. What are the various sources and uses of funds?
3. The following are the summarised Balance Sheets of Pratiksha Limited as on 31st December, 2004 and 31st December, 2005 respectively :

Assets	(Rs. in Thousands)	
	2004	2003
Freehold Property at cost	33.00	24.00
Plant and Machinery (cost less Dep.)	20.80	60.30
Inventories	30.35	32.85
Sundry Debtors	20.10	24.75
Cash and Bank	9.25	16.80
Preliminary Expenses	1.20	0.60
	114.70	159.30
Liabilities		
Issued Share Capital	60.00	75.00
Share Premium Account	-	5.00
Capital Reserve	-	17.00
Profit and Loss Account	21.50	21.20
Sundry Creditors	27.20	32.60
Proposed Dividend	6.00	8.50
	114.70	159.30

No Plant and Machinery was sold during 2005. Depreciation written off during 2005 was Rs. 7,500. Net profit for the year was Rs. 8,200. Rs 6,000 dividend was paid during 2005 in resect of previous year. Capital Reserve represents profit on sale of freehold premises.

Answer : Increase in working capital Rs. 9,300 ; Funds from Operations Rs. 16,300; Total of Funds Flow Statement Rs. 62,300; Sale of Freehold Property Rs. 26,300. Purchase of plant an Machinery Rs. 47.00]

4. What is a cash Flow Statement? How does it differ from the Funds Flow Statement?
5. Following are the comparative Balance Sheets of Asian Paints Limited as on 31st December, 2004 and 31st December 2005 :

Liabilities	2004	2005	Assets	2004	2005
	Rs.	Rs.		Rs.	Rs.
Equity Share Capital	2,00,000	2,00,000	Land	10,000	10,000
Profit and Loss A/c. (Cr.)	23,500	52,000	Building (at cost)	75,000	90,000
Debentures	40,000	35,000	Mahinery (at cost)	25,000	40,000
Outstanding Expenses	3,500	4,500	Investments (Long-tem)	50,000	30,000
Creditors	33,000	40,000	Stock	32,000	40,000
Accumulated Depreciation			Debtors	80,000	90,000
Machinery	3,000	7,500	Prepaid Expenses	2,000	2,000
Building	12,000	18,000	Cash	43,000	58,000
Prov. for Doubtful Debts	2,000	3,000			
	3,17,000	3,60,000		3,17,000	3,60,000

Additional Information

(i) Dividend paid during 2005 was Rs. 26,500.

(ii) Investments Costing Rs. 20,000 were sold in 2005 for Rs. 25,000.

(iii) Machinery costing Rs. 5,000 on which Rs. 1,000 depreciation was accumulated, was sold for Rs. 6,000 in the year 2005.

(iv) The provision for doubtful debts charged to profit was Rs. 1,500.

Prepare a Cash Flow Statement for the year 2005.

[Answer : Cash from Operating Activities Rs. 50,500; Investing Activities Rs. (4,000); Financing Activities Rs. (31,500)]

6. The following are the balance sheets of Swaraj Ltd. for the year ended 31st March, 2005 and 2006. Prepare a Cash Flow Statement for the year 2005-06.

Balance Sheet

Liabilities	31.3.05 Rs.	31.3.06 Rs.	Assets	31.3.05 Rs.	31.3.06 Rs.
Share Capital	1,00,000	2,00,000	Goodwill	15,000	10,000
General Reserve	63,250	68,250	Plant	1,50,000	2,40,000
Depreciation Fund	50,000	55,000	Land & Buildings	20,000	40,000
Debentures	50,000	-	Debtors	75,000	80,000
Sundry Creditors	1,22,750	1,14,850	Stock	1,08,000	60,000
Accrued Expenses	9,000	18,000	Bank Balance	29,000	28,000
Provision for Tax	5,000	5,400	Prepaid	3,000	3,500
			Insurance		
	4,00,000	**4,61,500**		**4,00,000**	**4,61,500**

Additional Information:

1. Sales for the year 2005-06 amounted to Rs. 10,50,000. In arriving at the Net Profit, items deducted from the sales includes among others : Cost of goods sold Rs. 8,25,000; Depreciation on Plant Rs. 25,000; Wages and salaries Rs. 1,00,000; and a profit of Rs. 5,000 on sale of a plant. The machinery was sold for Rs. 15,000 and had a cost of Rs. 30,000 (accumulated depreciation Rs. 20,000).
2. The Company declared and paid dividends of Rs. 30,000.
3. Debentures were redeemed for Rs. 49,000.

[Answer : Cash from Operating Activities Rs. 1,03,000; Investment Activities Rs. (1,25,000); Financing Activities Rs. 21,000]

13.20 Reference Books

1 Maheshwari S.L., *Management Accounting.*

2 Maheshwari Mittal, *Management Accounting.*

3 Agarwal and Agarwal, *Management Accounting.*

Unit- 14

Budgets and Related Report

Outline of the Unit

14.0. Objectives

14.1 Introduction

14.2 Meaning of Budget and Budgeting

14.3 Definitions

14.4 Essentials of Effective Budgeting

14.5 Characteristics of Budgetary Control

14.6 Objectives of Budgetary Control

14.7 Advantages of Budgetary Control

14.8 Limitations of Budgetary Control

14.9 Budget Control Process

14.10 Types of Budgets

14.11 Summary

14.12 Key Words

14.13 Self Assessment Test

14.14 Reference Books

14.0 Objectives

The study of this unit will enable you to understand:-

- The concept meaning and definition of budget and budgetary control.
- Objectives, Characteristics, Advantages and Disadvantages of Budgetary Control.
- Budgetary Control Process
- Types of Budgets.

14.1 Introduction

The efficiency of management depends upon the accomplishment of the goals of an organization. It is effective when it attains the objective with least cost and effort. A systematic approach for attaining effective management performance is budgeting, which is on integral part of management. This is the process of pre- estimation of cost, revenue, profit and other figures for the next year or period and on the basis, actual expenses incurred revenue generated/earned. Afterwards budget is used as a standard for measuring actual performance. The deviations are found out and responsibility is fixed for deviations. Various budgets are prepared for different purposes.

14.2 Meaning of Budget and Budgeting

In our routine life we prepare budgets for matching the expenses with income and available funds can be invested in business. Likewise, in business, budgets are prepared on the basis of future estimated cost, revenue, profit etc. Budget is a financial or quantitative statement prepared prior to a defined period of time for the purpose of execution of management, policies for accomplishing the given goal. It is a tool of

plan as the making of budget is nothing else but an advance planning. It provide standards by which actual operations can be evaluated to know variations from planned expenditure, profits.

Budgeting is the formulation of plans for the future activities of a business after careful consideration of goals. It provides yardsticks by which deviations from achievements can be measured. It helps in remaining unproductive activities and intimation of waste because preparation of budgets involves careful analysis of different phases of business, it is a tool of control as it fixes the individual responsibilities for fulfilling the plan.

Budgetary Control is a technique which uses budgets as a means of controlling all business aspects and is designed to assist management. In allocation of responsibility and authority, measurement of actual performance, analysis of variance between actual and budgeted.

Budgeting process includes - Budget and Budgetary control. Budget is means and budgetary control is the end result.

14.3 Definitions

The major definitions of budget are as follows-

1. **C.I.M.A. (England)** "Budget is financial and/or quantitative statement prepared prior to a defined period of time of the policy to be pursued during that period for the purpose of attaining a given object"
2. **Heman. C. Heises** "Budget is overall blueprint of comprehensive plan of operations and actions expressed in financial terms."
3. **Bartzal** " A budget is forecast in detail, of the results of an officially reorganized programmed of operations based on the highest reasonable expectation of operating efficiency"

The prominent definition of budgetary control is as under-

1. **C.I.M.A., England** "Budgetary control is the establishment of budgets relating to the responsibilities of executives to the requirement of a policy and the continuous comparison of actual with budgeted results either to secure by individual action the objectives of that policy or to provide a basis for its revision.
2. **J. Batty** "Budgetary control is a system which uses budgets as a means of planning and controlling all aspects of producing and selling commodities or service.
3. **Welsch** "Budgetary control is the use of budgets and budgetary reports throughout the period to co-ordinate, evaluate and control day to day operations in accordance with the goals specified by the budget."

14.4 Essentials of Effective Budgeting

The essential components of successful budgeting system are as under:-

(a) There must be full support by every member of top management without which no system can be effective.

(b) There should be a well defined responsibility center within the organization with clearly shown controllable cost for each such center.

(c) The business policies of organization must be clearly defined as budget are based on such policies.

(d) The accounting system must be complete in all regards from which reliable historical data is taken

which form basis for preparing budgets.

(e) The budgets must be reasonable so that responsible executives may agree. For this formation of budgets should be handed over to those executives by whom such budgets are to be used.

(f) The ultimate goal is maximizing profit through budget system so it should not cost more than its worth.

14.5 Characteristics of Budgetary Control

The major characteristics of budgetary control are as under:-

(1) Budgetary control implies the planning of activities as a plan cover all phases of operation for definite period.

(2) Budgetary control assists the management in co-coordinating their efforts in attaining the objectives of the organization.

(3) Budgetary control is a control tool aimed at keeping management, informed that whether predetermined plans are achieved or not.

(4) Budgetary control makes appraisal to find out variances by comparing actual with budgeted ones and fixing responsibilities.

(5) Budgetary control follow-up to make corrective measure and modify targets.

14.6 Objectives of Budgetary Control

The following are objectives of budgetary control.

(a) To run production activities in efficient manner by leaving behind the chances of interruption in production due to lack of any article.

(b) To control the cost and increase revenue, so as to know project at different stages of production.

(c) To bring economy by comparing actual data with budgeted data so that timely corrective actions can be taken.

(d) To predict short-term and long term financial positions for better financial position and management of working capital in a better manner.

14.7 Advantages of Budgetary Control

It is well known fact that a planned activity has better chances of success than unplanned one. The budgeting is forward planning and effective control following are advantage of budgetary control.

(a) Budget preparation involves participation of management at all levels of organization which brings co-operation and team spirit.

(b) It acts as tool for periodical evaluation of managerial policies and appraisal of performance of individual and department. So that corrective action can be taken in time to improve efficiency.

(c) Budgetary Control inspires management to develop a sense of care and caution before making decisions.

(d) Budgetary Control contributes to national economy by providing stability of employment, economic use of resources & effective prevention of waste.

(e) Budgetary control provide for self - examination and self- criticism which is indispensable for the success of organization.

14.8 Limitations of Budgetary Control

Although Budgetary Control is desirable to an organization but it has certain limitations which are as under:-

(a) Budgetary control faces objections by employees as the performance of employees is judged continuously.

(b) It requires the experienced and technical man-power, which is costly affair.

(c) Budgeting is an elaborate process which is time consuming affair.

(d) Budgetary control loses its usefulness due to rigidity, if budgets are not revised regularly with changing business environment.

(e) Forecasting, planning or budgeting is estimation not exact science and certain amount of judgment is present in budgeting.

14.9 Budget Control Process

For preparing an efficient budget, there is an urgent need of well-versed system for preparing the budget. This process is required an efficient system of implementation within the organization. The main essentials of establishment of system of budgeting are:

1. **Budget Centres** Budget centre are defined as various sections of an organization, where budgetary control measures are to be applied and for the purpose, separate budgets are to be prepared with the help of the head of these centers so that these may be executed more efficiently.
2. **Budget Committee** The budget committee is a group of representatives of various interrelated function in an organization, e.g. Sales manager, Production Manager, R&D Manager, Materials Manager, etc. It is necessary to discuss the targets so that a mutually agreed programmed can be determined. This is really the co-ordination in budget making. It is a powerful force in knitting together the various activities of the business and enforcing real control over operations.
3. **Budget Officer** To link up the various functions, to bring them together and to co- ordinate their efforts in the matter of preparation to target figures, there should be a person called budget Officer or Budget controller. He is enabling to provide ready data relating to all the functions. He helps in preparation of the various budgets and their co-ordinations and compilation into the master budget, bringing to the notice of the management the need for revision of budgets and assisting them in the task.
4. **Budget Manual** Budget manual is defined as a document which sets outstanding instructions, the responsibility of the persons engaged in, and the procedures, forms and records relating to the preparation and use of budgets. It is a booklet of budget policies which lays down the details of the organizational set up with duties and responsibilities of executives including the budget committee and budget officer and procedures to be followed for developing budget in respect of various activities.
5. **Budget period** This is the period for which forecasts can reasonably be made and budgets can be formulated. Budget periods vary between short-term and long -term and no specific period can be laid down for all budgets. The length of the budget period depends on the type of the business, the length of the manufacturing cycle from raw material to finished products, the ease or difficulty of forecasting future market conditions and other factors.
6. **Budget Key Factor or Determining Principal Budget Factor** The key factor is also known as

limiting factor, governing factor, etc. and may be defined as the factor which at particular time or over a period will limit the activities of and undertaking. The limiting factor is, usually, the level of demand for the products or services of the undertaking, but it could be a shortage of one of the productive resources, e.g. skilled labor, raw material, or machine capacity etc. The key factor is normally temporary in nature. In the long run, they can be overcome by proper planning and management action.

7. **Forecasting** Forecasting is the statement of events likely to occur. It is usually the practice to judge the accuracy of forecasts on the basis of actual performance, taking the latter to be correct. A forecast forms the basis for the budget. A budget indicates a target and it is a statement of planned events, evolved from forecast.
8. **Determining Level of Activity** The level of activities are determined on the basis of information and estimates provided regarding future conditions and activities of market and position of product in the market by departmental heads or concerned managers, for this purpose, detailed discussions, analysis, preparation of reports are to be done and then written report to be formed and submitted to budget committee for their decision making.
9. **Preparation of Budget** The budget should be prepared by the manager who is responsible for meeting the budgeted performance after discussing all the factors which may affect the process of budgeting. The budget should originate at the lowest levels of management and be refined and co- ordinated at higher levels. This will enable managers to participate in the preparation of their budgets and increase the probability that they will accept the budget and strive to achieve the budgeted targets.

14.10 Types of Budgets

Budgets can be classified into different categories on the basis of time, functions or flexibility. The different budgets covered under each category are shown in the following chart:

13.10.1 Classification of Budgets

Time	Function	Flexibility
• Long-term	• Sales	• Fixed
• Shrot-term	• Production	• Flexible
• Current	• Cost of Production	
	• Purchase	
	• Personnel	
	• Research	
	• Capital Expenditure	
	• Cash	
	• Master	

14.10.2 Classification According to Time

The Budget, on the basis of time, may be classified as:

1. **Current Budget** The budget prepared for a period of a week, a month, or a quarter is termed as a current budget. They are essentially short-term budgets adjusted to current conditions or prevailing circumstances.
2. **Short Term Budget** The budget prepared for a period of less then 5 year is short term budget.

Generally short term budgets are prepared for a period of one to two years. They are generally prepared in terms of physical as well as in monetary units.

3. **Long - Term Budget** A budget designed for a long period is termed as long term budget. The period generally is of 5 to 10 years. These budgets are concerned with planning of the operations of a firm over a considerably long period of time. They are generally prepared in terms of physical quantities.

14.10.3 Classification According to Function

Budgets can be classified on the basis of functions, they are meant to perform. Different types of budgets under this head are as follows:

1. **Sales Budget**: - This is the most important budget on which all other budgets are based. The sales manager is responsible for preparation and execution of the budget. The budget forecasts total sales in terms of quantity, value, items, periods, areas etc. Normally it is called as Key Folder Budget utmost cases sales is a governing factor for a manufacturing concern.

Activity
Normally which budget is treated as key factor budget?

Illustration :1

Shri Ram and Delhi Manufacturers make two types of toys, Bunty and Babli and sell them in Jaipur and Delhi markets. The followings information is made available for the current year 2009-2010:

Places/Markets	Type of Toys	Budgeted Sales 2009-2010	Actual Sales 2009-2010
Jaipur	Bunty	400 at Rs. 9 each	500 at Rs. 9 each
	Babli	300 at Rs. 21 each	200 at Rs. 21 each
Delhi	Bunty	600 at Rs. 9 each	700 at Rs. 9 each
	Bubli	500 at Rs. 21 each	400 at Rs. 21 each

Market studies reveal that toy Bunty is popular as it is under priced. It is observed that if its price is increased by Rs. 1 it will find a ready market. On the other hand, Babli over-priced and the market could absorb more sales if its selling price is reduced to Rs. 20. The management has agreed to give effect to the above price changes.

On the above basis, the following estimates have been prepared by the sales manager:

Product	% increase in Sales Over Current Budget	
	Jaipur	Delhi
Bunty	+10%	+5%
Babli	+20%	+10%

With the help of an intensive advertisement campaign, the following additional sales above the estimated sales are possible:

Product	Jaipur	Delhi
Bunty	60 Units	60 Units
Babli	40 Units	50 Units

You are required to prepare a budget for sales incorporating the above estimates.

Solution

Budgetd for the year		2009-2010			Actual Sales 2009-2010			Budget for the future		
Place	Product	Units	Price Rs.	Value Rs.	Units	Price Rs.	Value Rs.	Units	Price Rs.	Value Rs.
Jaipur	Bunty	400	9	3600	500	9	4500	500	10	5000
	Babli	300	21	6300	200	21	4200	400	20	8000
	Total	**700**	-	**9900**	**700**	-	**8700**	**900**	-	**13000**
Delhi	Bunty	600	9	5400	700	9	6300	700	10	7000
	Babli	500	21	10500	400	21	8400	600	20	12000
	Total	**1100**	-	**15900**	**1100**	-	**14700**	**1300**	-	**19000**
Total	Bunty	1000	9	9000	1200	9	10800	1200	10	12000
	Babli	800	21	16800	600	21	12600	1000	20	20000
	Total	**1800**	-	**25800**	**1800**	-	**23400**	**2200**	-	**32000**

Working Note:-

(i) Calculation of Budget Estimates

	Jaipur	Delhi
Bunty Budgeted	400	600
Increase	40(+10%)	30(+5%)
	440	630
Advertisement effect	60	70
	500	700
Babli Budgeted	300	500
Increase	60(+20%)	50(+10%)
	360	550
Advertisement effect	40	50
	400	600

2. **Production Budget** The budget is basically based on sales budget. It forecasts quantity of production in terms of items, periods, areas, etc. The works manager is responsible for the preparation of overall production budget and departmental works manager is responsible for departmental production budgets.

Illustration :2

Suraj Manufacturing Company wishes to prepare a production budget in respect of three products A,B, and C, the sales farecast for which is 80,000 units, 72,000 units and 85,000 units respectively. The estimated requirement of inventory both at the beginning and at the end of the budget period are shown in the following Schedule:

Inventory Schedule

	A	B	C
Ist January (Units)	16,000	12,000	20,000
3Ist December (Units)	20,000	11,000	27,000

You are required to prepare the Production Budget:

Solution:

Suraj Manufacturing Company
Production Budget
for the year ending 31st December

Particular	Products		
	A (Units)	B (Units)	C (Units)
Sales Budget	80,000	72,000	85,000
Add: Closing Inventory	20,000	11,000	27,000
Total Units required	1,00,000	83,000	1,12,000
Less: Opening Inventory	16,000	12,000	20,000
Planned Production	84,000	71,000	92,000

3. **Purchase Budget:** The budget forecasts the quantity and value of purchases required for production. It gives quantity-wise and period-wise information about the materials to be purchased. It correlates with sales forecast and production planning.

Budgeted purchase Quantity = Budgeted consumption Quantity + Required closing Stock - Opening Stock

Illustration:3

The following information relates to a manufacturing company:

Targeted sales of product P 2,00,000 units. Each unit of product P requires 3 units of material X and 4 units of material Y.

Estimated opening balance at the commencement of the next year.

Finished Product : 40,000 units
Material X : 48,000 units
Material Y : 60,000 units

The desirable closing balances at the end of the next year are:

Finished Product : 56,000 units
Material X : 52,000 units
Material Y : 64,000 units

From the above information prepare a Material Budget.

Solution:

The number of units to be produced.

Opening Stock + Production = Sales + Closing Stock
Units to be produced = Sales + Closing Stock - Opening Stock
= 2,00,000+56,000-40,000
= 2,16,000 units

Material required:

Material A = 2,16,000 x 3 = 6,48,000 units
Material B = 2,16,000 x 4 = 8,64,000 units

Material Purchase Budget (Units)

Particular	Finished Product	Material required	
		X	Y
Budget Production	216000	648000	864000
Add: Opening Stock	+40000	(-) 48000	(-) 60000
Less: Closing Stock	256000	600000	804000
Estimated product for Sales	(-) 56000	(+) 52000	(+) 64000
Estimated Material required:	200000	652000	868000

4. **Personnel budget:** The budget anticipates the quantity of personnel required during a period for production activity. This may be further split up between direct and indirect personnel budgets.

5. **Cost of Production Budget:** It forecasts the cost of production. Separate budgets are prepared for different elements of costs such as direct materials budgets, direct labour budget, factory overheads budget, office overheads budget, selling and distribution overhead budget, etc.

Illustration: 4

The following information is abstracted form the books of Mahalaxmi Co. Ltd., for the six months of 2010 in respect of products XX.

The following units are to be sold in different months of the year 2010.

January	2200
February	2200
March	3400
April	3800
May	5000
June	4600
July	4000

There will be work in progress at the end of the month. Finished units are equal to half the sales of the next month's stock at the end of every month (including December, 2009). Budgeted production and production cost for the half-year ending 30th June, 2010 are as follows:

Production (Units)	40000
Direct material per unit	Rs. 5
Direct Wages per unit	Rs. 2

Factory Overheads apportioned to production Rs. 160000

You are required to prepare product Budget and production Cost Budget for the six months of the year 2010.

Solution:

Production Budget (in Units)							
	January	**February**	**March**	**April**	**May**	**June**	**Total**
Estimated Sales	2200	2200	3400	3800	5000	4600	
Add: Closing Stock	1100	1700	1900	2500	2300	2000	
	3300	3900	5300	6300	7300	6600	
Less: Opening stock	1100	1100	1700	1900	2500	2300	
Production	2200	2800	3600	4400	4800	4300	22100

Production Cost Budget

	(Production : 22,100 units) Rs.
Direct Material @ Rs. 5 for 22,100 units	1,10,500
Direct Wages @ Rs. 2 for 22,100 units	44,200
Factory Overheads @ Rs. 4 for 22,100 units (Rs. 1,60,000/40,000 units)	88,400
Total Production Cost	2,43,100

6. **Cash Budget:-** The budget is a forecast of the cash position, for a specific duration of time of different time periods. It states the estimated amount of cash receipts and cash payments and the likely balance of cash in hand at the end of different periods,

Method of preparing cash Budgets

There are basically three methods for preparing cash budgets.

1. Receipts And Payments Method
2. Adjusted Profit And Loss Account Method
3. Balance Sheet Method

Activity
A company wants to know future liquidity position, so that liquidity can be arranged. Which budget should be prepared by the company?

Illustration: 5

A company newly starting manufacturing operations on 1st January 2010 has made adequate arrangement for funds required for fixed assets. It wants you to prepare an estimate of funds required as working capital. It is to be remembered that:

(a) In the first month there will be no sale, in the subsequent month sale will be 25% cash and 75% credit. Customer will be allowed one month credit.

(b) Payments for purchase of raw materials will be made on one month credit basic.

(c) Wages will be paid fortnightly on the 22nd and 7th of each month.

(d) Other expenses will be paid one month in arrear except that 5% of selling expenses are to be paid immediately on sale being affected.

The estimated sales and expenses for the first six months, spread evenly over the period subject to (a) above are us under:

	Rs.		Rs.
Sales	360000	Administrative Expenses	54000
Material Consumed	150000	Selling Expenses	42000
Wages	60000	Depreciation on fixed assets	50000

The article produced is subject to excise duty equal to 10% of the selling price. The duty is payable on March 31, June 30, September 30, and December 31 for sales up to February 28, May 31, August 31

and November 30 respectively.

Prepare cash Budget for each of the six months indicating the requirement of the working capital.

Solution:

Cash Budget

For the six month ended on June 30, 2010

Particular	January Rs	February Rs.	March Rs.	April Rs.	May Rs.	June Rs.
Receipts:						
Opening Balance	-	(-)7500	(-) 45000	(-) 39200	(-) 26200	(-)13200
Cash Sales	-	18000	18000	18000	18000	18000
Receipts from customer	-	-	54000	54000	54000	54000
Cash Available (A)		**10500**	**27000**	**32800**	**45800**	**58800**
Payments:						
Wages	7500	10000	10000	10000	10000	10000
Materials	-	25000	25000	25000	25000	25000
Manufacturing Exp.	-	8000	8000	8000	8000	8000
Administrative Exp.	-	9000	9000	9000	9000	9000
Selling Exp.	-	3500	7000	7000	7000	7000
Excise Duty	-	-	7200	-	-	21600
Total Payments(B)	**7500**	**55,500**	**66200**	**59000**	**59000**	**80600**
Closing Balance (A-B)	**(-) 7500**	**(-) 45000**	**(-) 39200**	**(-) 26200**	**(-) 13200**	**(-) 21800**

Note:- The company needs overdraft facility to the extent indicated above for every month.

Illustration: 6

The following data are available to you. You are required to prepare a cash budget according to Adjusted Profit and loss Method.

Balance Sheet As On 31st December, 2010

Liabilities	Amount Rs.	Assets	Amount Rs.
Share Capital	100000	Premises	50000
General Reserve	20000	Machinery	25000
Profit and Loss A/c	10000	Debtors	40000
Creditor	50000	Closing Stock	20000
Bills Payable	10000	Bills Receivable	5000
Outstanding Rent	2000	Prepaid Commission	1000
		Bank	51000
	192000		**192000**

Projected Trading and Profit and Loss Account
for the year ending 31st December, 2010

		Rs.		Rs.
To Opening Stock		20000	By Sales	200000
To Purchases		150000	By Closing Stock	15000
To Ocori		2000		
To Gross Profit C/d		43000		
		215000		**215000**
			By Gross Profit b/d	43000
		3000	By Sundry Receipts	5000
To Interest		6000		
To Salaries				
To Depreciation (10% on premises and Machinery)		7500		
To Rent	6000			
Less: Outstanding (Previous year)	2000			
	4000			
Add: outstanding (current year)	1000	5000		
	3000			
To Commission				
Add- Prepaid (Previous Year)	1000	4000		
To Office expenses		2000		
To Net profit c/d		1000		
		19500		
				48000
		48000		
To Dividends		8000	By Balance of Profit (from last year)	10000
		4000		19500
To Addition to Reserves				
To Balance c/d		17500		
		29500		**29500**

Closing Balance of Certain Items:

Share Capital Rs. 120000, 10% Debentures Rs. 3000, Creditors Rs. 40000, Debtors Rs. 60000 Bills Payable Rs. 12000, Bill Receivable Rs. 4000, Furniture Rs.15000 and Plant Rs. 50000 (Both these assets are purchased at the end of year).

Solution:

Cash Budget

For the period ending 31st December 2010

		Rs.	Rs.
Opening balance as on 1st January 2010			51000
Add:	Net profit of the Year	19500	
	Depreciation	7500	
	Decrease in Bill Receivable	1000	
	Increase in Bill Payable	2000	

	Issue of share Capital	20000	
	Issue of Debentures	30000	
	Decrease in Prepaid commission	1000	
	Decrease of Stock	5000	86000
			137000
Less:	Purchase of Plant	50000	
	Purchase of Furniture	15000	
	Increase of debtors	20000	
	decrease of Creditors	10000	
	Decrease in outstanding Rent	1000	
	Dividend Paid	8000	104000
	Closing Balance as on 31st December 2010		**Rs. 33000**

Illustration: 7

Prepare the cash Budget using Balance Sheet method on the basis of figures given in illustration 6.

Solution:

Budgeted Balance Sheet

as on 31st December, 2010

Liabilities	**Amount Rs.**	**Assets**		**Amount Rs.**
Shares Capital	120000	Premises	50000	
10% Debentures	30000	Less: Depreciation	5000	45000
General Reserve	24000	Machinery	25000	
(Rs. 20000 +Rs. 40000)				
Profit and Loss A/c	17500	Less: Depreciation	2500	22500
Creditors	40000	Furniture		15000
Bill Payble	12000	Debtors		60000
Outstanding Rent	1000	Bill Receivable		4000
		Plant		50000
		Closing Stock		15000
		Bal. (Balancing Figures)		33000
	244500			**244500**

7. **Capital Expenditure Budget:** The budget is the plan of the proposed outlay on fixed assets such as land, buildings, plant and machinery. The budget is prepared after taking into account the available productive capacities, probable reallocation of existing assets and possible improvement in production technique. etc.

Capital expenditure budget serves the following purposes:

(a) It facilitates long term planning and policy-making.

(b) It facilitates replacing the old machinery by latest machinery or to change the methods of production for reducing costs.

(c) It helps in the estimates of capital requirement after taking into account the disposable value of old assets.

(d) It helps in preparation of cash budget and also assessing the capital cost of improving working conditions or adopting safety measures, etc.

8. **Master Budget:** It is a summary budget incorporating all functional budgets in a capsule form. It interprets different functional budgets and covers within its range the preparation of projected income statement and projected balance sheet.

Illustration:8

A Glass Manufacturing Company requires you to calculate and present the budget for the next year from the following information.

Sales:

Toughened glass	Rs. 300000
Bent toughened glass	Rs. 500000
Direct material Cost	60% of sales
Direct Wages	20 Workers @ Rs 150 per month
Store and spares	2.5% on Sales
Depreciation on Machinery	Rs. 12600
Light and Power	Rs. 5000

Factory Overhead:

Indirect Labour:

Works Manager Rs. 500 per month

Foreman Rs. 400 per month

Repairs and maintenance 10% on direct wages

Administration, selling and distribution expenses Rs. 14000 per year.

Solution

Master Budget

For the period ending on.....

	Rs.	Rs.	Rs.
Sales (as per Sales Budget)			
Toughened Glass..... Units @ Rs.	300000		
Bent toughened glass ..... Units@ Rs	500000		800000
Less: Cost of Production (as per Cost of Production Budget):			
Direct Materials (..... Units @ Rs. ....)	480000		
Direct Wages	36000		
Prime Cost		516000	
Factory Overhead:			
Variable: Stores and Spares (2.5% of Sales)	20000		
Light and Power	5000		
Repair and Maintenance	8000	33000	
Fixed : Works Manager's Salary	6000		
Forman's Salary	4800		
Depreciation	12600		

Sundries	3600	27000	
Work Cost			576000
Gross Profit			224000
Less: Administration, Selling and Distribution Overhead			14000
			210000

14.10.3 Classification According to Flexibility

Budget can also be classified in the following categories:

1. **Fixed Budget:** A budget prepared on the basis of a standard or a fixed level of activity is called a fixed budget. It does not change with the change in the level of activity. If the output and sales do not fluctuate from year to year or if an accurate prediction of the same can be made, a fixed budget can be prepared.
2. **Flexible Budget:** A Budget designed in manner so as to give the budgeted cost of any level of activity is termed as a flexible budget. Such a budget is prepared after considering the fixed and variable elements of cost and the change that may be expected for each item at various levels of operation.

Illustration : 9

Prepare a flexible budget for production at 80% and 100% activity on the basis of the following information:

Production of 50% capacity	5000 Units
Raw Material	Rs. 80 Per Unit
Direct Labour	Rs. 50 Per Unit
Expenses	Rs. 15 Per Unit
Factory Expenses	Rs. 50,000 (50% fixed)
Administration Expenses	Rs. 60,000 (60% variable)

Solution

Flexible Budget

	Particular	Activity	
		80% (8000 Units)	100% (10000 Units)
		Rs.	Rs.
A	Fixed Expenses		
	Fixed factory expenses (50% of Rs. 50,000)	25,000	25,000
	Fixed Administrative expenses (40% of Rs. 60,000)	24,000	24,000
	Total	49,000	49,000
B	Variable Expenses		
	Material @ 80 Per Unit	6,40,000	8,00,000
	Labour @ 50 Per Unit	4,00,000	5,00,000
	Expenses @ 15 Per Unit	1,20,000	1,50,000
	Factory Expenses @ 5 Per Unit	40,000	50,000
	Administrative Expenses @ 4.80 Per Unit	57,000	72,000
	Total	13,06,600	15,72,000
	Total (A+ B)	13,55,600	16,21,000

Calculation of Factory Expenses per unit

Total - Fixed

$$\text{Rs. } 50,000 - 25,000 = \frac{25,000}{5,00} = @\ 5 \text{ Per Unit}$$

Calculation of Administrative Expenses per unit

$$\text{Rs. } 60,000 \times 60\% = \frac{36,000}{5,00} = @\ 7.20 \text{ Per Unit}$$

> Activity
>
> When production of a Factory has a variation, then which budget is suitable to know cost of production?

14.11 Summary

A budget is in the nature of an estimate for future actions to coordinate and control the use of resources for a specified period. It is used as a standard with which actual performance is measured. Budgeting is a process which includes both budget and budgetary control. Budget is a planning function and budgetary control is a system and technique which uses budgets as a means of controlling all aspects of the business and is designed to assist management in the measurement of actual performance, in the analysis of deviations from the budgeted targets and to evaluate performance and efficiency of the operations. A good budgeting system requires good organizational system with the lines of authority and responsibility clearly mentioned. The important essentials required for the establishment of a sound system of budgeting includes budget centers, budget committee, budget officer, budget manual, budget period, budget key factor, forecasting, determining level of activity and preparation of budget. Budget may be classified on the basis of time, function and flexibility.

Budgeting is the main instrument for projecting the future costs and revenues and for financial control of the organization. Preparation of budgets involves a number of forecasts or projections, it starts with sales forecasting and ends with the compilation of master budget.

14.12 Key Words

- **Budget:** A comprehensive and coordinated plan, expressed in financial terms, for the operations and resources of an enterprise for some specific period in the future.
- **Budgeting:** The process of preparing plans for future activities of business enterprise for attaining the objectives of an organization.
- **Budgetary control:** The establishment of budgets relating to the responsibilities of executives to the requirement of a policy and the continuous comparison of the actual with budgeted results either to secure by individual action the objectives of that policy or to provide a basis for its revision.
- **Budget key factor:** The factor which at a particular time or over a period will limit the activities of an undertaking.
- **Forecasting:** A statement of events likely to occur.
- **Master Budget:** A summary budget incorporating all functional budgets which is finally approved, adopted and employed.
- **Cash Budget:** A summary statement of future cash receipts and payments over a projected time period.

14.13 Self Assessment Test

1. "A budget is a means and budgetary control is the end result". Explain.
2. What is budgeting? What are the advantages and limitations of Budgeting?
3. What do you mean by Budgeting? Mention different types of budgets that a big industrial concern would normally prepare.
4. Write short notes on the following:
   (a) Sales Budget
   (b) Material Budget
   (c) Production Cost Budget
5. What is a Master Budget? What are its components?
6. From the following particulars, prepare a Production budget of a manufacturing company for year ended 31st March 2010:-

Product	Sales Budget (Units)	Estimated Stock (units)	
		01-04-2009	31-03-2010
A	7500	700	750
B	5000	250	725
C	3500	400	400

(Ans: A: 7550 Units, B: 5475 Units, C: 3500 Units)

7. Prepare a material procurement budget (in Units) from the following Information:

Estimated sales of product 40000 units. Each unit of the product requires 3 units of Material P and 4 units of Material Q Estimated opening balance at the Beginning of the next year:

	Units
Finished products	5000
Material P	19000
Material Q	31,000

The desired level of closing balances at the end of the next year:

Finished Product	7000
Material P	23,000
Material Q	35,000

(Ans. Production 42000 Units, Material required: Material P: 130000 Units, Material Q: 172000 Units)

8. A company produces and sells three products: Product X, Product Y and Product Z. The company has divided its market into two areas as East zone and West zone. The actual sales for the year 2010 were as follows:

Products	East Zone		West Zone	
	Price per unit (Rs.)	No. of units	Price per unit (Rs.)	No. of units
X	12	800000	12	500000
Y	15	500000	15	700000
Z	16	600000	16	600000

For the current year i.e. 2009, it is estimated that the sales of product X will go up by 10% in West zone and of product Z by 5000 Units in East zone. The company plans to launch an intensive advertisement campaign through which budgeted figures for product Y are to be increased by 20% in both the Zones.

There will be no change in the pries of the Product X and Z but price of product Y will be reduced by Rs. 1.

You are required to prepare a sales budget for the year 2010.

Ans:

	East Zone (Units)	**West Zone (Units)**	**Total Budget (Rs.)**
Product X	800000	550000	16200000
Product Y	600000	84000	20160000
Product Z	650000	600000	20000000

9. Jammu Co. Ltd. has three sales divisions at Jodhpur, Delhi, Patna. It sells two products-I and II. The budgeted sales for the year ending 31st December, 2009 at each place are given below:

Jodhpur	Product I	50000 units @ Rs. 16 each
	Product II	35000 units @ Rs. 10 each
Delhi	Product II	55000 Units @ Rs. 10 each
Patna	Product I	75000 Units @ Rs. 16 each

The actual sales during the same period were:

Jodhpur	Product I	62500 units @ Rs. 16 each
	Product II	37500 units @ Rs. 10 each
Delhi	Product II	62500 Units @ Rs. 10 each
Patna	Product I	77500 Units @ Rs. 16 each

From the reports of the sales department it was estimated that the sales budget for the yea ending 31st December 2010 would be higher than 2009 budget in the following.

Jodhpur	Product I	4000 Units
	Product II	2500 Units
Delhi	Product II	6500 Units
Patna	Product I	5000 Units

Intensive sales campaign in Delhi and Patna is likely to result in additional sales of 12500 units of product I in Delhi and 9000 Units of product II in Patna. Let us prepare a sales budget for the period ending 31st December 2010.

(Ans:)

Jodhpur	Product I	54000 Units
	Product II	37500 Units
Delhi	Product I	12500 Units
	Product II	61500 Units
Patna	Product I	80000 Units
	Product II	9000 Units)

10. Draw a Material Procurement Budget (Quantitative) from the following information:

Estimated sales of a product are 20000 units. Each units of the product requires 3 Units of material X and 5 Units of Material Y.

Estimated opening balance at the commencement of next year:

Finished Product	2500 Kgs.
Material X	6000 Units
Material Y	10000 Units
Material on Order:	
Material X	3500 Units
Material Y	5500 Units

The desirable closing balance at the end of the next year:

Finished Product

3500 Units

Material X	7500 Units
Material Y	12500 Units
Material on order:	
Material X	4000 Units
Material Y	5000 Units

11. A company is expecting to have Rs. 500000 cash in hand on 1st April, 2010 and it requires you to prepare an estimate of cash position during the three months, April to June 2010. The following information is supplied to you:

	Sales	Purchase	Wages	Expenses
February	1400000	800000	160000	120000
March	1600000	1000000	160000	140000
April	1840000	1040000	180000	140000
May	2000000	1200000	200000	160000
June	2400000	1100000	240000	180000

Additional Information:

(a) The credit period allowed by supplies is two months.

(b) 25% of sales is for cash and credit period allowed to customers is one month.

(c) Delay in payment of wages and expenses is one month.

(d) Income tax Rs. 500000 is to be paid in June 2010.

(Ans: April Rs. 1060000, May Rs. 1620000, June Rs. 1820000)

12. From the following information, you are required to prepare cash budget according to Adjusted Profit and Loss method as well as Balance Sheet Method.

Balance Sheet as on 01-01-2010

Liabilities	Rs.	Assets	Rs.
Share capital	50000	Debtors	500000
Reserves	1000000	Stock & Store	300000
Debentures	300000	Fixed assets	1300000
Public deposits	200000	Cash balance	100000
Current liability	200000		
	2200000		**2200000**

Projected Trading and Profit and Loss A/c for the year ending 31-12-2010

Particular	Rs.	Particular	Rs.
To Opening Stock	300000	By Sales	1500000
To Direct Cost of production	1200000	By closing Stock	600000
To Depreciation	100000		
To variable selling and distribution costs	200000		
To net profit c/d	300000		
	2100000		**2100000**
To Dividends	50000	By net profit b/d	300000
To Balance c/d	250000		
	300000		**300000**

Additional Information:

Collection of debtors and sales proceeds during the year Rs. 1700000, refund of public deposits Rs. 100000 increase in current liability Rs. 50000.

(Ans: Cash balance as on 31.12.2010: Rs. 300000, Debtors as on 31.12.2010: Rs. 300000 (opening debtors Rs. 500000+sales Rs. 1500000- Collection form debtors Rs. 1700000)

14.14 Reference Books

1 Agrawal , Sharma, Agrawal, Shah & Agrawal, *Financial Accounting and Decision Making.*

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