

COURSE NOTES FOR Bachelor Computer Applications

Second Semester

Subject : Financial Accounting & Management

as per syllabus of



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Microtek College of Management & Technology
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Course Code Syllabus

BCA-S109 Financial Accounting & Management

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Overview - Meaning and Nature of Financial Accounting, Scope of Financial Accounting, Financial Accounting & Management Accounting, Accounting concepts & convention, accounting standards in India.

UNIT-II

Basics of accounting – Capital & Revenue items, Application of Computer in Accounting, Double Entry System, Introduction to Journal, Ledger and Procedure for Recording and Posting, Introduction to Trial Balance, Preparation of Final Account, Profit & Loss Account and related concepts, Balance Sheet and related concept.

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Financial statement analysis: Ratio analysis, Funds flow analysis, concepts, uses, Preparation of funds flow statement - simple problems, Cash flow analysis, Concepts, uses, preparation of cash flow statement- simple problems, Break – even analysis.

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Definition nature and Objective of Financial Management, Long Term Sources of Finance, Introductory idea about capitalization, Capital Structure, Concept of Cost of Capital, introduction, importance, explicit & implicit cost, Measurement of cost of capital, cost of debt.

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UNIT-I

Overview - Meaning and Nature of Financial Accounting:

Accounting has got a very wide scope and area of application. Its use is not confined to the business world alone, but spread over in all the spheres of the society and in all professions. Now-a-days, in any social institution or professional activity, whether that is profit earning or not, financial transactions must take place. So there arises the need for recording and summarizing these transactions when they occur and the necessity of finding out the net result of the same after the expiry of a certain fixed period. Besides, there is also the need for interpretation and communication of those information to the appropriate persons. Only accounting use can help overcome these problems.

In the modern world, accounting system is practiced not only in all the business institutions but also in many non-trading institutions like Schools, Colleges, Hospitals, Charitable Trust Clubs, Co-operative Society etc. and also Government and Local Self-Government in the form of Municipality, Panchayat. The professional persons like Medical practitioners, practicing Lawyers, Chartered Accountants etc. also adopt some suitable types of accounting methods. As a matter of fact, accounting methods are used by all who are involved in a series of financial transactions.

Nature of Accounting:

We know Accounting is the systematic recording of financial transactions and presentation of the related information of the appropriate persons. The basic features of accounting are as follows:

1. Accounting is a process: A process refers to the method of performing any specific job step by step according to the objectives, or target. Accounting is identified as a process as it performs the specific task of collecting, processing and communicating financial information. In doing so, it follows some definite steps like collection of data recording, classification summarization, finalization and reporting.
2. Accounting is an art: Accounting is an art of recording, classifying, summarizing and finalizing the financial data. The word 'art' refers to the way of performing something. It is a behavioral knowledge involving certain creativity and skill that may help us to attain some specific objectives. Accounting is a systematic method consisting of definite techniques and its proper application requires applied skill and expertise. So, by nature accounting is an art.
3. Accounting is means and not an end: Accounting finds out the financial results and position of an entity and the same time, it communicates this information to its users. The users then take their own decisions on the basis of such information. So, it can be said that mere keeping of accounts can be the primary objective of any person or entity. On the other hand, the main objective may be identified as taking decisions on the basis of financial information supplied by accounting. Thus, accounting itself is not an objective, it helps attaining a specific objective. So it is said the accounting is 'a means to an end' and it is not 'an end in itself.'
4. Accounting deals with financial information and transactions; Accounting records the financial transactions and date after classifying the same and finalizes their result for a definite period for conveying them to their users. So, from starting to the end, at every stage, accounting deals with financial information. Only financial information is its subject matter. It does not deal with non-monetary information of non-financial aspect.
5. Accounting is an information system: Accounting is recognized and characterized as a storehouse of information. As a service function, it collects processes and communicates financial information of any entity. This discipline of knowledge has been evolved out to meet the need of financial information required by different interested groups.

Accounting & Management Accounting:

The process of preparing management reports and accounts that provide accurate and timely financial and statistical information required by managers to make day-to-day and short-term decisions.

Unlike financial accounting, which produces annual reports mainly for external stakeholders, management accounting generates monthly or weekly reports for an organization's internal audiences such as department managers and the chief executive officer. These reports typically show the amount of available cash, sales revenue generated, amount of orders in hand, state of accounts payable and accounts receivable, outstanding debts, raw material and inventory, and may also include trend charts, variance analysis, and other statistics.

Accounting concepts & convention:

Accounting Concepts are the assumptions and conditions on the basis of which financial statements of an entity are prepared. These are the concepts which are adopted by the organizations in preparation of financial statements to achieve uniformity in reporting. Accounting concepts are the base for formulation of accounting principles. Accounting concepts have universal application. Here I'm going to discuss some basic details about these concepts.

(1) Entity concept :

Entity concept assumes that business Enterprise is separate from its owners. Accounting transactions should be recorded with this concept only. The main intention of this concept is to keep the business transactions keep away from the influence of personal transactions of its owners.

(2) Periodicity Concept :

As per going concern concept an entity is assumed to have indefinite life. If we want to measure the financial performance of an entity then we need to divide the operations of entity for a specific period, otherwise it's very difficult to ascertain the performance of business.

Periodicity concept assumes a small but workable fraction of time period for measuring the business performance. Generally it assumes 1 year is taken for this purpose.

(3) Money measurement concept :

As per this concept transactions which can be measured in monetary terms only are to be recorded in books of accounts. Any transactions which can not be converted into monetary terms should not be recorded in books. Since money is the medium of exchange and unit of measurement for showing the financial performance, it doesn't accept the transactions other than monetary to record in books of accounts.

(4) Accrual concept :

As per this concept transactions should be recognized in the books of accounts only when they occur and not on any cash basis. The main advantage of this concept is that financial Statements prepared as per this concept inform the users not only about past events involving payment and receipt of cash but also about obligations to pay cash in the future and resources that represent cash to be received in the future.

(5) Matching concept :

As per this concept all the expenses which can be matched with the revenue of that period only should be taken into consideration for financial reporting. This concept is based on Accrual concept as it gives importance to occurrence of an expense which is spent for generating a revenue. This concept leads to adjustments at the end like outstanding expenses, income and Prepaid expenses, incomes.

(6) Going concern concept :

As per this concept financial statements are prepared on an assumption that enterprise will continue its operations for the foreseeable future. Thus, it says that enterprise has neither the intention nor the need to liquidate or curtail the scale of its operations. Valuation of assets of a business entity is dependent on this assumption.

(7) Cost concept :

As per this concept valuation of assets should be done at historical costs/acquisition cost.

(8) Realisation concept :

This concept says that any change in value of an asset is to be recorded only when the business realises it. This concept highly prefers Realisation of the value for which we want to give effect in books of accounts.

(9) Dual Aspect concept :

This concept is base for double entry Accounting.s of a transaction. Under the system, aspects of transactions are classified into two main types:

1. Debit

2. Credit

Every transaction should have a Debit and credit. Debit is the portion of transaction that accounts for the increase in assets and expenses, and the decrease in liabilities, equity and income. And credit is the portion which is a results of decreases the asset, increases the liability, income, gains, equity.

Accounting conventions:

Accounting conventions are the generally accepted guidelines in preparation of financials. They arise from customs and practical application. They are not legally documented policies.

Following are the accounting conventions:

(1) Conservatism :

As per this concept while Accounting one should not anticipate the income but should provide for all possible losses. When there are many alternative values to account an asset then we should choose the lesser value. Inventory valuation is done as per this concept only , as cost or Market value which ever is lower.

(2) Consistency :

As per this concept the accounting policies followed in preparation and presentation of financial statements should be consistent from one period to another period. A change in Accounting policy can be made only when it is required by law , or for better presentation of accounts or change in Accounting standards.

(3) Materiality :

As per this concept items having significant economic effect on the business of the enterprise should be disclosed in financial statements and any insignificant item which is not relevant to the users should not be disclosed in financial statements.

Accounting standards in India:

Accounting is the art of recording transactions in the best manner possible, so as to enable the reader to arrive at judgments/come to conclusions, and in this regard it is utmost necessary that there are set guidelines. These guidelines are generally called accounting policies. The intricacies of accounting policies permitted Companies to alter their accounting principles for their benefit. This made it impossible to make comparisons. In order to avoid the above and to have a harmonised accounting principle, Standards needed to be set by recognised accounting bodies. This paved the way for Accounting Standards to come into existence.

Accounting Standards in India are issued By the Institute of Chartered Accountants of India (ICAI). At present there are 30 Accounting Standards issued by ICAI.

Objective of Accounting Standards

Objective of Accounting Standards is to standardize the diverse accounting policies and practices with a view to eliminate to the extent possible the non-comparability of financial statements and the reliability to the financial statements.

The institute of Chartered Accountants of India, recognizing the need to harmonize the diverse accounting policies and practices, constituted an Accounting Standard Board (ASB) on 21st April, 1977.

Compliance with Accounting Standards issued by ICAI

Sub Section(3A) to section 211 of Companies Act, 1956 requires that every Profit/Loss Account and Balance Sheet shall comply with the Accounting Standards. 'Accounting Standards' means the standard of accounting recommended by the ICAI and prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards(NACAs) constituted under section 210(1) of companies Act, 1956.

Accounting Standards Issued by the Institute of Chartered Accountants of India are as below:

- Disclosure of accounting policies:
- Valuation Of Inventories:
- Cash Flow Statements
- Contingencies and events Occurring after the Balance sheet Date
- Net Profit or loss For the period, Prior period items and Changes in accounting Policies.
- Depreciation accounting.
- Construction Contracts.
- Revenue Recognition.
- Accounting For Fixed Assets.

- The Effect of Changes In Foreign Exchange Rates.
- Accounting For Government Grants.
- Accounting For Investments.
- Accounting For Amalgamation.
- Employee Benefits.
- Borrowing Cost.
- Segment Reporting.
- Related Party Disclosures.
- Accounting For Leases.
- Earning Per Share.
- Consolidated Financial Statement.
- Accounting For Taxes on Income.
- Accounting for Investment in associates in Consolidated Financial Statement.
- Discontinuing Operation.
- Interim Financial Reporting.
- Intangible assets.
- Financial Reporting on Interest in joint Ventures.
- Impairment Of assets.
- Provisions, Contingent, liabilities and Contingent assets.
- Financial instrument.
- Financial Instrument: presentation.
- Financial Instruments, Disclosures and Limited revision to accounting standards.

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

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

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

Contingencies and Events occurring after the balance sheet date: In preparing financial statement of a particular enterprise, accounting is done by following accrual basis of accounting and prudent accounting policies to calculate the profit or loss for the year and to recognize assets and liabilities in balance sheet. While following the prudent accounting policies, the provision is made for all known liabilities and losses even for those liabilities / events, which are probable. Professional judgement is required to classify the likelihood of the future events occurring and, therefore, the question of contingencies and their accounting arises.

Objective of this standard is to prescribe the accounting of contingencies and the events, which take place after the balance sheet date but before approval of balance sheet by Board of Directors. The Accounting Standard deals with Contingencies and Events occurring after the balance sheet date.

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

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

Construction Contracts : Accounting for long term construction contracts involves question as to when

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

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

Accounting for Fixed Assets : It is an asset, which is:- Held with intention of being used for the purpose of producing or providing goods and services. Not held for sale in the normal course of business. Expected to be used for more than one accounting period.

The Effects of changes in Foreign Exchange Rates : Effect of Changes in Foreign Exchange Rate shall be applicable in Respect of Accounting Period commencing on or after 01-04-2004 and is mandatory in nature. This accounting Standard applicable to accounting for transaction in Foreign currencies in translating in the Financial Statement Of foreign operation Integral as well as non- integral and also accounting for For forward exchange.Effect of Changes in Foreign Exchange Rate, an enterprises should disclose following aspects:

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

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

Accounting for Investments : It is the assets held for earning income by way of dividend, interest and rentals, for capital appreciation or for other benefits.

Accounting for Amalgamation : This accounting standard deals with accounting to be made in books of Transferee company in case of amalgamation. This accounting standard is not applicable to cases of acquisition of shares when one company acquires / purchases the share of another company and the acquired company is not dissolved and its separate entity continues to exist. The standard is applicable when acquired company is dissolved and separate entity ceased exist and purchasing company continues with the business of acquired company

Employee Benefits : Accounting Standard has been revised by ICAI and is applicable in respect of accounting periods commencing on or after 1st April 2006. the scope of the accounting standard has been enlarged, to include accounting for short-term employee benefits and termination benefits.

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

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

Related Party Disclosure : Sometimes business transactions between related parties lose the feature and character of the arms length transactions. Related party relationship affects the volume and decision of

business of one enterprise for the benefit of the other enterprise. Hence disclosure of related party transaction is essential for proper understanding of financial performance and financial position of enterprise.

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

Earning Per Share : Earning per share (EPS) is a financial ratio that gives the information regarding earning available to each equity share. It is very important financial ratio for assessing the state of market price of share. This accounting standard gives computational methodology for the determination and presentation of earning per share, which will improve the comparison of EPS. The statement is applicable to the enterprise whose equity shares or potential equity shares are listed in stock exchange.

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

Accounting for Taxes on Income : This accounting standard prescribes the accounting treatment for taxes on income. Traditionally, amount of tax payable is determined on the profit/loss computed as per income tax laws. According to this accounting standard, tax on income is determined on the principle of accrual concept. According to this concept, tax should be accounted in the period in which corresponding revenue and expenses are accounted. In simple words tax shall be accounted on accrual basis; not on liability to pay basis.

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

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

Interim Financial Reporting (IFR) : Interim financial reporting is the reporting for periods of less than a year generally for a period of 3 months. As per clause 41 of listing agreement the companies are required to publish the financial results on a quarterly basis.

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

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

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

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

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

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

Financial Instrument: Recognition and Measurement, issued by The Council of the Institute of Chartered Accountants of India, comes into effect in respect of Accounting periods commencing on or after 1-4-2009

and will be recommendatory in nature for An initial period of two years. This Accounting Standard will become mandatory in respect of Accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business Entities except to a Small and Medium-sized Entity. The objective of this Standard is to establish principles for recognizing and measuring Financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in Accounting Standard.

Financial Instrument: presentation : The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset. The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in Accounting Standard Financial Instruments:

Financial Instruments, Disclosures and Limited revision to accounting standards: The objective of this Standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- the significance of financial instruments for the entity's financial position and performance; and
- the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

UNIT-2

Basics of accounting – Capital & Revenue items:

The main objective of accounting is to ascertain the true profit or loss and to reveal the financial position of a business at the end of financial year.

To achieve the objectives, the business must take a clear distinction between its capital and revenue items. The distinction between capital and revenue items is essential for their correct treatment in the final accounts. Any incorrect treatment of those two items in the final accounts adversely affects the operating results and financial position of the business.

Capital is the wealth invested by an investor for producing additional wealth. The original figure of wealth is known as capital. Making of additional wealth with the investment of original capital is known as revenue. Thus, capital is the source of the basis of revenue. In other words, capital is invested in the business to earn revenue. For example, a trader has started a business with \$ 1,00,000 and earns a profit of \$ 30,000 during the year. The original investment of the trader, i.e \$ 1,00,000 is the capital and the profit of \$ 30,000 earned by the investor out of the investment is the revenue.

Capital items concerned with the payment for assets and receipt from the owners and outsiders. It is the item of the balance sheet. It is of long-term nature and its benefit is long-lasting. In fact, capital items are assets, liabilities and capital that determine the financial strength of the business.

Revenue item is concerned with the payment for producing or buying goods and receipt from sale of goods and services. Those revenue incomes and expenditures are the items of trading account and profit and loss account. It is of short-term nature. Its benefit expires within the year. In fact, revenue items are incomes and expenses, which determine the operating result (profit or loss) of the business.

The following capital and revenue concepts are relevant for accounting purpose

- * Capital and revenue expenditures
- * Capital and revenue receipts
- * Capital and revenue losses
- * Capital and revenue profits
- * Capital and revenue reserves

Application of Computer in Accounting:

Computer is very helpful in accounting. All the interested parties of financial statements can easily track all accounting reports if it is in connected computers. That is the reason, today, all accounting departments make accounts in computer. Before explaining the application of computer in accounting, we are providing little introduction to those who are new for understanding this important concept.

Application of Computer in Accounting

1. To Keep Accounting Record of Big Company is Possible



Suppose, you are the accountant of big MNC. What you see in its business. There are millions of clients from whole world. Is it possible to record all in manual basis. It will be impossible. So, computer and accounting software in it, it will so easy to keep unlimited accounting records without any risk of forgetting.

2. Separate Payroll Accounting is Possible

We all know top costly expense in the business is the salary of employees. So, it must be recorded separately. Computer can help in this. Anytime any edit regarding salary, name or any other adjustment in payroll is possible.

3. Automation of All Financial Accounts

Just go to any CA office. In its computer system, you will see lots of company's financial statements and other accounting reports. How can company fastly send its financial statements to CA office for audit. Answer is very simple. Everything has connected with computer. If accountant will pass voucher entries, financial accounts will automatically be created by computer software.

4. Graphic Presentation of Accounting Results

Computer can be used for graphic presentation of accounting results. You can see the sale trend graphs, charts and diagrams. Not only sale trend but you can see anything in accounting area through graphic way. It will so easy and understandable instead of reading only manual financial results.



5. Updated Fastly

If there is any mistake, we can easily correct. All the accounts will automatically corrected. In manual accounting, it is not possible. There are lots of options which can help more fastly providing the updated accounting reports. For example, computer reminder system can send updated debtor balance to the customer.

6. Best Inventory Control

To record every small item in computer is so easy without keeping big inventory registers. By comparing computer records of inventory and actual inventory, anytime, we can check the difference and find the reason behind this difference.

In simple words, single computer has saved the cost of keeping hundred accounts clerks. Without any errors, computer can records millions of transactions.

Double Entry System:

The double entry system of accounting or bookkeeping means that every business transaction will involve two accounts (or more). For example, when a company borrows money from its bank, the company's Cash account will increase and its liability account Loans Payable will increase. If a company pays \$200 for an advertisement, its Cash account will decrease and its account Advertising Expense will increase.

Double entry also allows for the accounting equation (assets = liabilities + owner's equity) to always be in balance. In our example involving Advertising Expense, the accounting equation remained in balance because expenses cause owner's equity to decrease. In that example, the asset Cash decreased and the owner's capital account within owner's equity also decreased.

Introduction to Journal, Ledger and Procedure for Recording and Posting:

In accounting and bookkeeping, a journal is a record of financial transactions in order by date. A journal is often defined as the book of original entry. The definition was more appropriate when transactions were written in a journal prior to manually posting them to the accounts in the general ledger OR subsidiary ledger. Manual systems usually had a variety of journals such as a sales journal, purchases journal, cash receipts journal, cash disbursements journal, and a general journal.

A journal is a sequential record of business transactions. It records all financial transactions of business in a book in chronological order; however, it does not record transactions relating to a particular subject, thing or persons into one account. For example, if we want to know the total purchase of business for a period of three months, we have to go through all journals of three months, which is quite time consuming and tedious. To overcome the short coming of journal, a ledger account is maintained.

General Journal					GJ1	
Date	Account Title and Description	Ref.	Debit	Credit		
20X1						
Aug. 1	Cash	100	50,000			
	Notes Payable	280		50,000		
	Borrowed \$50,000					

Cash					
Date	Explanation	Ref.	Debit	Credit	Balance
20X1					
Aug. 1	Borrowed \$50,000	GJ1	50,000		50,000

Notes Payable					
Date	Explanation	Ref.	Debit	Credit	Balance
20X1					
Aug. 1	Borrowed \$50,000	GJ1		50,000	50,000

Ledger is a statement prepared to collect and record transactions relating to similar nature or subject into one place. In other words, a book which records transactions having similar features, nature and subject into the account is called ledger account. It is a book which contains a classified and summer' zed form of permanent record of all transactions. Ledger is called the book of secondary entry because it is prepared from journal.

O.P. Gupta, 'ledger is the principle book of account in which all transactions find their ultimate place in the shape of account in a classified place form. The book supplied all information regarding working of business.'

Objective of ledger

A ledger is principal book of account. It is prepared with a view to gathering similar transactions into one account to show their combined effects. The main objectives of ledger are:

1. To provide information about income and expenditures:

One of the main objectives of preparation of ledger account is to record various incomes and expenditures of the business. For example, expenses during the period in total. Similarly income like interest received and receivable is posted to interest account to find total interest earned during the period.

2. To provide information about position of assets and liabilities

A separate ledger account is prepared for individual asset and liability which helps to know its effect on financial position of business during a particular period. For example: debtor account is prepared to know the amount receivable during the period.

3. To provide information regarding purchase and sales

In a period, a firm can have several purchase and sales. A purchase account is prepared to know the total purchase made during the period and similarly, sales account shows the total sales made during the

period. Therefore, ledger is very helpful to know the information about purchase and sales.

4. To help in preparation of trial balance

Since trial balance is prepared on the basis of information provided by ledger account. Thus, ledger account is immense help for preparing trial balance.

Specimen of ledger

A ledger may be prepared either in T-shape or showing balance after each transaction which is called a

Ledger account showing running balance i.e. running shape.

T-shape ledger account

This type of ledger account commonly used in book keeping. The ledger is divided into two parts, the left part of debit and right part for credit. A specimen ruling of ledger accounting is presented below:

1. Date dr.
2. Particular
3. JF
4. Amount rs
5. Date cr.
6. Particular
7. JF
8. Amount rs

Posting

It is the act of transferring recorded in journal into ledger. In other words, the process of recording transaction into ledger is called posting. The posting in various columns of ledger is done as follows:

1. Date: the date of transaction as mentioned in journal is recorded.
2. Particulars: in this column, the account which was credited in journal is recorded with prefix 'to'.
3. Journal folio (JF): the page number of journal from which the entry is being posted is recorded here, if available.
4. Amount: in this column, the debit amount of the ledger account is recorded.
5. Date: the date transaction same as in journal is recorded.
6. Particular: in this column, the account was originally debited in journal is recorded with prefixed "BY".
7. Journal folio (JF): the page of journal entry is recorded here, if available.
8. Amount; in this column, the credit amount of ledger account is recorded.

Rules for posting

1. First make sure the ledger account being opened.
2. Then, if ledger account being opened is debited in journal, posting should be made in debit side with opposite account i.e. account credited and
3. If the ledger account being opened is credit in journal, posting should also be made in credit side of the account with opposite account i.e. debit account in journal.

Posting of opening entry

To transfer the assets, liabilities and capital of last year to this year, an opening journal entry is passed. In other words, it recorded the beginning assets, liabilities and capital of business.
Posting without journal entries

Ledger account can also be maintained without passing journal entries. But transactions should be journalized in mind and remembered the account to be debited and credited and other procedure is same. However, instead of journal folio (jf), ledger folio (LF) is recorded since journal entries will not be passed. For example, salary paid rs. 1000,

Balancing of ledger accounts

After posting transaction journalized into ledger account, all the ledger account must be closed to find

their and posting on the business at the end of certain period. For example, if the ledger has to determine the amount of cash balance at the end of certain period. Then he has to prepare cash a/c and debit and credit of the account are totaled. The difference between two sided (i.e. dr, and cr.) is balance of the account. The process is called balance of ledger accounts.

Balancing of account is done periodically i.e. monthly, quarterly, semi-annually as per requirement. Normally, monthly balancing is common in practice.

Debit side of an account greater than credit side

In this case, the debit of an account will be greater than credit total. It is known as debit balance of an account. Here the excess debit in the credit side of the account as by balance C/D and closed the account in the beginning of next period. The balancing figure is brought down as to balance b/d.

Credit side of an account greater than debit side

In this case, the credit total of an account is greater than debit total. It is known as credit balance of an account. Here excess credit amount is entered in the debit side of account as "to balance c/d" and closed the account. In the next period, the balancing figure is brought down as "By balance b/d".

Introduction to Trial Balance:

Trial Balance is a list of closing balances of ledger accounts on a certain date and is the first step towards the preparation of financial statements. It is usually prepared at the end of an accounting period to assist in the drafting of financial statements. Ledger balances are segregated into debit balances and credit balances. Asset and expense accounts appear on the debit side of the trial balance whereas liabilities, capital and income accounts appear on the credit side. If all accounting entries are recorded correctly and all the ledger balances are accurately extracted, the total of all debit balances appearing in the trial balance must equal to the sum of all credit balances.

Purpose of a Trial Balance

- Trial Balance acts as the first step in the preparation of financial statements. It is a working paper that accountants use as a basis while preparing financial statements.
- Trial balance ensures that for every debit entry recorded, a corresponding credit entry has been recorded in the books in accordance with the double entry concept of accounting. If the totals of the trial balance do not agree, the differences may be investigated and resolved before financial statements are prepared. Rectifying basic accounting errors can be a much lengthy task after the financial statements have been prepared because of the changes that would be required to correct the financial statements.
- Trial balance ensures that the account balances are accurately extracted from accounting ledgers.
- Trial balance assists in the identification and rectification of errors.

Example

Following is an example of what a simple Trial Balance looks like:

ABC LTD Trial Balance as at 31 December 2011		
Account Title	Debit	Credit
	\$	\$
Share Capital		15,000

Furniture & Fixture	5,000	
Building	10,000	
Creditor		5,000
Debtors	3,000	
Cash	2,000	
Sales		10,000
Cost of sales	8,000	
General and Administration Expense	2,000	
Total	30,000	30,000

1. Title provided at the top shows the name of the entity and accounting period end for which the trial balance has been prepared.
2. Account Title shows the name of the accounting ledgers from which the balances have been extracted.
3. Balances relating to assets and expenses are presented in the left column (debit side) whereas those relating to liabilities, income and equity are shown on the right column (credit side).
4. The sum of all debit and credit balances are shown at the bottom of their respective columns.

Limitations of a trial balance

Trial Balance only confirms that the total of all debit balances match the total of all credit balances. Trial balance totals may agree in spite of errors. An example would be an incorrect debit entry being offset by an equal credit entry. Likewise, a trial balance gives no proof that certain transactions have not been recorded at all because in such case, both debit and credit sides of a transaction would be omitted causing the trial balance totals to still agree. Types of accounting errors and their effect on trial balance are more fully discussed in the section on Suspense Accounts.

Preparation of Final Account, Profit & Loss Account and related concepts:

Final accounts give an idea about the profitability and financial position of a business to its management, owners, and other interested parties. All business transactions are first recorded in a journal. They are then transferred to a ledger and balanced. These final tallies are prepared for a specific period. The preparation of a final accounting is the last stage of the accounting cycle. It determines the financial position of the business. Under this it is compulsory to make trading account, profit and loss account and balance sheet.

The term "final accounts" includes the trading account, the profit and loss account, and the balance sheet. Section 209 of the Companies Act 1956 makes it compulsory for companies to keep certain books of accounts.

After having checked the accuracy of the books of accounts through preparation of Trial Balance, businessman wants to ascertain the profit earned or loss suffered during the year and also the financial position of his business at the end of the year. For this purpose he prepares 'Final Accounts' which are also termed as 'Financial Statement'. These include the following:

1. Trading Account
2. Profit and Loss Account
3. Balance Sheet

Trading Account

Trading account is prepared for calculating the gross profit or gross loss arising or incurred as a result of the trading activities of a business. In other words, it is prepared to show the result of manufacturing, buying and selling of goods. If the amount of sales exceeds the amount of purchases and the expenses directly connected with such purchases, the difference is termed as gross profit. On the contrary, if the purchases, and direct expenses exceed the sales, the difference is called gross loss. A Trading Account records the amount of purchases of goods and also the expenses which are incurred in bringing that commodity to a saleable state. In other words, all expenses which relate to either purchase of raw material for manufacturing of goods are recorded in the Trading Account. All such expenses are called 'Direct Expenses'. According to J.R. Batliboi, "The Trading Account shows the results of buying and selling of goods. In preparing this account, the general establishment charges are ignored and only the transaction in goods are included."

Sometimes, a Trading Account is also called 'Good A/c' because all the transaction relating to goods are recorded in it. Such as (i) Opening Stock, (ii) Purchases, (iii) Purchases Returns, (iv) Sales, (v) Sales Returns, (vi) Closing Stock, (vii) Expenses incurred on manufacturing of goods, and (viii) Expenses incurred on purchasing and bringing the goods to the trading place. All such expenses are summarised and recorded in the Trading Account at the end of the year.

Need and Importance of Trading Account

Preparation of Trading Account serves the following objectives:

1. It provides information about Gross Profit and Gross Loss: It informs of the gross profit or gross loss as a result of buying and selling the goods during the year. The percentage of Current Year's gross profit on the amount of sales can be calculated and compared with those of the previous years. Thus, it provides data for comparison, analysis and planning for a future period.
2. It provides information about the direct expenses: All the expenses incurred on the purchase and manufacturing of goods are recorded in the trading account in a summarised form. Percentage of such expenses on sales can be calculated and compared with those of the previous years. In this way it enables the management to control and rationalise the expenses.
3. Comparison of closing stock with those of the previous years: closing stock has to be valued and recorded in a trading account. This stock can be compared with the closing stock of the previous years and if the stock shows an increasing trend, the reasons may be inquired into.
4. It provides safety against possible losses: If the ratio of gross profit has decreased in comparison to the preceding year, the businessman can take effective measures to safeguard himself against future losses. For example, he may increase the sale price of his goods or may proceed to analyse and control the direct expenses.

Preparation of Trading Account

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

Item written on the Dr. side of the Trading Account:

1. Opening Stock: The stock of goods remaining unsold at the end of the previous year is termed as the opening stock of the current year. In other words, the closing stock of the last year becomes the opening stock of the current year. Opening Stock will include the following:
 - I. Opening Stock of Raw Material.
 - II. Opening Stock of Semi-finished goods, and
 - III. Opening Stock of Finished goods.

2. Purchases and Purchases Returns: Goods which have been bought for resale are termed as Purchases and goods which are returned to suppliers are termed as purchase returns or returns outwards. Purchase Account will be given on the debit side of the trial balance and Purchase Return Account on the credit side of the trial balance. Purchase returns will be shown as a deduction from Purchases on the debit side of the trading account. Purchases include cash as well as credit purchases.
 3. Direct Expenses: All expenses incurred in purchasing the goods, bringing them to the godown and manufacture of goods are called direct expenses. Direct expenses include the following:
 - I. Wages: Wages are paid to workers who are directly engaged in the loading, unloading and production of goods and as such are debited to the trading account. It should be noted that:
 - (i) If the item 'Wages and Salaries' is given in the question it will be shown on the trading account. On the contrary, if 'Salaries and Wages' is given it will be shown on the profit & loss account.
 - (ii) If wages are paid for bringing a new machine or for its installation it will be added to the cost of the machine and hence will not be shown in the trading account.
 - II. Carriage or Carriage Inwards or Freight: These expenses should be debited to trading account because these are generally paid for bringing the goods to the factory or place of business. However, if any carriage or freight is paid on bringing an asset, the amount should be added to the asset account and must not be debited to trading account.
 - III. Manufacturing Expenses: All expenses incurred in the manufacture of goods are shown on the debit side of the trading account such as Coal, Gas, Fuel, Water, Power, Factory Rent, Factory Lighting etc.
 - IV. Dock Charges: These are the charges levied on ships and their cargo while entering or leaving docks. If dock charges are paid on import of goods they are shown on the debit side of trading account. In the absence of specific instructions, these are debited to trading account.
 - V. 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.
 - VI. Octroi: This is levied by the Municipal Committee when the goods enter the city and hence debited to trading account.

VII. 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 and 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 Trail Balance. This is so because its valuation is made after the accounts have been closed. It is incorporated in the books by means of the following entry:

Closing Stock A/c	Dr.
To Trading A/c	

(Closing Stock transferred to Trading A/c)

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

Closing Entries Relating to Trading Account

The preparation of the Trading Account requires that the balances of all such accounts which are due to appear in the Trading Account are transferred to it. The entries required for such transfer are termed as Closing entries. These will be as follows:

1. Purchases Return Account is closed by transferring its balance to Purchase Account. Following entry is recorded for this purpose.

Purchases Return A/c	Dr.
To Purchases A/c	

(Transfer of Purchases Return Account to Purchases (Account))

2. Similarly, the Sales Return Account is closed by transferring its balance to the Sales Account as:

Sales A/ct Dr.
 To Sales Return A/c
(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/ct
 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
(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.
Closing Stock A/c Dr.
 To Trading A/c
(Transfer of above accounts to the Cr. Side of the Trading A/c)

5. Another Closing entry is needed to close the trading account itself. 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 and loss account:

Trading A/c Dr.
 To Profit & Loss A/c
 (Transfer of Gross Profit to the Credit side of P & L A/c)

6. If the debt 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 and Loss A/c Dr.
 To Trading A/c
 (Transfer of Gross Loss to the Debit side of P & L A/c)

Form of Trading Account

TRADING A/C

(for the year ended.....)

Dr.
Cr.

Particular	Amount	Particulars	Amount
	Rs.		Rs.
To Opening Stock		By Sales	
To Purchases		Less: Sales Returns	
Less: Purchase Returns		or	
or		Returns inwards	
Returns outward		By Closing Stock	
To Wages		By Gross loss	
To Wages & Salaries		(if any) transferred to Profit and Loss A/c	
To Direct Expenses		(Balancing Figure)	
To Carriage, or			
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 Dock Charges and Clearing charges		
To Import Duty or Custom duty		
To Royalty		
To Gross Profit		
Transferred to P & L A/c		
(Balancing Figures)		

Notes: (1) In the heading of the Trading Account the words 'For the year ended.....' are used. Because it discloses the position of the business for the full accounting year and not at a particular point of time.

(2) No separate column for date is prepared in the Final Accounts because the date will be already mentioned in the heading itself.

(3) No column for L.F. is prepared in Final Accounts because these are prepared from trial balance and not from ledge accounts directly.

Illustration:

Prepare a Trading Account for the year ended 31st December 2010 from the following balances:

	Rs.		Rs.
Opening Stock	4,00,000	Purchases Return	1,20,000
Purchases	20,00,000	Sales Return	2,00,000
Sales	50,00,000	Carriage on Purchase	80,000
Freight and Octroi	65,000	Carriage on sales	1,00,000
Wages	3,00,000	Factory Rent	1,20,000
Factory Lighting	1,08,000	Office Rent	75,000
Coal, Gas and Water	22,000	Import Duty	3,20,000

Closing Stock is valued at Rs. 6,00,000.

Solution:

TRADING A/C
(for the year ended.....)

Dr.
Cr.

Particular	Amount	Particulars	Amount
	Rs.		Rs.
To Opening Stock	4,00,000	By Sales	50,00,000
To Purchases	20,00,000	Less: Sales Returns	2,00,000
Less: Purchases Return	1,20,000	By Closing Stock	6,00,000
	18,80,000		
To Freight and Octroi	65,000		
To Wages	3,00,000		
To Factory Lighting	1,08,000		
To Coal, Gas and Water	22,000		
To Carriage on Purchase	80,000		
To Factory Rent	1,20,000		
To Import Duty	3,20,000		
To Gross Profit transferred to Profit & Loss A/c	21,05,000		
	54,00,000		54,00,000

Profit And Loss Account

Trading account only discloses the gross profit earned as a result of buying and selling of goods. However, a businessman has to incur a number of expenses which are not taken to trading account.

Hence, a businessman is more interested in knowing the net profit earned or net loss incurred during the year. As such, a Profit & Loss Account is prepared which contains all the items of losses and gains pertaining to the accounting period. According to Prof. Carter, "A Profit & Loss Account is an account into which all gains and losses are collected, in order to ascertain the excess gains over the losses or vice-versa".

Need and Importance of Profit & Loss A/c

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

Preparation of Profit and Loss Account

A Profit and Loss Account is started with the amount of gross profit or gross loss brought down from the Trading Account. As such, all those expenses and losses which have not been debited to the Trading Account are now debited to Profit & Loss Account. These expenses include administrative expenses, selling expenses, distribution expenses etc. These are called 'Indirect Expenses'. Profit and Loss Account is a Nominal Account and as such, all the expenses and losses are shown on its debit side and all the incomes and gains are shown on its credit side.

Items written on the 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 fee etc.
3. Selling and Distribution Expenses: Such as advertisement charges, commission, carriage outwards, bad-debts, packing charges etc.
4. Miscellaneous Expenses: Such as interest on loan, interest on capital, repair charges, depreciation, charity etc.

Items written on the Cr. side of Profit & Loss Account

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

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

Closing Entries relating to Profit and Loss Account

The preparation of profit and loss account requires that the balances of all concerned items are transferred to it by passing 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 Salaries A/c	
To Rent, Rates and Taxes A/c	
To Printing and Stationer A/c	
To Postage and Telegrams A/c	
To General Expenses etc.	

(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 and Loss A/c	

(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	

(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
(Transfer of net loss to Capital A/c)

Form of Profit and Loss Account

PROFIT AND LOSS A/C
(for the year ending.....)

Dr.
Cr.

Particular	Amount	Particulars	Amount
	Rs.		Rs.
To Gross Loss b/d (if any) (Transferred from Trading A/c)		By Gross Profit b/d (Transferred from Trading A/c)	
Office Expenses:		By Rent from Tenant	
To Salaries		By Rent (Cr.)	
To Salaries & Wages		By Discount received or discount (Cr.)	
To Rent, Rates & Taxes		By Commission Received	
To Printing & Stationery		By Interest on Investments	
To Postage & Telegram		By Dividend on Shares	
To Lighting		By Bad-Debts Recovered	
To Insurance Premium		By apprentice Premium*	
To Telephone Charges		By Profit on sale of Assets	
To Legal Charges		By Income from other Sources	
To Audit Fees		By Miscellaneous Receipts	
To Travelling Expenses		By Net Loss (if any) Transferred to Capital A/c	
To Establishment Expenses			
To Trade Expenses			
To General Expenses			
Selling and Distribution Expenses:			

To Carriage Outwards, or Carriage on Sales		
To Advertisement		
To Commission		
To Brokerage		
To Bad-debts		
To Export Duty		
Packing charges		
To Delivery Van Expenses		
To Stable Expenses		
Miscellaneous Expenses:		
To Discount		
To Repairs		
To Depreciation		
To Interest (Dr.)		
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.

(2) Only those items of expenses and incomes are shown in the Profit & Loss Account which have not been shown in the Trading Account.

* Income received by providing training to someone is called "Apprentice Premium".

Illustration:

From the following particulars, prepare a Profit & Loss Account for the year ending 31st December, 2010.

	Rs.		Rs.
Gross Profit	21,05,000	Discount allowed	30,000
Trade Expenses	20,000	Lighting	7,800
Carriage on Sales	1,00,000	Commission Received	8,400
Office Salaries	1,58,000	Bad-debts	12,000
Postage and Telegram	7,200	Discount (Cr.)	6,000
Office Rent	75,00	Interest on Loan	22,000
Legal Charges	4,000	Stable Expenses	14,000
Audit Fee	16,000	Export Duty	23,000
Donation	11,000	Miscellaneous Receipts	5,000
Sundry Expenses	3,600	Unproductive Expenses	41,000
Selling Expenses	53,200	Travelling Expenses	25,000

Solution:

PROFIT AND LOSS ACCOUNT

for the year ending on 31st December, 2010

Dr.

Cr.

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Trade Expenses	20,000	By Gross Profit	21,05,000
To Carriage on Sales	1,00,000	By Commission Received	8,400
To Office Salaries	1,58,000	By Discount	6,000
To Postage & Telegram	7,200	By Miscellaneous Receipts	5,000
To Office Rent	75,000		
To Legal Charges	4,000		
To Audit Fee	16,000		
To Donation	11,000		
To Sundry Expenses	3,600		

To Selling Expenses	53,200	
To Discount Allowed	30,000	
To Lighting	7,800	
To Bad-Debts	12,000	
To Interest on Loan	22,000	
To Stable Expenses	14,000	
To Export Duty	23,000	
To Unproductive Expenses	41,000	
To Travelling Expenses	25,000	
To Net Profit transferred to Capital Account	15,01,600	
	21,24,400	21,24,400

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.

Definitions: A Balance Sheet has been defined as follows:

In the words of Karlson, "A business form showing what is owed and what the proprietor is worth, is called a Balance Sheet."

According to A. Palmer, "The Balance Sheet is a statement at a particular date showing on one side the trader's property and possessions and on the other hand the liabilities."

According to J.R. Batliboi, "A Balance Sheet is a statement prepared with a view to measure the exact financial position of a business on a certain fixed date."

Need and Importance of Preparing a Balance Sheet

The purposes of preparing a Balance Sheet are as follows:

1. The main purpose of preparing a Balance Sheet is to ascertain the true financial position of the business at a particular point of time.

2. It helps in ascertaining the nature and cost of various assets of the business such as the amount of Closing Stock, amount owing from Debtors, amount of fictitious assets etc.
3. It helps in determining the nature and amount of various liabilities of the business.
4. It gives information about the exact amount of capital at the end of the year and the addition or deduction made into it in the current year.
5. It helps in finding out whether the firm is solvent or not. The firm is solvent if the assets exceed the external liabilities. It would be insolvent if opposite is the case.
6. It helps in preparing the Opening Entries at the beginning of the next year.

Drafting a Balance Sheet

Characteristics of Balance Sheet:

1. A Balance Sheet is a part of the Final Account. This is the reason that the Trading and Profit & Loss Account and the Balance Sheet are together called 'Final Accounts'. However, the Balance Sheet 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.
2. A Balance Sheet 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.
3. 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.
4. Balance sheet is prepared on a particular date and not for a fixed period. As such, it discloses the financial position of a business on a particular date and not for a period. It is True only for the date on which it is prepared because even a single transaction would cause a change in the assets and liabilities.
5. It shows the financial position of the business according to the going concern concept.

Grouping and Marshalling of Assets and Liabilities in Balance Sheet

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. For example, the amount owing from various customers will be shown under the heading 'Sundry Debtors'. Similarly, under the heading 'Current Assets', the balance of Cash, bank, debtors, stock etc. will be shown.

'Marshalling' is the arrangement of various assets and liabilities in a proper order. Marshalling can be made in one of the following two ways:

1. In the Order of Liquidity: According to this method, 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.

Generally, sole proprietors and partnership firms prepare their Balance Sheet in the order of liquidity. Proforma of a Balance Sheet in the order of liquidity will be as follows:

BALANCE SHEET

as on or as at.....

Particular	Amount	Particulars	Amount
	Rs.		Rs.
Current Liabilities:		Current Assets:	
Bank Overdraft		Cash in Hand	
Bill Payable		Cash at Bank	
Sundry Creditors		Bills Receivable	
Outstanding Expenses		Short Term Investments	
Unearned Income		Sundry Debtors	
Fixed Liabilities:		Closing Stock	
Long Term Loans		Prepaid Expenses(3)	
Reserves:		Accrued Income	
Capital:		Fixed Assets:	
Add: Net Profit		Furniture	
Less: Drawings		Loose Tools	
Less: Income Tax		Motor Vehicle	
Less: Life Insurance Premium		Long Term Investments	
		Plant and Machinery	
		Land and Buildings	
		Patents	
		Goodwill	

Notes: (1) The words 'As at' or 'As on' are used in the heading of the Balance Sheet. Because it is true only for the date on which it is prepared.

(2) The total of both the sides of the Balance Sheet is always equal.

(3) Prepaid expenses are treated as current assets. Though Cash cannot be realised from prepaid expenses, the service will be available against these without further payment.

2. In the Order of Permanence: This method is exactly the reverse of the first method discussed above. 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.

It is essential to understand the classification of various assets and liabilities before preparing a Balance Sheet.

Classification of Assets

According to the nature of assets, these may be classified into the following:

1. Fixed Assets: Fixed assets are those which are acquired for continued use and last for many years such as Land & Building, Plant and Machinery, Motor Vehicles, Furniture etc. According to Finney & Miller, "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.

2. 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 Balance Sheet. In the words of Howard & Upton, "The current assets are usually defined as those assets which are convertible into cash through the normal course of business within a short time ordinarily in a year."

Current assets include Cash, Bills Receivable, Short Term Investments, Debtors, Prepaid Expenses, Accrued Income, Closing Stock etc. While valuing these assets, Closing Stock is valued at cost or realisable value whichever is less and a reasonable provision for doubtful debts is deducted out of Sundry Debtors.

3. Liquid Assets: Liquid assets are those which are either in the form of Cash or can be quickly converted into cash, such as Cash, 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.

4. Fictitious or Nominal Assets: These are the assets which cannot be realised in Cash or no further benefit can be derived from these assets. Such assets include Debit balance of P & L A/c and the expenditure 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.

5. Wasting Assets: These are the assets which are exhausted or consumed over a period of time such as mines and oil wells. Their value reduces through being worked. These also include Patents and the properties taken on lease for a definite period of time.

6. Tangible and Intangible Assets: Tangible assets are those which have a physical existence or which can be seen and felt like Plant and Machinery, Building, Furniture, Stock, Cash etc. Intangible assets are those which do not have any physical existence or which cannot be seen or felt such as the Goodwill, Trade Marks, Patents etc. Intangible assets are as much valuable as tangible assets because they also help the firm in earning profits. For example, Goodwill helps in attracting customers and patents are actually the know-how which help in producing the goods.

Classification of Liabilities

According to their nature, the liabilities may be classified as follows:

1. **Fixed or Long-term Liabilities:** 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.
2. **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 of some specific event, otherwise not. Such as:
 - (i) **Liabilities for bill discounted:** In case a bill discounted from the bank is dishonoured by the acceptor on the due date, the firm will become liable to the bank.
 - (ii) **Liability in respect of a suit pending in a court of law:** This would become an actual liability if the suit is decided against the firm.
 - (iii) **Liability in respect of a guarantee given for another person:** The firm would become liable to pay the amount if the person for whom guarantee is given fails to meet his obligation.

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.

Difference between Trial Balance and Balance Sheet

S.No.	Basis of Difference	Trial Balance	Balance Sheet
1.	Object	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.	Information about profit or	It is not possible to have information about net profit or net	Since net profit or loss is recorded in the Capital shown in Balance Sheet, it is possible to have the

	loss		information about net profit or net loss from a Balance Sheet.
3.	Necessity	Though desirable, its preparation is not necessary.	It is necessary to prepare a Balance Sheet.
4.	Headings	The headings of its two columns are debit and credit.	The headings of its two sides are assets and liabilities.
5.	Period	It is normally prepared every month or whenever needed.	It is normally prepared half-yearly or yearly at the end of the accounting period.
6.	Types of Accounts	All types of accounts whether personal, real or nominal must be written in it.	Only personal and real accounts are included in it.
7.	Closing Stock	Normally, it does not contain the item of Closing Stock.	It contains the item of Closing Stock.
8.	Adjustments	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.
9.	Evidence	It is not accepted by the court as documentary evidence.	It is accepted by the court as documentary evidence. It is also helpful while making payment of income-tax and sales-tax.

Following points should be noted for preparing Final Accounts:

1. If a trial balance is not given in the question, it is better to prepare a Trial Balance first of all. If there is a difference in the Trial Balance, the difference is placed to a 'Suspense A/c' and shown in the Balance Sheet.
2. It should be remembered that all items which appear in the Trial Balance should be shown only once whereas items which appear outside the Trial Balance, known as adjustments, have to be shown at two places.
3. The items which appear on the debit side of the Trial Balance should be shown either on the debit side of the Trading or Profit and Loss A/c or on the Assets side of the Balance Sheet.
4. The items which appear on the credit side of the Trial Balance should be shown either on the credit side of the Trading or Profit & Loss A/c or on the Liabilities side of the Balance Sheet.
5. All accounts relating to Goods such as Purchases, Sales, Purchase Returns and Sales Returns are written in the Trading Account. In addition to these, the Trading Account will also be debited with all expenses which are directly related to either purchase or manufacturing of goods. All the remaining expenses or the balances of the Nominal Accounts are shown in the Profit & Loss Account.

6. The balances of Personal and Real Accounts are always shown in the Balance Sheet.
7. If the expenses in respect of 'Rent' and 'Lighting' are clearly stated as having been incurred in respect of factory, these will be shown in the Trading Account, otherwise these will be shown in Profit & Loss Account. For example, if 'Factory Rent' is given in the question, it will be shown in Trading Account. Instead, if 'Rent' is given, it will be shown in Profit & Loss Account.
8. If a trial balance is not given in the question, and it is not clearly stated whether a particular item is expense or income, it will be treated as expense such as Discount, commission, Brokerage or Rent etc.
9. The total of both sides of the Balance Sheet will always be equal.

Illustration:

From the following balances of Siya Ram, Prepare a Balance Sheet as on 31st December, 2010.

Particulars	Amount (Dr.)	Amount (Cr.)
Plant and machinery	8,00,000	
Land and Building	6,00,000	
Furniture	1,50,000	
Cash in Hand	20,000	
Bank Overdraft		1,80,000
Debtors and Creditors	3,20,000	2,40,000
Bills Receivable and Bill Payable	1,00,000	60,000
Closing Stock	4,00,000	
Investments (Short-term)	80,000	
Capital		15,00,000
Drawings	1,30,000	
Net Profit		6,20,000
	26,00,0000	26,00,0000

Solution:

BALANCE SHEET

as on 31st December, 2010

Liabilities	Amount	Assets	Amount
	Rs.		Rs.

Bank overdraft		1,80,000	Cash in Hand	20,000
B/P		60,000	B/R	1,00,000
Creditors		2,40,000	Investments (Short-term)	80,000
Capital			Debtors	3,20,000
Add: Net Profit	15,00,000		Closing Stock	4,00,000
	6,20,000		Furniture	1,50,000
	<u>21,20,000</u>		Plant & Machinery	8,00,000
Less: Drawings	1,30,000	19,90,000	Land & Building	6,00,000
		<u>24,70,000</u>		<u>24,70,000</u>

Illustration:

From the following Trial Balance of Radhe Shyam Trading and Profit and Loss A/c for the year ending 31st December, 2010 and Balance Sheet as on that date. The Closing Stock on 31st December, 2010 was valued at Rs. 2,50,000.

Debit Balances	Amount (Rs.)	Credit Balance	Amount (Rs.)
Stock (1-1-2010)	2,00,000	Sundry Creditors	1,50,000
Purchases	7,50,000	Purchases Return	30,000
Sales Return	80,000	Sales	25,00,000
Freight and Carriage	75,000	Commission	33,000
Wages	3,65,000	Capital	17,00,000
Salaries	1,20,000	Interest on Bank Deposit	20,000
Repairs	12,000	B/P	62,000
Trade Expenses	40,000		
Rent and Taxes	2,40,000		
Cash in Hand	57,000		
B/R	40,000		
	5,50,000		
Plant and Machinery	16,00,000		
Withdrawals (Drawings)	1,66,000		

Bank Deposit	2,00,000	
	44,95,000	44,95,000

Solution:

TRADING AND PROFIT & LOSS ACCOUNT

for the year ending 31st December, 2010

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
To Opening Stock	2,00,000	By Sales	25,00,000
To Purchases	7,50,000	Less: Sales Return	80,000
Less: Purchases Return	30,000		
To Freight & Carriage	75,000	By Closing Stock	2,50,000
To Wages	3,65,000		
To Gross Profit c/d	13,10,000		
	26,70,000		26,70,000
To Salaries	1,20,000	By Gross Profit b/d	13,10,000
To Repairs	12,000	By Commission	33,000
To Trade Expenses	40,000	By Interest on Bank Deposit	20,000
To Rent & Taxes	2,40,000		
To Net profit transferred to Capital A/c	9,51,000		
	13,63,000		13,63,000

BALANCE SHEET

as on 31st December, 2010

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
B/P	62,000	Cash in Hand	57,000
Sundry Creditors	1,50,000	B/R	40,000
Capital	17,00,000	Sundry Debtors	5,50,000
Add: Net Profit	9,50,000	Closing Stock	2,50,000
	26,51,000	Bank Deposit	2,00,000
Less: Drawings	1,66,000	Plant & Machinery	16,00,000
	26,97,000		26,97,000

Note: The heading of Trading A/c and Profit & Loss A/c is put collectively as 'Trading and Profit & Loss A/c'. The first part of this Account is Trading A/c, whereas the second part is Profit & Loss A/c. Trading Account, in fact, is apart of Profit & Loss Account.

Illustration:

From the following balances prepare a Trading, Profit & Loss Account and Balance Sheet.

	Rs.		Rs.
Carriage on Goods Purchased	80,000	Cash in Hand	25,000
Carriage on Goods Sold	35,000	Banker's A/c (Cr.)	3,00,000
Manufacturing Expenses	4,20,000	Motor Car	6,00,000
Advertisement	70,000	Drawings	80,000
Freight and Octroi	44,000	Audit Fees	27,000
Lighting	60,000	Plant	15,39,000
Customer's A/c	8,00,000	Repairs to Plant	22,000
Supplier's A/c	6,10,000	Stock at the end	7,60,000
Duty and Clearing Charges	52,000	Purchase Less Returns	16,00,000
Postage and Telegram	8,000	Commission on Purchases	20,000
Fire Insurance Premium	36,000	Incidental Trade Exp.	32,000
Patents	1,20,000	Investments	3,00,000

Income Tax	2,40,000	Interest on Investments	45,000
Office Expenses	72,000	Capital A/c	10,00,000
		Sales Less Returns	52,00,000
		Rent	1,20,000
		Discount Paid	27,000
		Discount on Purchases	34,000

Solution:

TRADING AND PROFIT & LOSS ACCOUNT

for the year ending

	Rs.		Rs.
To Purchases Less Returns	16,00,000	By Sales Less Returns	52,00,000
To Commission on Purchases	20,000		
To Carriage on goods Purchased	80,000		
To Manufacturing Expenses	4,20,000		
To Freight and Octroi	44,000		
To Duty & Clearing Charges	52,000		
To Gross Profit c/d	29,84,000		
	52,00,000		52,00,000
To Carriage on Goods Sold	35,000	By Gross Profit b/d	29,84,000
To Advertisement	70,000	By Interest on Investments	45,000
To Lighting	60,000	By Discount on Purchases	34,000
To Postage & Telegram	8,000		
To Fire Insurance Premium	36,000		
To Office Expenses	72,000		
To Audit Fees	27,000		
To Repair to Plant	22,000		
To Incidental Trade Expenses	32,000		

To Rent	1,20,000		
To Discount Paid	27,000		
To Net Profit Transferred to Capital A/c	25,54,000		
	30,63,000		30,63,000

Note: If Closing Stock appears inside the Trial Balance, it will be shown only at one place, i.e., only on the assets side of the Balance Sheet.

Illustration:

From the following balances prepare Final Accounts as on 31st December, 2010.

	Rs.		Rs.
Opening Stock	1,53,100	Capital	25,00,000
Purchase	8,24,000	Drawings	4,80,000
Sales	25,60,000	Sundry Debtors	5,70,000
Returns (Dr.)	40,000	Sundry Creditors	1,40,000
Returns (Cr.)	24,000	Depreciation	42,000
Factory Rent	1,80,000	Charity	5,000
Custom Duty	1,15,000	Cash Balance	44,600
Coal, Gas and Power	60,000	Bank Balance	40,000
Wages & Salary	3,66,000	Bank Charges	1,800
Discount (Dr.)	75,000	Establishment Expenses	36,000
Commission (Cr.)	12,000	Plant	4,20,000
Bad-Debts	58,500	Leasehold Building	15,00,000
Bad-Debts Recovered	20,000	Goodwill	2,00,000
Apprentice Premium	48,000	Patents	1,00,000
Productive Expenses	26,000	Trade Marks	50,000
Unproductive Expenses	50,000	Loan Cr.	2,50,000
Carriage	87,000	Interest on Loan	30,000

The value of Closing Stock on 31st December, 2010 was Rs. 2,54,000.

Solution:

TRADING AND PROFIT & LOSS ACCOUNT

for the year ending 31st December, 2010

	Rs.		Rs.
To Opening Stock	1,53,100	By Sales	25,60,000
To Purchases	8,24,000	Less: Returns (Dr.)	40,000
Less: Returns (Cr.)	24,000	By Closing Stock	2,54,000
To Factory Rent	1,80,000		
To Custom Duty	1,15,000(1)		
To Coal, Gas and Power	60,000		
To Wages & Salary	3,66,000		
To Productive Expenses	26,000		
To Carriage	87,000		
To Gross Profit c/d	9,86,900		
	27,74,000		27,74,000
To Discount	75,000	By Gross Profit b/d	9,86,900
To Bad-Debts	58,500	By Commission	12,000
To Unproductive Expenses	50,000	By Bad Debts Recovered	20,000
To Depreciation	42,000	By Apprentice Premium	48,000(2)
To Charity	5,000		
To Bank Charges	1,800		
To Establishment			

Expenses	36,000		
To Interest on Loan	30,000		
To Net Profit transferred to Capital A/c	7,68,600		
	10,66,900		10,66,900

BALANCE SHEET

as on 31st December, 2010

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Sundry Creditors	1,40,000	Cash Balance	44,600
Loan	2,50,000	Bank Balance	40,000
Capital	25,00,000	Sundry Debtors	5,70,000
Add: Net Profit	7,68,600	Closing Stock	2,54,000
	32,68,600	Plant	4,20,000
Less: Drawings	4,80,000	Leasehold Building	15,00,000
	27,88,600	Patents	1,00,000
		Trade Marks	50,000
		Goodwill	2,00,000
	31,78,600		31,78,600

Balance Sheet and related concept:

The balance sheet, sometimes called the statement of financial position, lists the company's assets, liabilities, and stockholders' equity (including dollar amounts) as of a specific moment in time. That specific moment is the close of business on the date of the balance sheet. A balance sheet is like a photograph; it captures the financial position of a company at a particular point in time. The other two statements are for a period of time. As you study about the assets, liabilities, and stockholders' equity contained in a balance sheet, you will understand why this financial statement provides information about the solvency of the business.

The Balance Sheet

If an error is found on a previous year's financial statement, a correction must be made and the financials reissued.

The balance sheet is a formal document that follows a standard accounting format showing the same categories of assets and liabilities regardless of the size or nature of the business. Accounting is considered the language of business because its concepts are time-tested and standardized. Even if you do not utilize the services of a certified public accountant, you or your bookkeeper can adopt certain generally accepted accounting principles (GAAP) to develop financial statements. The strength of GAAP is the reliability of company data from one accounting period to another and the ability to compare the financial statements of different companies.

Balance Sheet Formats

XYZ Company		
Balance Sheet		
As at 30 June 2010		
Current Assets		
Cash at bank	30,000	
Inventory	250,000	
Debtors	75,000	
Total current assets		355,000
Non - Current Assets		
Buildings	550,000	
Plant & equipment	250,000	
Vehicles	120,000	
Total non-current assets		920,000
Total Assets		1,275,000
Current Liabilities		
Credit cards	15,000	
Creditors	110,000	
Tax Payable	25,000	
Total current liabilities		150,000
Non-current Liabilities		
Long term loans		700,000
Total Liabilities		850,000
Owners Equity		
Capital	100,000	
Retained earnings	250,000	
Current earnings	75,000	
Total Owners Equity		425,000

Standard accounting conventions present the balance sheet in one of two formats: the account form (horizontal presentation) and the report form (vertical presentation). Most companies favor the vertical report form, which doesn't conform to the typical explanation in investment literature of the balance sheet as having "two sides" that balance out.

Whether the format is up-down or side-by-side, all balance sheets conform to a presentation that positions the various account entries into five sections:

Assets = Liabilities + Equity

1. Current assets (short-term): items that are convertible into cash within one year
2. Non-current assets (long-term): items of a more permanent nature
3. Current liabilities (short-term): obligations due within one year
4. Non-current liabilities (long-term): obligations due beyond one year
5. Shareholders' equity (permanent): shareholders' investment and retained earnings.

UNIT-3

Ratio analysis:

Financial ratios are mathematical comparisons of financial statement accounts or categories. These relationships between the financial statement accounts help investors, creditors, and internal company management understand how well a business is performing and of areas needing improvement.

Financial ratios are the most common and widespread tools used to analyze a business' financial standing. Ratios are easy to understand and simple to compute. They can also be used to compare different companies in different industries. Since a ratio is simply a mathematically comparison based on proportions, big and small companies can be use ratios to compare their financial information. In a sense, financial ratios don't take into consideration the size of a company or the industry. Ratios are just a raw computation of financial position and performance.

Ratios allow us to compare companies across industries, big and small, to identify their strengths and weaknesses. Financial ratios are often divided up into seven main categories: liquidity, solvency, efficiency, profitability, market prospect, investment leverage, and coverage.

Liquidity Ratios:

Liquidity ratios analyze the ability of a company to pay off both its current liabilities as they become due as well as their long-term liabilities as they become current. In other words, these ratios show the cash levels of a company and the ability to turn other assets into cash to pay off liabilities and other current obligations.

Liquidity is not only a measure of how much cash a business has. It is also a measure of how easy it will be for the company to raise enough cash or convert assets into cash. Assets like accounts receivable, trading securities, and inventory are relatively easy for many companies to convert into cash in the short term. Thus, all of these assets go into the liquidity calculation of a company.

Quick Ratio:

The quick ratio or acid test ratio is a liquidity ratio that measures the ability of a company to pay its current liabilities when they come due with only quick assets. Quick assets are current assets that can be converted to cash within 90 days or in the short-term. Cash, cash equivalents, short-term investments or marketable securities, and current accounts receivable are considered quick assets.

Short-term investments or marketable securities include trading securities and available for sale securities that can easily be converted into cash within the next 90 days. Marketable securities are traded on an open market with a known price and readily available buyers. Any stock on the New York Stock Exchange would be considered a marketable security because they can easily be sold to any investor when the market is open.

Formula:

The quick ratio is calculated by adding cash, cash equivalents, short-term investments, and current receivables together then dividing them by current liabilities.

$$\text{Quick Ratio} = \frac{\text{Cash} + \text{Cash Equivalents} + \text{Short Term Investments} + \text{Current Receivables}}{\text{Current Liabilities}}$$

Current Ratio:

The current ratio is a liquidity and efficiency ratio that measures a firm's ability to pay off its short-term liabilities with its current assets. The current ratio is an important measure of liquidity because short-term liabilities are due within the next year.

This means that a company has a limited amount of time in order to raise the funds to pay for these liabilities. Current assets like cash, cash equivalents, and marketable securities can easily be converted into cash in the short term. This means that companies with larger amounts of current assets will more easily be able to pay off current liabilities when they become due without having to sell off long-term, revenue generating assets.

Formula

The current ratio is calculated by dividing current assets by current liabilities. This ratio is stated in numeric format rather than in decimal format. Here is the calculation:

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

Working Capital Ratio:

The working capital ratio, also called the current ratio, is a liquidity ratio that measures a firm's ability to pay off its current liabilities with current assets. The working capital ratio is important to creditors because it shows the liquidity of the company.

Current liabilities are best paid with current assets like cash, cash equivalents, and marketable securities because these assets can be converted into cash much quicker than fixed assets. The faster the assets can be converted into cash, the more likely the company will have the cash in time to pay its debts.

The reason this ratio is called the working capital ratio comes from the working capital calculation. When current assets exceed current liabilities, the firm has enough capital to run its day-to-day operations. In other words, it has enough capital to work. The working capital ratio transforms the working capital calculation into a comparison between current assets and current liabilities.

Formula

The working capital ratio is calculated by dividing current assets by current liabilities.

$$\text{Working Capital Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Funds flow analysis, concepts, uses, Preparation of funds flow statement:

Funds flow statement is a statement which discloses the analytical information about the different sources of a fund and the application of the same in an accounting cycle. It deals with the transactions which change either the amount of current assets and current liabilities (in the form of decrease or increase in working capital) or fixed assets, long-term loans including ownership fund.

It gives a clear picture about the movement of funds between the opening and closing dates of the Balance Sheet. It is also called the Statement of Sources and Applications of Funds, Movement of Funds Statement; Where Got—Where Gone Statement; Inflow and Outflow of Fund Statement, etc. No doubt, Funds Flow Statement is an important indicator of financial analysis and control. It is valuable and also

helps to determine how the funds are financed. The financial analyst can evaluate the future flows of a firm on the basis of past data.

The significance and importance of Funds Flow Statements may be summarized as:

(a) Analysis of Financial Statement:

The traditional financial statements, viz. Profit and Loss Account and Balance Sheet, exhibit the result of the operation and financial position of a firm. Balance Sheet presents a static view about the resources and how the said resources have been utilized at a particular date with recording the changes in financial activities. But Funds Flow Statement can do so, i.e., it explains the causes of changes so made and effect of such change in the firm accordingly.

(b) Highlighting Answers to Various Perplexing Questions:

Funds Flow Statement highlights answers of the following questions:

- (i) Causes of changes in Working Capital;
- (ii) Whether the firm sells any Non-Current Asset; if sold, how were the proceeds utilized?
- (iii) Why smaller amount of dividend is paid in spite of sufficient profit?
- (iv) Where did the net profit go?
- (v) Was it possible to pay more dividend than the present one?
- (vi) Did the firm pay-off its scheduled debts? If so, how, and from what sources?
- (vii) Sources of increased Working Capital, etc.

(c) Realistic Dividend Policy:

Sometimes it may so happen that a firm, instead of having sufficient profit, cannot pay dividend due to lack of liquid sources, viz. cash. In such a circumstance, Funds Flow Statement helps the firm to take decision about a sound dividend policy which is very helpful to the management.

(d) Proper Allocation of Resources:

Resources are always limited. So, it is the duty of the management to make its proper use. A projected Funds Flow Statement helps the management to take proper decision about the proper allocation of business resources in a best possible manner since it highlights the future.

(e) As a Future Guide:

A projected Funds Flow Statement acts as a business guide. It helps the management to make provision for the future for the necessary funds to be required on the basis of the problem faced. In other words, the future needs of the fund for various purposes can be known well in advance which is a very helpful guide to the management. In short, a firm may arrange funds on the basis of this statement in order to avoid the financial problem that may arise in future.

Cash flow analysis, Concepts, uses, preparation of cash flow statement:

A cash flow statement is one of the most important financial statements for a project or business. The statement can be as simple as a one page analysis or may involve several schedules that feed information into a central statement.

A cash flow statement is a listing of the flows of cash into and out of the business or project. Think of it as your checking account at the bank. Deposits are the cash inflow and withdrawals (checks) are the cash outflows. The balance in your checking account is your net cash flow at a specific point in time.

A *cash flow statement* is a listing of cash flows that occurred during the past accounting period. A projection of future flows of cash is called a *cash flow budget*. You can think of a cash flow budget as a projection of the future deposits and withdrawals to your checking account.

A cash flow statement is not only concerned with the amount of the cash flows but also the timing of the flows. Many cash flows are constructed with multiple time periods. For example, it may list monthly cash inflows and outflows over a year's time. It not only projects the cash balance remaining at the end of the year but also the cash balance for each month.

Format of Cash Flow Statement:

FORMAT OF THE STATEMENT OF CASH FLOWS
(INDIRECT METHOD)

Net cash flow from operating activities:		
Net income	x	
Adjustments for noncash expenses, revenues, losses and gains included in income:	x	
	<u>(x)</u>	
Net cash flow from operating activities		x
Cash flows from investing activities:		
	x	
	<u>(x)</u>	
Net cash flows provided (used) by investing activities		x
Cash flows from financing activities:		
	x	
	<u>(x)</u>	
Net cash provided (used) by financing activities		<u>x</u>
Net increase (decrease) in cash		<u>xx</u>
Schedule of noncash investing and financing activities:		
	x	
	x	

Break – even analysis:

The point at which total of fixed and variable costs of a business becomes equal to its total revenue is known as **break-even point (BEP)**. At this point, a business neither earns any profit nor suffers any loss. Break-even point is therefore also known as no-profit, no-loss point or zero profit point. Calculation of break-even point is important for every business because it tells business owners and managers how much sales are needed to cover all fixed as well as variable expenses of the business or the sales volume after which the business will start generating profit. The computation of sales volume required to break-even is known as *break-even analysis*. The concept explained above can also be presented as follows:

When there is a profit:

$$\text{Revenues} > \text{Variable cost} + \text{fixed cost}$$

At break-even point (BEP):

$$\text{Revenues} = \text{Variable cost} + \text{fixed cost}$$

When there is a loss:

$$\text{Revenues} < \text{Variable cost} + \text{fixed cost}$$

Computation of break-even point:

(1). Use of equation method:

The application of equation method facilitates the computation of break-even point both in units and in dollars. As we have already described that the sales are equal to total variable and fixed expenses at break-even point, the equation can therefore be written as follows:

$$\mathbf{Sp \times Q = Ve \times Q + Fe}$$

Or

$$\mathbf{SpQ = VeQ + Fe}$$

Where;

Sp = Sales price per unit.

Q = Number (quantity) of units to be manufactured and sold during the period.

Ve = Variable expenses to manufacture and sell a single unit of product.

Fe = Total fixed expenses for the period.

Notice that the left hand side of the equation represents the total sales in dollars and the right hand side of the equation represents the total cost. If the information about sales price per unit, variable expenses per unit and the total fixed expenses is available, we can solve the equation for 'Q' to find the number of units to break-even. The break-even point in units can then be multiplied by the sales price per unit to calculate the break-even point in dollars. Suppose, for example, you run a manufacturing business that is involved in manufacturing and selling a single product. The annual fixed expenses to run the business are \$15,000 and variable expenses are \$7.50 per unit. The sale price of your product is \$15 per unit. The number of units to be sold to break even can be easily calculated using **equation method**:

$$Sp \times Q = Ve \times Q + Fe$$

$$15 \times Q = 7.5 \times Q + 15,000$$

$$15Q = 7.5Q + 15,000$$

$$15Q - 7.5Q = 15,000$$

$$7.5Q = 15,000$$

$$Q = 15,000 / 7.5$$

$$Q = 2,000 \text{ units}$$

The break-even point in units is 2,000 units and the break-even point in dollars can be computed as follows:

$$= (2,000 \text{ units}) \times (\$15)$$

$$= \$30,000$$

(2). Use of contribution margin method:

The method described above is known as **equation method of calculating break-even point**. Some people use another method called **contribution margin method** (read about contribution margin and its calculation). Under this method, the total fixed expenses are divided by contribution margin per unit.

Consider the following computations:

Total fixed expenses / Contribution margin per unit

$$= 15,000 / 7.5^*$$

$$= 2,000 \text{ units}$$

or

$$= (2,000 \text{ units}) \times (\$15)$$

$$= \$30,000$$

$$*\$15 - \$7.5$$

A little variation of this method is to divide the total fixed expenses by the contribution margin ratio (CM ratio). Doing so results in break-even point in dollars. It is shown below:

Total fixed expenses / Contribution margin ratio

$$= \$15,000 / 0.5^*$$

$$= \$30,000$$

$$*(\$15 - \$7.5)/\$15$$

Graphical presentation (Preparation of break-even chart or CVP graph):

Explanation of the graph:

1. The number of units have been presented on the X-axis (horizontally) where as dollars have been presented on Y-axis (vertically).
2. The straight line in red color represents the total annual fixed expenses of \$15,000.
3. The blue line represents the total expenses. Notice that the line has a positive or upward slop that indicates the effect of increasing variable expenses with the increase in production.
4. The green line with positive or upward slop indicates that every unit sold increases the total sales revenue.
5. The total revenue line and the total expenses line cross each other. The point at which they cross each other is the *break-even point*. Notice that the total expenses line is above the total revenue line before the point of intersection and below after the point of intersection. It tells us that the business suffers a loss before the point of intersection and makes a profit after this point. The break-even point in the above graph is 2,000 units or \$30,000 that agrees with the break-even point computed using equation and contribution margin methods above.
6. The difference between the total expenses line and the total revenue line before the point of intersection (BE point) is the *loss area*. The loss area has been filled with pink color. Notice that this area reduces as the number of units sold increases. It means every additional unit sold before the break-even point reduces the loss.
7. The difference between the total expenses line and the total revenue line after the point of intersection (BE point) is the profit area. The profit area has been filled with green color. Notice that this area increases as the number of units sold increases. It means every additional unit sold after the break-even point increases the profit of the business.

UNIT -5

Definition nature and Objective of Financial Management:

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

Objectives of Financial Management:

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
4. To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

Functions of Financial Management:

1. **Estimation of capital requirements:** A finance manager has to make estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programmes and policies of a concern. Estimations have to be made in an adequate manner which increases earning capacity of enterprise.
2. **Determination of capital composition:** Once the estimation have been made, the capital structure have to be decided. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.
3. **Choice of sources of funds:** For additional funds to be procured, a company has many choices like-
 - a. Issue of shares and debentures
 - b. Loans to be taken from banks and financial institutions
 - c. Public deposits to be drawn like in form of bonds.

Choice of factor will depend on relative merits and demerits of each source and period of financing.

4. **Investment of funds:** The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.
5. **Disposal of surplus:** The net profits decision have to be made by the finance manager. This can be done in two ways:
 - a. Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
 - b. Retained profits - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.
6. **Management of cash:** Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintainance of enough stock, purchase of raw materials, etc.

7. **Financial controls:** The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

Long Term Sources of Finance

There are various sources of finance such as equity, debt, debentures, retained earnings, term loans, working capital loans, letter of credit, euro issue, venture funding etc. These sources are useful in different situations. They are classified based on time period, ownership and control, and their source of generation.

As the name suggests, **Long term financing** is a form of financing that is provided for a period of more than a year. Long term financing services are provided to those business entities that face a shortage of capital. There are various long term sources of finance.

It is different from short term financing which is normally used to provide money that has to be paid back within a year. The period may be shorter than one year as well.

Examples of long-term financing include – a 30 year mortgage or a 10-year Treasury note. Equity is another form of long-term financing, such as when a company issues stock to raise capital for a new project.

Purpose of Long Term Finance:

- To finance fixed assets.
- To finance the permanent part of working capital.
- Expansion of companies.
- Increasing facilities.
- Construction projects on a big scale.
- Provide capital for funding the operations. This helps in adjusting the cash flow.

Factors determining Long-term Financial Requirements:

- Nature of Business
- Nature of Goods produced
- Technology used

Types of Long Term Financing:

The kind of long term financing that is provided to a particular company depends on its type. For example, the long term financing that is provided to a solo proprietorship is different from the one received by a partnership firm.

Uses of Long Term Financing:

Long term financing is used in separate ways by different types of business entities. The business entities that are not corporations are only supposed to use long term financing for the purpose of debt. However, the corporations can use long term financing for both debt and equity purposes.

Sources of Long Term Financing:

Following are the various sources of long term finance are as follows –

Shares: These are issued to the general public. The holders of shares are the owners of the business. These may be of two types:
Equity shares and
Preference shares.

Debentures: These are also issued to the general public. The holders of debentures are the creditors of the company.

Public Deposits: General public also likes to deposit their savings with a popular and well established company which can pay interest periodically and pay-back the deposit when due.

Retained Earnings: The company may not distribute the whole of its profits among its shareholders. It may retain a part of the profits and utilize it as capital.

Term Loans from Banks: Many industrial development banks, cooperative banks and commercial banks grant medium term loans for a period of 3-5 years.

Loan from Financial Institutions: There are many specialized financial institutions established by the Central and State governments which give long term loans at reasonable rates of interest.

Long Term Financing Products: The following products are provided as part of long term financing services.

Introductory idea about capitalization:

The term capital structure refers to the percentage of capital (money) at work in a business by type. Broadly speaking, there are two forms of capital: equity capital and debt capital. Each has its own benefits and drawbacks, and a substantial part of wise corporate stewardship and management is attempting to find the perfect capital structure in terms of risk / reward payoff for shareholders. This is true for Fortune 500 companies and for small business owners trying to determine how much of their start-up money should come from a bank loan without endangering the business.

Let's look at each in detail:

- **Equity Capital:** This refers to money put up and owned by the shareholders (owners). Typically, equity capital consists of two types: 1.) contributed capital, which is the money that was originally invested in the business in exchange for shares of stock or ownership and 2.) retained earnings, which represents profits from past years that have been kept by the company and used to strengthen the balance sheet or fund growth, acquisitions, or expansion.

Many consider equity capital to be the most expensive type of capital a company can utilize because its "cost" is the return the firm must earn to attract investment. A speculative mining company that is looking for silver in a remote region of Africa may require a much higher return on equity to get investors to purchase the stock than a firm such as Procter & Gamble, which sells everything from toothpaste and shampoo to detergent and beauty products.

- **Debt Capital:** The debt capital in a company's capital structure refers to borrowed money that is at work in the business. The safest type is generally considered long-term bonds because the company has years, if not decades, to come up with the principal, while paying interest only in the meantime.

Other types of debt capital can include short-term commercial paper utilized by giants such as Wal-Mart and General Electric that amount to billions of dollars in 24-hour loans from the capital markets to meet day-to-day working capital requirements such as payroll and utility bills. The cost of debt capital in the capital structure depends on the health of the company's balance sheet - a triple AAA rated firm is going to be able to borrow at extremely low rates versus a speculative company with tons of debt, which may have to pay 15% or more in exchange for debt capital.

- **Other Forms of Capital:** There are actually other forms of capital, such as vendor financing where a company can sell goods before they have to pay the bill to the vendor, that can drastically increase return on equity but don't cost the company anything. This was one of the secrets to Sam Walton's success at Wal-Mart. He was often able to sell Tide detergent before having to pay the bill to Procter & Gamble, in effect, using PG's money to grow his retailer. In the case of an insurance company, the policyholder "float" represents money that doesn't belong to the firm but that it gets to use and earn an investment on until it has to pay it out for accidents or medical bills, in the case of an auto insurer.

Concept of Cost of Capital:

A firm raises funds from various sources, which are called the components of capital. Different sources of fund or the components of capital have different costs. For example, the cost of raising funds through issuing equity shares is different from that of raising funds through issuing preference shares. The cost of each source is the specific cost of that source, the average of which gives the overall cost for acquiring capital.

The firm invests the funds in various assets. So it should earn returns that are higher than the cost of raising the funds. In this sense the minimum return a firm earns must be equal to the cost of raising the fund. So the cost of capital may be viewed from two viewpoints—acquisition of funds and application of funds. From the viewpoint of acquisition of funds, it is the borrowing rate that a firm will try to minimize.

On the other hand from the viewpoint of application of funds, it is the required rate of return that a firm tries to achieve. The cost of capital is the average rate of return required by the investors who provide long-term funds. In other words, cost of capital refers to the minimum rate of return a firm must earn on its investment so that the market value of company's equity shareholders does not fall.

Measurement of cost of capital:

Measurement of cost of capital is totally related with the risk level of business. In above screenshot, you can see, when the risk is very very low. We will pay low cost of capital. Our measuring tool will show also low rate of this cost. Both cost of debt and cost of equity will low. If we have to simplify, we may calculate the weighted average cost of capital. It will also be very low if risk are at low level. But when the risk level of business will increase, we have to pay more cost of capital and rate angle will move to right side in measurement tool.

Because, we have explained all the formulae for calculating [cost of capital](#), so this content, we will explain some examples of measuring cost of capital.

1. Cost of Debt Measurement

B Ltd issues \$ 1,00,000 9% debentures at a premium of 10%. The cost of flotation are 2%. The tax rate applicable is 60%. Measure cost of debt capital.

$$K_{da} = \text{Interest} / \text{NP} \times (1-t)$$

$$\text{NP} = (1,00,000 + 10,000) - (1,10,000 \times 2/100) = 1,10,000 - 2,200 = 1,07,800$$

t = Tax rate

$$= 1,00,000 \times 9\% / 1,07,800 \times (1 - 0.6) = 3.34\%$$

2. Cost of Preference Share Capital Measurement

A company issues 1000 7% preference shares of \$ 100 each at a premium of 10% redeemable after 5 years at par. Measure the cost of preference capital

$$K_{pr} = D + 1/n (MV - NP) / 1/2 (MV + NP) \times 100$$

$$D = 100,000 \times 7\% = 7,000$$

$$MV = 1,00,000$$

$$NP = 1,00,000 + 1,00,000 \times 10\% = 1,10,000$$

n = 5 years

$$= 7,000 + 1/5 (1,00,000 - 1,10,000)$$

3. Cost of Equity Share Capital Measurement

A company is considering an expenditure of \$ 60 lakhs for expanding its operations. The relevant information is as follows.

Number of existing equity shares = 10 Lakhs

Market Value of existing share = \$ 60

Net Earnings = \$ 90 Lakhs

Measure the cost of existing equity share capital of new equity capital assuming that new shares will be issued at a price of \$ 52 per share and the cost of new issue will be \$ 2 per share.

Cost of existing equity share capital

$$K_e = \text{EPS} / \text{MP}$$

EPS = Earning per share

$$= \$ 90 / 10 = \$ 9$$

$$K_e = 9 / 60 \times 100 = 15\%$$

Cost of New Equity Share Capital

$$K_e = \text{EPS} / \text{NP}$$

$$= 9 / (52 - 2) \times 100 = 18\%$$

4. Cost of Retained Earning Measurement

A company's return available to shareholders is 15%. The average tax rate of shareholders is 40% and it is expected that 2% is brokerage cost that shareholders will have to pay while investing their dividends in alternative securities. What is the cost of retained earnings?

$$\text{Cost of Retained Earnings} = K_r = K_e (1 - t) (1 - b)$$

K_e = rate of return available to shareholders

t = tax rate

b = brokerage cost

$$K_r = 15\% (1 - 0.4) (1 - 0.02)$$

$$= 15\% \times 0.6 \times 0.98$$

$$= 8.82\%$$

UNIT-5

Concept & Components of working Capital:

The funds invested in current assets are termed as working capital. It is the fund that is needed to run the day-to-day operations. It circulates in the business like the blood circulates in a living body. Generally, working capital refers to the current assets of a company that are changed from one form to another in the ordinary course of business, i.e. from cash to inventory, inventory to work in progress (WIP), WIP to finished goods, finished goods to receivables and from receivables to cash.

Need for Working Capital:

Working capital plays a vital role in business. This capital remains blocked in raw materials, work in progress, finished products and with customers.

The needs for working capital are as given below:

- i. Adequate working capital is needed to maintain a regular supply of raw materials, which in turn facilitates smoother running of production process.
- ii. Working capital ensures the regular and timely payment of wages and salaries, thereby improving the morale and efficiency of employees.
- iii. Working capital is needed for the efficient use of fixed assets.
- iv. In order to enhance goodwill a healthy level of working capital is needed. It is necessary to build a good reputation and to make payments to creditors in time.
- v. Working capital helps avoid the possibility of under-capitalization.
- vi. It is needed to pick up stock of raw materials even during economic depression.
- vii. Working capital is needed in order to pay fair rate of dividend and interest in time, which increases the confidence of the investors in the firm.

Importance of Working Capital:

It is said that working capital is the lifeblood of a business. Every business needs funds in order to run its day-to-day activities.

The importance of working capital can be better understood by the following:

- i. It helps measure profitability of an enterprise. In its absence, there would be neither production nor profit.
- ii. Without adequate working capital an entity cannot meet its short-term liabilities in time.
- iii. A firm having a healthy working capital position can get loans easily from the market due to its high reputation or goodwill.
- iv. Sufficient working capital helps maintain an uninterrupted flow of production by supplying raw materials and payment of wages.
- v. Sound working capital helps maintain optimum level of investment in current assets.
- vi. It enhances liquidity, solvency, credit worthiness and reputation of enterprise.
- vii. It provides necessary funds to meet unforeseen contingencies and thus helps the enterprise run successfully during periods of crisis.

Classification of Working Capital:

Working capital may be of different types as follows:

(a) Gross Working Capital:

Gross working capital refers to the amount of funds invested in various components of current assets. It consists of raw materials, work in progress, debtors, finished goods, etc.

(b) Net Working Capital:

The excess of current assets over current liabilities is known as Net working capital. The principal objective here is to learn the composition and magnitude of current assets required to meet current liabilities.

(c) Positive Working Capital:

This refers to the surplus of current assets over current liabilities.

(d) Negative Working Capital:

Negative working capital refers to the excess of current liabilities over current assets.

(e) Permanent Working Capital:

The minimum amount of working capital which even required during the dullest season of the year is known as Permanent working capital.

(f) Temporary or Variable Working Capital:

It represents the additional current assets required at different times during the operating year to meet additional inventory, extra cash, etc.

It can be said that Permanent working capital represents minimum amount of the current assets required throughout the year for normal production whereas Temporary working capital is the additional capital required at different time of the year to finance the fluctuations in production due to seasonal change. A firm having constant annual production will also have constant Permanent working capital and only Variable working capital changes due to change in production caused by seasonal changes.

UNIT-6

Cash Management:

Cash management refers to a broad area of finance involving the collection, handling, and usage of cash. It involves assessing market liquidity, cash flow, and investments.

In banking, cash management, or treasury management, is a marketing term for certain services related to cash flow offered primarily to larger business customers. It may be used to describe all bank accounts (such as checking accounts) provided to businesses of a certain size, but it is more often used to describe specific services such as cash concentration, zero balance accounting, and automated clearing house facilities. Sometimes, private banking customers are given cash management services.

Inventory Management:

Inventory is an idle stock of physical goods that contain economic value, and are held in various forms by an organization in its custody awaiting packing, processing, transformation, use or sale in a future point of time.

Any organization which is into production, trading, sale and service of a product will necessarily hold stock of various physical resources to aid in future consumption and sale. While inventory is a necessary evil of any such business, it may be noted that the organizations hold inventories for various reasons, which include speculative purposes, functional purposes, physical necessities etc.

From the above definition the following points stand out with reference to inventory:

- All organizations engaged in production or sale of products hold inventory in one form or other.
- Inventory can be in complete state or incomplete state.
- Inventory is held to facilitate future consumption, sale or further processing/value addition.
- All inventoried resources have economic value and can be considered as assets of the organization.

Different Types of Inventory:

Inventory of materials occurs at various stages and departments of an organization. A manufacturing organization holds inventory of raw materials and consumables required for production. It also holds inventory of semi-finished goods at various stages in the plant with various departments. Finished goods inventory is held at plant, FG Stores, distribution centers etc. Further both raw materials and finished goods those that are in transit at various locations also form a part of inventory depending upon who owns the inventory at the particular juncture. Finished goods inventory is held by the organization at various stocking points or with dealers and stockiest until it reaches the market and end customers.

Besides Raw materials and finished goods, organizations also hold inventories of spare parts to service the products. Defective products, defective parts and scrap also forms a part of inventory as long as these items are inventoried in the books of the company and have economic value.

Types of Inventory by Function

INPUT	PROCESS	OUTPUT
Raw Materials	Work In Process	Finished Goods
Consumables required for processing. Eg : Fuel, Stationary, Bolts & Nuts etc. required in manufacturing	Semi Finished Production in various stages, lying with various departments like Production, WIP Stores, QC, Final Assembly, Paint Shop, Packing, Outbound Store etc.	Finished Goods at Distribution Centers through out Supply Chain
Maintenance Items/Consumables	Production Waste and Scrap	Finished Goods in transit
Packing Materials	Rejections and Defectives	Finished Goods with Stockiest and Dealers
Local purchased Items required for production		Spare Parts Stocks & Bought Out items
		Defectives, Rejects and Sales Returns
		Repaired Stock and Parts
		Sales Promotion & Sample Stocks

Receivables Management:

Receivables, also termed as trade credit or debtors are component of current assets. When a firm sells its product in credit, account receivables are created.

Account receivable are the money receivable in some future date for the credit sale of goods and services at present. These days, most business transactions are in credit. Most companies, when they face competition, use credit sales as an important tool for sales promotion. As a sales promotion tool, credit sale enhances firm's sales revenue and ultimately pushes up the profitability. But after the credit sale has been made, the actual collection of cash may be delayed for months. As these late payments stretch out over time, they may cause substantial drop in a company's profit margin. Since the extension of credit involves both cost and benefits, the firm's manager must be able to measure them to determine the ultimate effect of credits sales. In this prospective, we define the receivable management as the aspect of a firm's current assets management, which is concerned with determining optimum credit policy associated to a firm, such that the benefit from extension of credit is greater than the cost of maintaining investment in accounts receivables.

Significance And Purpose Of Receivable Management

The basic purpose of firm's receivable management is to determine effective credit policy that increases the efficiency of firm's credit and collection department and contributes to the maximization of value of the firm. The specific purposes of receivable management are as follows:

1. To evaluate the creditworthiness of customers before granting or extending the credit.
2. To minimize the cost of investment in receivables.
3. To minimize the possible bad debt losses.
4. To formulate the credit terms in such a way that results into maximization of sales revenue and still maintaining minimum investment in receivables.
5. To minimize the cost of running credit and collection department.
6. To maintain a trade off between costs and benefits associated to credit policy.

