BIJU PATNAIK INSTITUTE OF IT & MANAGEMENT STUDIES, BHUBANESWAR

Financial Accounting & Analysis (FAA)

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MODULE-I

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

The business activities require resources (which are limited & have multiple uses) primarily in terms of material, labour, machineries, factories and other services. The success of business depends on how efficiently and effectively these resources are managed. Therefore, there is a need to ensure the businessman tracks the use of these resources. The resources are not free and thus one must be careful to keep an eye on cost of acquiring them as well.

As the basic purpose of business is to make profit, one must keep an ongoing track of the activities undertaken in course of business. Two basic questions would have to be answered:

(a) What is the result of business operations? This will be answered by finding out whether it has made profit or loss.

(b) What is the position of the resources acquired and used for business purpose? How are these resources financed? Where the funds come from?

The answers to these questions are to be found continuously and the best way to find them is to record all the business activities. Recording of business activities has to be done in a scientific manner so that they reveal correct outcome. The science of book-keeping and accounting provides an effective solution. It is a branch of social science. This study material aims at giving a platform to the students to understand basic principles and concepts, which can be applied to accurately measure performance of business.

After studying the various chapters included herein, the student should be able to apply the principles, rules, conventions and practices to different business situations like trading, manufacturing or service.

Definition of Accounting

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

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

Definition by the American Accounting Association (Year 1966):

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

(a) Objectives of Accounting

(i) Providing Information to the Users for Rational Decision-making

The primary objective of accounting is to provide useful information for decision-making to stakeholders such as owners, management, creditors, investors, etc. Various outcomes of business activities such as costs, prices, sales volume, value under ownership, return of investment, etc. are measured in the accounting process. All these accounting measurements are used by stakeholders (owners, investors, creditors/bankers, etc.) in course of business operation. Hence, accounting is identified as 'language of business'.

(ii) Systematic Recording of Transactions

To ensure reliability and precision for the accounting measurements, it is necessary to keep a systematic record of all financial transactions of a business enterprise which is ensured by bookkeeping. These financial records are classified, summarized and reposted in the form of accounting measurements to the users of accounting information i.e., stakeholder.

(iii) Ascertainment of Results of above Transactions

'Profit/loss' is a core accounting measurement. It is measured by preparing profit and loss account for a particular period. Various other accounting measurements such as different types of revenue expenses and revenue incomes are considered for preparing this profit and loss account. Difference between these revenue incomes and revenue expenses is known as result of business transactions identified as profit/loss. As this measure is used very frequently by stockholders for rational decision making, it has become the objective of accounting.

For example, Income Tax Act requires that every business should have an accounting system that can measure taxable income of business and also explain nature and source of every item reported in Income Tax Return.

(iv) Ascertain the Financial Position of Business

'Financial position' is another core accounting measurement. Financial position is identified by preparing a statement of ownership i.e., Assets and Owings i.e., liabilities of the business as on a certain date. This statement is popularly known as balance sheet. Various other accounting measurements such as different types of assets and different types of liabilities as existed at a particular date are considered for preparing the balance sheet. This statement may be used by various stakeholders for financing and investment decision.

(v) To Know the Solvency Position

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

- To Know the Solvency Position
- Ascertain the Financial Position of Business
- Ascertainment of Results of above Transactions
- Systematic Recording of Transactions
- Providing Information to the Users for Ratio

Accounting – Classification

(a) Financial Accounting

It is commonly termed as Accounting. The American Institute of Certified Public Accountants defines Accounting as "an art of recoding, classifying and summarizing in a significant manner and in terms of money, transactions and events which are in part at least of a financial character, and interpreting the results thereof."

(b) Cost Accounting

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

(c) Management Accounting

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

BASIC ACCOUNTING TERMS

(i) **Transaction:** It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person e.g. purchase of goods would involve receiving material and making payment or creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction. In credit transaction, the payment is settled at a future date as per agreement between the parties.

(ii) **Goods/Services :** These are tangible article or commodity in which a business deals. These articles or commodities are either bought and sold or produced and sold. At times, what may be classified as 'goods' to one business firm may not be 'goods' to the other firm. e.g. for a machine manufacturing company, the machines are 'goods' as they are frequently made and sold. But for the buying firm, it is not 'goods' as the intention is to use it as a long term resource and not sell it. Services are intangible in nature which are rendered with or without the object of earning profits.

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

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

(v) **Asset:** Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be Tangible and Intangible. Tangible Assets are the Capital assets which have some physical existence. They can, therefore, be seen, touched and felt, e.g. Plant and Machinery, Furniture and Fittings, Land and Buildings, Books, Computers, Vehicles, etc. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as lntangible Assets. They cannot be seen or felt although they help to generate revenue in future, e.g. Goodwill, Patents, Trade-marks, Copyrights, Brand Equity, Designs, Intellectual Property, etc. Assets can also be classified into Current Assets and Non-Current Assets.

Current Assets – An asset shall be classified as Current when it satisfies any of the following :

(a) It is expected to be realised in, or is intended for sale or consumption in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded ,

(c) It is due to be realised within 12 months after the Reporting Date, or

(d) It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Non-Current Assets – All other Assets shall be classified as Non-Current Assets. e.g. Machinery held for long term etc.

(vi) **Liability:** It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. E.g. when goods are bought on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date or when a loan is taken from bank, an obligation to pay interest and principal amount is created. Depending upon the period of holding, these obligations could be further classified into Long Term on non-current liabilities and Short Term or current liabilities.

Current Liabilities – A liability shall be classified as Current when it satisfies any of the following :

(a) It is expected to be settled in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded,

(c) It is due to be settled within 12 months after the Reporting Date, or

(d) The Company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Non-Current Liabilities – All other Liabilities shall be classified as Non-Current Liabilities. E.g. Loan taken for 5 years, Debentures issued etc.

(vii) **Internal Liability :** These represent proprietor's equity, i.e. all those amount which are entitled to the proprietor, e.g., Capital, Reserves, Undistributed Profits, etc.

(viii) **Working Capital :** In order to maintain flows of revenue from operation, every firm needs certain amount of current assets. For example, cash is required either to pay for expenses or to meet obligation for service received or goods purchased, etc. by a firm. On identical reason, inventories are required to provide the link between production and sale. Similarly, Accounts Receivable generate when goods are sold on credit. Cash, Bank, Debtors, Bills Receivable, Closing Stock, Prepayments etc. represent current assets of firm. The whole of these current assets form the working capital of a firm which is termed as Gross Working Capital.

Gross Working capital = Total Current Assets = Long term internal liabilities plus long term debts plus the current liabilities minus the amount blocked in the fixed assets.

There is another concept of working capital. Working capital is the excess of current assets over current liabilities. That is the amount of current assets that remain in a firm if all its current liabilities are paid. This concept of working capital is known as Net Working Capital which is a more realistic concept.

Working Capital (Net) = Current Assets – Currents Liabilities.

(ix) **Contingent Liability :** It represents a potential obligation that could be created depending on the outcome of an event. E.g. if supplier of the business files a legal suit, it will not be treated as a liability because no obligation is created immediately. If the verdict of the case is given in favour of the supplier then only the obligation is created. Till that it is treated as a contingent liability. Please note that contingent liability is not recorded in books of account, but disclosed by way of a note to the financial statements.

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

(xi) **Drawings :** It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use. e.g. if the life insurance premium of proprietor or a partner of business is paid from the business cash, it is called drawings. Drawings will result in reduction in the owners' capital. The concept of drawing is not applicable to the corporate bodies like limited companies.

(xii) **Net worth :** It represents excess of total assets over total liabilities of the business. Technically, this amount is available to be distributed to owners in the event of closure of the business after payment of all liabilities. That is why it is also termed as Owner's equity. A profit making business will result in increase in the owner's equity whereas losses will reduce it.

(xiii) **Non-current Investments :** Non-current Investments are investments which are held beyond the current period as to sale or disposal. e. g. Fixed Deposit for 5 years.

(xiv) **Current Investments :** Current investments are investments that are by their nature readily realizable and are intended to be held for not more than one year from the date on which such investment is made. e. g. 11 months Commercial Paper.

(xv) **Debtor :** The sum total or aggregate of the amounts which the customer owe to the business for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Payable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or service rendered on credit. These debtors may again be classified as under:

(i) Good debts : The debts which are sure to be realized are called good debts.

(ii) Doubtful Debts : The debts which may or may not be realized are called doubtful debts.

(iii) Bad debts : The debts which cannot be realized at all are called bad debts.

It must be remembered that while ascertaining the debtors balance at the end of the period certain adjustments may have to be made e.g. Bad Debts, Discount Allowed, Returns Inwards, etc.

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

(xvii) **Capital Expenditure:** This represents expenditure incurred for the purpose of acquiring a fixed asset which is intended to be used over long term for earning profits there from. e. g. amount paid to buy a computer for office use is a capital expenditure. At times expenditure may be incurred for enhancing the production capacity of the machine. This also will be a capital expenditure. Capital expenditure forms part of the Balance Sheet.

(xviii) **Revenue expenditure:** This represents expenditure incurred to earn revenue of the current period. The benefits of revenue expenses get exhausted in the year of the incurrence. e.g.

repairs, insurance, salary & wages to employees, travel etc. The revenue expenditure results in reduction in profit or surplus. It forms part of the Income statement.

(xix) **Balance Sheet:** It is the statement of financial position of the business entity on a particular date. It lists all assets, liabilities and capital. It is important to note that this statement exhibits the state of affairs of the business as on a particular date only. It describes what the business owns and what the business owes to outsiders (this denotes liabilities) and to the owners (this denotes capital). It is prepared after incorporating the resulting profit/losses of Income statement.

(xx) **Profit and Loss Account or Income Statement:** This account shows the revenue earned by the business and the expenses incurred by the business to earn that revenue. This is prepared usually for a particular accounting period, which could be a month, quarter, a half year or a year. The net result of the Profit and Loss Account will show profit earned or loss suffered by the business entity.

(xxi) **Trade Discount:** It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price. e.g. the list price of a TV set could be ` 15000. The wholesaler may allow 20% discount thereof to the retailer. This means the retailer will get it for ` 12000 and is expected to sale it to final customer at the list price. Thus the trade discount enables the retailer to make profit by selling at the list price. Trade discount is not recorded in the books of accounts. The transactions are recorded at net values only. In above example, the transaction will be recorded at ` 12000 only.

(xxii) **Cash Discount:** This is allowed to encourage prompt payment by the debtor. This has to be recorded in the books of accounts. This is calculated after deducting the trade discount. e.g. if list price is 15000 on which a trade discount of 20% and cash discount of 2% apply, then first trade discount of 3000 (20% of 15000) will be deducted and the cash discount of 2% will be calculated on 12000 (15000 – 3000). Hence the cash discount will be 240 (2% of 12000) and net payment will be 11,760 (12,000 - 240)

Introduction to the Accounting Equation

From the large, multi-national corporation down to the corner beauty salon, every business transaction will have an effect on a company's financial position. The financial position of a company is measured by the following items:

1. Assets (what it owns)

2. Liabilities (what it owes to others)
3. Owner's Equity (the difference between assets and liabilities)

The **accounting equation** (or basic accounting equation) offers us a simple way to understand how these three amounts relate to each other. The accounting equation for a sole proprietorship is:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

The accounting equation for a corporation is:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

Assets are a company's resources—things the company owns. Examples of assets include cash, accounts receivable, inventory, prepaid insurance, investments, land, buildings, equipment, and goodwill. From the accounting equation, we see that the amount of assets must equal the combined amount of liabilities plus owner's (or stockholders') equity.

Liabilities are a company's obligations—amounts the company owes. Examples of liabilities include notes or loans payable, accounts payable, salaries and wages payable, interest payable, and income taxes payable (if the company is a regular corporation). Liabilities can be viewed in two ways:

(1) as claims by creditors against the company's assets, and

(2) a source—along with owner or stockholder equity—of the company's assets.

Owner's equity or stockholders' equity is the amount left over after liabilities are deducted from assets:

Assets - Liabilities = Owner's (or Stockholders') Equity.

Owner's or stockholders' equity also reports the amounts invested into the company by the owners plus the cumulative net income of the company that has not been withdrawn or distributed to the owners.

If a company keeps accurate records, the accounting equation will always be "in balance," meaning the left side should always equal the right side. The balance is maintained because every business transaction affects at least two of a company's accounts. For example, when a company borrows money from a bank, the company's assets will increase and its liabilities will increase by the same amount. When a company purchases inventory for cash, one asset will increase and one asset will decrease. Because there are two or more accounts affected by every transaction, the accounting system is referred to as double-entry accounting.

A company keeps track of all of its transactions by recording them in accounts in the company's general ledger. Each account in the general ledger is designated as to its type: asset, liability, owner's equity, revenue, expense, gain, or loss account.

Accounting Cycle

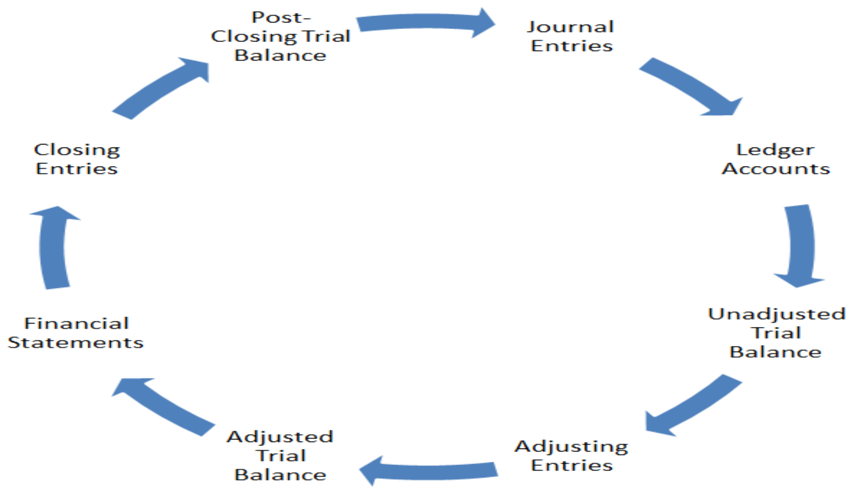
Accounting cycle is a step-by-step process of recording, classification and summarization of economic transactions of a business. It generates useful financial information in the form of financial statements including income statement, balance sheet, cash flow statement and statement of changes in equity.

The time period principle requires that a business should prepare its financial statements on periodic basis. Therefore accounting cycle is followed once during each accounting period. Accounting Cycle starts from the recording of individual transactions and ends on the preparation of financial statements and closing entries.

Major Steps in Accounting Cycle

Following are the major steps involved in the accounting cycle. We will use a simple example problem to explain each step.

- Analyzing and recording transactions via journal entries
- Posting journal entries to ledger accounts
- Preparing unadjusted trial balance
- Preparing adjusting entries at the end of the period
- Preparing adjusted trial balance
- Preparing financial statements
- Closing temporary accounts via closing entries
- Preparing post-closing trial balance



GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

A widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board are called Generally Accepted Accounting Principles (GAAP). These are the common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

GAAP is to be followed by companies so that investors have a optimum level of consistency in the financial statements they use when analyzing companies for investment purposes. GAAP cover such aspects like revenue recognition, balance sheet item classification and outstanding share measurements.

Accounting Standards –Its Meaning, Significance & Need

Preparation and presentation of corporate financial statement are governed by the companies act, 1956 and accounting standards. In India the institute of chartered accountants of India had established in 1977 an Accounting Standard Board (ASB).

Meaning of Accounting Standards

In this respect main purpose of standards is to provide information to the users as to the basis on which the accounts have been prepared.

The objective of setting standards is to bring about uniformity in financial reporting and to ensure consistency in the data published by enterprises. For accounting standards, to be useful tool to enhance the corporate governance and responsibility, two criteria must be satisfied, i.e.

(i) A standard must provide a generally understood and accepted measure of the phenomena of concern.

(ii) A standard should significantly reduce the amount of manipulation of the reported numbers and is likely to occur in the absence of the standards.

Significance of Accounting Standards

Accounting standards facilities uniform preparation and reporting of general purpose financial statements published annually for the benefit of shareholders, creditors, employee and public at large. They are very useful to the investors and other external groups in assessing the progress and prospects of alternative investments in different companies in different countries.

Need for Accounting Standards

Accounting standards can be seen as providing an important mechanism to help in the resolution of potential financial conflicts of interest between the various important groups in society. It is essential that accounting standards should command the greatest possible credibility among shareholders, creditors, employee and public at large.

Indian Accounting Standards

The accounting standards board of the Institute of Chartered Accountants of India has issued the following Accounting Standards:

- AS 1 Disclosure of Accounting Policies
- AS 2 Valuation of Inventories
- AS 3 Cash Flow Statements
- AS 4 Contingencies and Events Occuring after the Balance Sheet Date

- AS 5 Net Profit or Loss for the period,Prior Period Items and Changes in Accounting Policies
- AS 6 Depreciation Accounting
- AS 7 Construction Contracts (revised 2002)
- AS 9 Revenue Recognition
- AS 10 Accounting for Fixed Assets
- AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003),
- AS 12 Accounting for Government Grants
- AS 13 Accounting for Investments
- AS 14 Accounting for Amalgamations
- AS 15 Employee Benefits (revised 2005)
- AS 16 Borrowing Costs
- AS 17 Segment Reporting
- AS 18 Related Party Disclosures
- AS 19 Leases
- AS 20 Earnings Per Share
- S 21 Consolidated Financial Statements
- AS 22 Accounting for Taxes on Income.
- AS 23 Accounting for Investments in Associates in Consolidated Financial Statements
- AS 24 Discontinuing Operations
- AS 25 Interim Financial Reporting
- AS 26 Intangible Assets
- AS 27 Financial Reporting of Interests in Joint Ventures
- AS 28 Impairment of Assets
- AS 29 Provisions, Contingent` Liabilities and Contingent Assets

Accounting Concepts

Accounting concept refers to the basic assumptions and rules and principles which work as the basis of recording of business transactions and preparing accounts.

Business Entity Concept: This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate. For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as business expense.

Thus, the accounting records are made in the books of accounts from the point of view of the business unit and not the person owning the business. This concept is the very basis of accounting.

Let us take an example. Suppose Mr. Sahoo started business investing Rs100000. He purchased goods for Rs40000, Furniture for Rs20000 and plant and machinery of Rs30000. Rs10000 remains in hand. These are the assets of the business and not of the owner. According to the business entity concept Rs100000 will be treated by business as capital i.e. a liability of business towards the owner of the business.

Now suppose, he takes away Rs5000 cash or goods worth Rs5000 for his domestic purposes. This withdrawal of cash/goods by the owner from the business is his private expense and not an expense of the business. It is termed as Drawings. Thus, the business entity concept states that business and the owner are two separate/distinct persons. Accordingly, any expenses incurred by owner for himself or his family from business will be considered as expenses and it will be shown as drawings.

Significance

- The following points highlight the significance of business entity concept:
- This concept helps in ascertaining the profit of the business as only the business expenses and revenues are recorded and all the private and personal expenses are ignored.
- These concept restraints accountants from recording of owner's private/personal transactions.
- It also facilitates the recording and reporting of business transactions from the business point of view
- It is the very basis of accounting concepts, conventions and principles.

Money Measurement Concept

This concept assumes that all business transactions must be in terms of money, that is in the currency of a country. In our country such transactions are in terms of rupees. Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts. For example, sale of goods worth Rs.200000, purchase of raw materials Rs.100000, Rent Paid Rs.10000 etc. are expressed in terms of money, and so they are recorded in the books of accounts. But the transactions which cannot be expressed in monetary terms are not recorded in the books of accounts. For example, sincerity, loyality, honesty of employees are not recorded in books of accounts because these cannot be measured in terms of money although they do affect the profits and losses of the business concern.

Another aspect of this concept is that the records of the transactions are to be kept not in the physical units but in the monetary unit. For example, at the end of the year 2006, an organisation may have a factory on a piece of land measuring 10 acres, office building containing 50 rooms, 50 personal computers, 50 office chairs and tables, 100 kg of raw materials etc. These are expressed in different units. But for accounting purposes they are to be recorded in money terms i.e. in rupees. In this case, the cost of factory land may be say Rs.12 crore, office building of Rs.10 crore, computers Rs.10 lakhs, office chairs and tables Rs.2 lakhs, raw material Rs.30 lakhs. Thus, the total assets of the organisation are valued at Rs.22 crore and Rs.42 lakhs. Therefore, the transactions which can be expressed in terms of money is recorded in the accounts books, that too in terms of money and not in terms of the quantity.

Significance

The following points highlight the significance of money measurement concept:

- This concept guides accountants what to record and what not to record.
- It helps in recording business transactions uniformly.
- If all the business transactions are expressed in monetary terms, it will be easy to understand the accounts prepared by the business enterprise.
- It facilitates comparison of business performance of two different periods of the same firm or of the two different firms for the same period.

Going Concern Concept

This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future.

This is an important assumption of accounting, as it provides a basis for showing the value of assets in the balance sheet; For example, a company purchases a plant and machinery of Rs.100000 and its life span is 10 years.

According to this concept every year some amount will be shown as expenses and the balance amount as an asset. Thus, if an amount is spent on an item which will be used in business for many years, it will not be proper to charge the amount from the revenues of the year in which the item is acquired. Only a part of the value is shown as expense in the year of purchase and the remaining balance is shown as an asset.

Significance

The following points highlight the significance of going concern concept;

- This concept facilitates preparation of financial statements.
- On the basis of this concept, depreciation is charged on the fixed asset.
- It is of great help to the investors, because, it assures them that they will continue to get income on their investments.
- In the absence of this concept, the cost of a fixed asset will be treated as an expense in the year of its purchase.
- A business is judged for its capacity to earn profits in future.

Accounting Period Concept

All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept. Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. This is necessary for different purposes like, calculation of profit, ascertaining financial position, tax computation etc.

Further, this concept assumes that, indefinite life of business is divided into parts. These parts are known as Accounting Period. It may be of one year, six months, three months, one month, etc. But usually one year is taken as one accounting period which may be a calender year or a financial year.

Year that begins from 1st of January and ends on 31st of December, is known as Calendar Year. The year that begins from 1st of April and ends on 31st of March of the following year, is known as financial year.

As per accounting period concept, all the transactions are recorded in the books of accounts for a specified period of time. Hence, goods purchased and sold during the period, rent, salaries etc. paid for the period are accounted for and against that period only.

Significance

- It helps in predicting the future prospects of the business.
- It helps in calculating tax on business income calculated for a particular time period.
- It also helps banks, financial institutions, creditors, etc to assess and analyze the performance of business for a particular period.
- It also helps the business firms to distribute their income at regular intervals as dividends.

Cost Concept

Accounting cost concept states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that fixed assets like building, plant and machinery, furniture, etc are recorded in the books of accounts at a price paid for them. For example, a machine was purchased by XYZ Limited for Rs.500000, for manufacturing shoes. An amount of Rs.1,000 were spent on transporting the machine to the factory site. In addition, Rs.2000 were spent on its installation. The total amount at which the machine will be recorded in the books of accounts would be the sum of all these items i.e. Rs.503000. This cost is also known as historical cost. Suppose the market price of the same is now Rs 90000 it will not be shown at this value. Further, it may be clarified that cost means original or acquisition cost only for new assets and for the used ones, cost means original cost less depreciation. The cost concept is also known as historical cost concept. The effect of cost concept is that if the business entity does not pay anything for acquiring an asset this item would not appear in the books of accounts. Thus, goodwill appears in the accounts only if the entity has purchased this intangible asset for a price.

Significance

- This concept requires asset to be shown at the price it has been acquired, which can be verified from the supporting documents.
- It helps in calculating depreciation on fixed assets.
- The effect of cost concept is that if the business entity does not pay anything for an asset, this item will not be shown in the books of accounts.

Dual Aspect Concept

Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e. it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. For example, goods purchased for cash has two aspects which are (i) Giving of cash (ii) Receiving of goods. These two aspects are to be recorded. Thus, the duality concept is commonly expressed in terms of fundamental accounting equation : Assets = Liabilities + Capital

The above accounting equation states that the assets of a business are always equal to the claims of owner/owners and the outsiders. This claim is also termed as capital or owners equity and that of outsiders, as liabilities or creditors' equity. The knowledge of dual aspect helps in identifying the two aspects of a transaction which helps in applying the rules of recording the transactions in books of accounts. The implication of dual aspect concept is that every transaction has an equal impact on assets and liabilities in such a way that total assets are always equal to total liabilities.

Significance

- This concept helps accountant in detecting error.
- It encourages the accountant to post each entry in opposite sides of two
- affected accounts.

Realization Concept

This concept states that revenue from any business transaction should be included in the accounting records only when it is realized. The term realization means creation of legal right to receive money. Selling goods is realization, receiving order is not. In other words, it can be said that : Revenue is said to have been realized when cash has been received or right to receive cash on the sale of goods or services or both has been created.

Significance

It helps in making the accounting information more objective.

It provides that the transactions should be recorded only when goods are delivered to the buyer.

Accrual Concept

The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognized when they become receivable. Though cash is received or not received and the expenses are recognized when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate. Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses.

The accrual concept under accounting assumes that revenue is realized at the time of sale of goods or services irrespective of the fact when the cash is received. For example, a firm sells goods for Rs 55000 on 25th March 2005 and the payment is not received until 10th April 2005, the amount is due and payable to the firm on the date of sale i.e. 25th March 2005. It must be included in the revenue for the year ending 31st March 2005. Similarly, expenses are recognized at the time services provided, irrespective of the fact when actual payment for these services are made.

For example, if the firm received goods costing Rs.20000 on 29th March 2005 but the payment is made on 2nd April 2005 the accrual concept requires that expenses must be recorded for the year ending 31st March 2005 although no payment has been made until 31st March 2005 though the service has been received and the person to whom the payment should have been made is shown as creditor.

In brief, accrual concept requires that revenue is recognized when realized and expenses are recognized when they become due and payable without regard to the time of cash receipt or cash payment.

Significance

- It helps in knowing actual expenses and actual income during a particular time period.
- It helps in calculating the net profit of the business.

Matching Concept

The matching concept states that the revenue and the expenses incurred to earn the revenues must belong to the same accounting period. So once the revenue is realised, the next step is to allocate it to the relevant accounting period. This can be done with the help of accrual concept.

Significance

- It guides how the expenses should be matched with revenue for determining exact profit or loss for a particular period.
- It is very helpful for the investors/shareholders to know the exact amount of profit or loss of the business.

Limitations of Accounting

Financial accounting is significant for management as it helps them to control the firm activities and in determining appropriate managerial policies in different areas production, sales, administration, finance etc. However, financial accounting does not provide adequate and useful information. Most of limitations are mainly due to the cumulative effect of recorded facts, accounting conventions and personal judgments on financial statements. Financial accounting suffers from the following limitations which have been responsible for the emergence of Cost and Management Accounting:

1. Transactions of non-monetary nature do not find place in accounting. Accounting is limited to monetary transactions only. It excludes qualitative elements like management reputation, employee morale, labour strike etc.

2. Cost concept is found in accounting. Price changes are not considered. Money value is bound to change often from time to time. This is a strong limitation of accounting.

3. Acceptable alternatives are so broad based that comparisons are likely to be confusing or misleading. For instance, inventory cost may be ascertained by LIFO or FIFO; or stock may be evaluated at cost price or market price.

4. Accounting policies are framed by the Accountant. The figures of balance sheet are largely resulted by personal judgment of accountant hence it is the subjective factor that prevails in accounting and objective factor is ignored.

5. Recording and accounting for wages and labour is not carried out for different jobs, processes, products or departments. This creates problems in analyzing the cost associated with different activities.

6. It is difficult to know the behavior of costs in financial accounting as expenses are not assigned to the product at each stage of production. Expenses are not classified into direct and indirect and therefore, cannot be classified as controllable and uncontrollable. Control of cost which is the most important objective of all business enterprise, cannot be achieved with the aid of financial accounting alone.

7. Financial accounting does not provide information to analyze the losses due to various factors —idle plant and equipment, seasonal fluctuations in volume of business etc. It does not help management in taking important decisions about expansion of business, dropping a product, alternative methods of production, improvement in products etc.

8. Financial accounting does not set up a proper system of controlling materials and supplies. Undoubtedly, if materials and supplies are not controlled in a manufacturing concern, they will lead to losses on account of misappropriation, misutilisation, scrap, defectives etc.

"Ethical Issue" in Financial Accounting

Ethics in accounting are concerned with how to make good and moral choices in regard to the preparation, presentation and disclosure of financial information. During the 1990s and 2000s, a series of financial reporting scandals brought this issue into the forefront. Knowing some of the issues presented in accounting ethics can help you ensure that you are considering some of the implications for the actions that you take with your own business.

Fraudulent Financial Reporting

Most accounting scandals over the last two decades have centered on fraudulent financial reporting. Fraudulent financial reporting is the misstatement of the financial statements by company management. Usually, this is carried out with the intent of misleading investors and maintaining the company's share price. While the effects of misleading financial reporting may boost the company's stock price in the short-term, there are almost always ill effects in the long run. This short-term focus on company finances is sometimes known as "myopic management."

Misappropriation of Assets

On an individual employee level, the most common ethical issue in accounting is the misappropriation of assets. Misappropriation of assets is the use of company assets for any other purpose than company interests. Otherwise known as stealing or embezzlement, misappropriation of assets can occur at nearly any level of the company and to nearly any degree. For example, a senior level executive may charge a family dinner to the company as a business expense. At the same time, a line-level production employee may take home office supplies for personal use. In both cases, misappropriation of assets has occurred.

Disclosure

As a subtopic of fraudulent financial reporting, disclosure violations are errors of ethical omission. While intentionally recording transactions in a manner that is not in accordance with generally accepted accounting principles is considered fraudulent financial reporting, the failure to disclose information to investors that could change their decisions about investing in the company could be considered fraudulent financial reporting, as well. Company executives must walk a fine line; it is important for management to protect the company's proprietary information. However, if this information relates to a significant event, it may not be ethical to keep this information from the investors.

Penalties

Penalties for violations of accounting ethics laws have increased greatly since the passage of the Sarbanes-Oxley Act of 2002. This legislation allows for harsh penalties for manipulating financial records, destroying information, interfering with an investigation and provides legal protection for whistle-blowers. In addition, chief executives can be held criminally liable for the misreporting of their company. If accounting ethics wasn't an important consideration before, the higher stakes provided by the Sarbanes-Oxley Act have definitely upped the ante.

MODULE-II

Classification of accounts

Personal Accounts: The accounts related to a person or group of persons, business organizations, educational institutions, clubs, banks etc. is called personal account. Again it can be divided as natural personal account (Ram, Rahim), artificial personal account (TELCO, SBI, ISBM), and representative personal account (outstanding rent, prepaid insurance, accrued commission, unexpired insurance).

Real accounts: The accounts related to assets of the business are called real accounts. It can be divided as tangible real accounts (land & building, plant & machinery, stock, cash) and intangible real accounts (patent, copyrights, goodwill, and trademark).

Nominal Accounts: The accounts related to all expenses & losses or incomes & gains are called nominal accounts.(rent, salary, commission, interest).

Double Entry System

Each business transaction used to record in minimum of two accounts, so that the accounting is always in balance. In the double entry system every transaction must be recorded with equals debits and credits. As a result, the total of all debits must equals to total of all credits.

Meaning of Debit & Credit

Debit: It means to enter an amount of transaction on the left-hand side of an account.

Credit: It means to enter an amount of transaction on the right-hand side of an account.

Rules of debit and credit

Traditional (Golden Rules)

Personal Accounts:	Debit the receiver	Credit the giver.
Real Accounts:	Debit what comes in	Credit what goes out
Nominal Accounts:	Debit all expenses & losses	Credit all incomes & gains

Modern

Assets Accounts	Increases are debits	Decreases are credits
Liabilities Accounts	Increases are credits	Decreases are Debits
Capital Accounts	Increases are credits	Decreases are Debits
Expenses Accounts	Increases are debits	Decreases are credits
Revenues Accounts	Increases are credits	Decreases are Debits

Journal: A journal is a book in which business transactions are recorded chronologically. A journal is called the book of prime entry and it also called the book of original entry.

Specimen of Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount

L.F.- It refers to ledger folio. At the time of journal this column shall keep blank. At the time of posting from journal to ledger the page number of ledger on which it is transferred to be mentioned.

Recording Transactions

Analysis of each transaction (Process of Recording in the journal)

- ✓ Identify the transaction from the source document, such as a sales invoice.
- ✓ Determine which accounts affected or which accounts are increases and which decreases.
- ✓ Apply the rules of debit and credit
- ✓ Enter the transaction in the journal, listing first the debit and then the credit
- ✓ Verify that total debits equal total credits
- ✓ A journal entry

Types of Journal

There are many primary books (i.e., Journal Books). The transactions are categorized as per their nature and, for each type of transaction, a separate journal is used for recording the transaction. Since transactions are recorded in journal chronologically as these occur, journal books are generally called *day books.* There are *eight* types of journal books:

Purchases Day Book: It records credit purchase of raw materials, and traded goods

Sales Day Book: It records credit sale of goods.

Return Outward (also called Purchases Return) Book: It records goods returned to the supplier (s) of raw materials and traded goods.

Return Inward (also called Sales Return) Book: It records goods returned by customers.

Bills Receivable Book: It records bills (of exchange) accepted by customers.

Bills Payable Book: It records bills (of exchange) raised by suppliers.

Cash Book: It records all cash (and bank) transactions: receipts and payments.

Journal Proper: It records all residual transactions i.e., transactions which do not find place in any of the other journal books.

Secondary Books (LEDGER)

- Secondary books record transactions in a classified manner to derive meaningful information.
- It is 'secondary' because transactions are re-recorded in these books from the Primary Books.
- A secondary book is also called a 'Ledger'.
- A ledger may also be called a principal book which contains all the accounts.
- When an entry from the Journal is re-recorded in Ledger, it is called "posting".

Account Format

An account in the ledger has the following format:

Ledger Account

Dr. **Cr.**

Date	Particulars	F	Amount	Date	Particulars	F	Amount

Where,

Dr. stands for *Debit* and Cr. Stands for *Credit*

F stands for folio: It means in which page of the journal this account appeared.

Postings in the Ledger

- The process of copying (transferring) data from the journal to accounts in the ledger
- To post an entry from Journal to Ledger, follow these steps:
    - Identify the account heads;
    - Observe which account (s) is *debited* and which is *credited;*
    - Debits in the journal are posted as debits to the appropriate accounts; credits in the journal are posted as credits to the appropriate accounts.
    - All transactions must be keyed by date or number to provide a link between the journal and the ledger.

- Ledger accounts appear after a series of transactions have been posted and account balances calculated.

Balancing of accounts

The word ***Balance*** means the difference between the total amounts of two sides of an account. Periodically, the businessman is interested to know the cumulative effect of the entries in the accounts or to know the net position of the accounts. For this purpose they total the two sides of an account separately and find out the difference of the two sides which is called the net balance of the account.

Balancing of an account is the process of finding out the difference between totals of two sides of an account and recording it on the shorter side of the account.

The balance ascertained is put on the shorter side of the account with a reference "Balance c/d". The c/d (carried down) is written to indicate that the balance has been carried down to tally both sides.

Cash Book

Cash book is a subsidiary book which records all cash and bank transactions. It records all receipts and payments made in the form of cash, cheques, and bank drafts.

Types of cash Book

Simple/Single Column Cash Book: It is a cash book which has one column on each side for recording the amounts

Dr. **Cash Book**. **Cr.**

Date	Receipts	LF	Amount	Date	Payments	LF	
Amount							

Single column cash book will always show either a debit balance or zero balance. It cannot show a credit balance.

Double Column Cash Book

It is a cash book with two columns on each side, one for recording cash and the other for discount. Offering and accepting cash discounting is closely related to receipt and payment of cash. So discount allowed and received should be simultaneously recorded along with cash in order to get full picture.

Dr. **Double column cash Book** **Cr.**

Date	Receipts	LF	Discount	Cash	Date	Payments	LF	Discount	Cash

Note: The discount column in the cash book is not balanced.

Triple Column Cash Book

It is a cash book with three columns on each side for recording amounts. These columns are:

- **Cash Column**: to record cash receipts and cash payments.
- **Bank Column**: to record all receipts and payments through bank.
- **Discount Column**: to record all cash discount received and allowed.

Cash Book (Triple column)

Date	Particulars	LF	**Discount**	**Cash**	**Bank**	**Date**	**particulars**	**LF**	**Discount**	**Cash**	**bank**

Contra entries: The word ***contra*** is a Latin word which means opposite side. Contra entry is an entry on one side of the cash book against which another entry appears o the opposite side. It means two entries, one appearing on the debit side and the other on the credit side of the cash book. Contra entries are denoted by the letter **C** in the LF column on both sides of the cash book. There are three contra entries:

- ❑ Cash deposited or paid into the bank.
- ❑ Cash withdrawn from bank for office use.
- ❑ Cheque deposited into the bank on a latter date.

Petty Cash Book

The word petty is a French word which means small. In every business house, payments involving very small or petty amounts are mad daily. But recording of all these small payments in the main cash book will make it unnecessarily heavy. Hence, it is better to record all these small payments in a separate cash book. Such a cash book is known as petty cash book. The person in charge of this book is called petty cashier. There are two types of petty cash book like:

a. Simple Petty Cash Book
b. Analytical petty cash Book

Other subsidiary Books

- ✓ **Purchase book**: Only the credit purchase of goods, meant for resale will take place on the purchase book.
- ✓ **Sales book :** Only the credit sales of goods, meant for resale will take place on the sales book
- ✓ **Purchase return book (Return outwards book):** Goods, which are purchased, may be returned to the supplier for any reason are recorded in this book.
- ✓ **Sales Return book (Return inwards book):** Goods, which are sold for credit or cash may be returned to company, if they are defective are recorded in this book.
- ✓ **Bills receivable book:** Goods are sold for credit to customers with an agreement written by company and counter signed by customer called bills receivable book.
- ✓ **Bills Payable book:** Goods are purchased for credit from Suppliers with an agreement written by suppliers and counter signed by company called bills payable book.

Journal Proper: There are certain transaction which cannot be entered in through any subsidiary books and such transaction entered in the form of journal, called journal proper. Like opening entries, closing entries and adjusting entries

Trial Balance

Under double entry system, for every debit, there must be an equal and corresponding credit. If all the transactions are recorded perfectly in the books of accounts, then the total of the debits should be equal to the total of the credits. Similarly, if all the accounts are correctly balanced, then total of the accounts with debit balances must be equal to the total of accounts with credit balances. In order to verify whether the two totals are equal or not, a statement is prepared periodically showing the debit items in one column and credit items in another. This statement is called the ***Trial Balance.***

Meaning: a trial balance is a statement of balances of all the accounts, prepared on a specified date to ascertain the arithmetical accuracy of the books of accounts.

Features of a Trial balance

1. The trial balance is simply an abstract or list of all the accounts in ledger and cash book. So it is prepared only when the posting in ledger is complete.
2. The balances are listed in the order in which they appeared in the ledger
3. Trial balance is prepared on a specific date. It is normally prepared at the end of a certain period, such as at the end of each month & in all the cases, before yearly closing of the books at the end of the financial period.
4. The two amount columns should tally. Tallying of the columns indicates the arithmetical accuracy of the books of account.
5. If the two columns don't tally, it implies that some errors have occurred while posting in the ledger or while balancing the individual accounts.
6. Tallying of the two totals of the trial balance ensures arithmetical accuracy, but not the accounting accuracy.

The format of a trial balance is as follows:

Sl. No.	Accounts Title	L.F.	Debit Amount Rs.	Credit Amount Rs.

Methods of preparing Trial Balance

Balance method: In this method, all ledger accounts are balance first. All ledger accounts showing debit balance are taken in the debit amount column and all ledger accounts showing credit balance are taken I the credit amount column.

Total method : Under this method, the trial balance should be prepared by taking all individual balances of all the items and the following rules must be followed :

The balances of all accounts relating to the following items are placed in the debit column of the trial balance:

Assets
Expenses & Losses
Drawings
Purchases

Sales Return/Return Inward
Debtors
Bills Receivable
Opening stock

The balances of all accounts relating to the following items are placed in the credit column of the trial balance:

Liabilities
Capital
Incomes & Gains
Sales
Purchase Return/ Return Outward
Creditors
Bills Payable
Provision for doubtful Debtors
Reserve fund/ General reserve

Note; Closing Stock is excluded from Trial balance at the time of preparation of trial balance.

Final Accounts

- Final Accounts for a non-corporate entity (e.g., partnership, sole-proprietorship etc.) broadly consist of *Manufacturing Account*, *Trading Account*, *Profit and Loss Account* and *Balance Sheet*.
- Final Accounts for a corporate entity broadly consist of *Profit and Loss Account* and *Balance Sheet*.
- The Profit and Loss Account shows the financial results (performance) of an entity.
- The Balance Sheet shows financial position (i.e., the position of assets, liabilities and equity) of an entity.
- The Profit and Loss Account is a periodic statement.
- The Balance Sheet is a position statement as on a particular date.
- The Profit and Loss Account consists of elements of income (including gains) and expenses (including losses).
- The balance of Profit and Loss Account represents profit (when income is more than expenses) or loss (when expenses are more than income).
- Final Accounts are prepared from the *Trial Balance*.
- *Trial Balance* consists of five financial elements. Hence, any item in the *Trial Balance* will find its place only once in the Final Accounts-either in Profit and Loss Account or in Balance Sheet.
- Any transaction which has not become a part of *Trial Balance* should find its place twice in the Final Accounts (e.g., accrued expenses not yet recorded). This is to ensure double-entry principle.
- Ideally, a revised *Trial Balance* should be drawn after incorporating all rectification and closing adjustment entries. Such *Trial Balance* will capture all financial elements.

Accounts and Statement to be prepared

Trading Account: Trading account is prepared mainly to know the profitability of goods bought or manufactured sold by the businessmen. Difference between the selling price and cost price of the goods is that gross results.

Profit and Loss account: To know the net profit or net loss of the business activities after adjusting Office , administrative, selling and distribution expenses

Balance Sheet: To know the financial position of the company like assets and liabilities of the business. It contains two sides Assets and Liabilities

Terms used in final accounts Reserves and Surplus:

- Reserves are normally created by appropriating retained earnings to meet unforeseen future contingencies.
- Reserves are broadly classified as *free reserves* and specific *reserve.*
- A reserve fund is such a reserve which is specifically represented by earmarked investments.
- Surplus denotes residual retained earnings after distribution of dividend and appropriation to reserves.

Current Assets, Loans and Advances

- Current assets are short-term assets which are ideally realisable within twelve months from the date of the balance sheet.
- Loans are essentially long term loans given to other corporate and/or to employees. Loans carry interest.
- Advances are short-term facilities and hence normally do not carry interest.

Current Liabilities and Provisions

- Current liabilities are short-term obligations payable within next twelve months. Such liabilities do not normally carry interest.
- Provisions are estimated liabilities. They are estimated on the basis of available information (e.g., provision for tax, proposed dividend)

Fixed Assets

- There are four items related to fixed assets that are reported in balance sheet:
  - Gross block
  - Accumulated depreciation
  - Net block
  - Capital work in progress
- Gross block denotes original cost of assets.
- Net block represents depreciated value of fixed assets.
- Capital work in progress denotes assets under construction.
- Once construction of an asset is over and the asset is ready for commercial use, the costs incurred till date will get transferred from capital work in progress to gross block.

- Depreciation can only be charged once the asset is being used.

Loan Funds

- All interest-bearing short term and long-term loans are shown under ‘loan funds’. Loan funds are classified in the balance sheet as below:
  - Secured Loan (e.g., cash credit, term loan)
  - Unsecured Loan (e.g., public deposit, commercial paper)
- Secured loans are borrowings against security of company’s assets.
- Borrowing without any asset backing are called unsecured loan.

Shareholders Funds

- Shareholders Funds comprise of two broad items:
  - Share Capital
  - Reserves and Surplus
- Share Capital should be bifurcated into:
  - Authorised capital
  - Issued capital
  - Subscribed capital
  - Paid up capital
- Under most circumstances issued, subscribed and paid up capital will be equal.
- Issued capital cannot exceed authorised capital.

Trading A/c

Particulars		Amount	Particulars		Amount
To Opening stock		xxxx	By Sales	xxxx	
To Purchase	xxxx		less sales return	xxxx	xxxx
less purchase return	xxxx	xxxx	By Closing stock		xxxx
To Production wages		xxxx			
To Manufacturing expenses		xxxx			
To Factory related expenses					
To Gross Profit c/d		xxxx			
		xxxx			

Profit and Loss A/c

Particulars	Amt	Amt	Particulars	Amt	Amt
To Gross loss b/d			By Gross Profit b/d		
To Salary			By Interest received		
To Rent			By Commission received		
To Commission			By Discount received		
To Office expenses			By Apprenticeship Premium		
To Lighting charge			By All Incomes		
To Discount allowed			By Net Loss		
To Advertisement					
To Warehouse charges					
To Travelling expenses					
To Carriage outwards					
To Interest on capital					
To Depreciation					
To Repairs					
To All Losses Like Bad debts					
To Bank charges			Total		
To Audit fees					
To Net Profit					
Total					

Balance Sheet

Liabilities	Amount	Assets	Amount
Current Liability		Current assets	
Sundry Creditors		Cash in hand	
Bills Payable		Cash at Bank	
Bank Overdraft		Closing Stock	
Outstanding Expenses		Bills Receivable	
Long term Liabilities		Short-term Investment	
Share capital		Sundry Debtors	
Reserves and Surplus		Fixed Assets	
Debentures		Land & Building	
Long term loans		Plant & Machinery	
		Furniture	
		Vehicles	
		Goodwill	
		Copyrights	

MODULE-III

ISSUE OF SHARE

COMPANY:

Under the companies Act, 1956 a Company means "A Company formed and registered under that Act or under any previous Companies Act.

DISTINCTION FEATURES OF A COMPANY:

a) Voluntary Association

b) Independent Existence

c) Artificial Person

d) Compulsory Incorporation

e) Common Seal

f) Perpetual Succession

g) Limited Liability

h) Transferability of shares

i) Separation of Ownership and Management

j) Large Membership

k) Ability to raise large amount of Capital

SHARE CAPITAL:

(a) Authorized Capital: This is the Maximum Capital which the company can raise in its life time. This is mentioned in the Memorandum of the Association of the Company. This is also called as Registered Capital or Nominal Capital.

(b) Issued Capital: Part of the Authorised Capital which is issued to the public for Subscription is called as Issued Capital.

(c) Subscribed Capital: The issued Capital may not be fully subscribed by the public Subscribed Capital is that part of issued Capital which has been taken off by the public i.e. the capital for which applications are received from the public.

(d) Called – up Capital: The Company may not need to receive the entire amount of capital of capital at once. It may call up only part of the subscribed capital as and when needed in installments. Called – up Capital is the part of „subscribed capital which the company has actually called upon the shareholders to pay. Called – up Capital includes the amount paid by the shareholder from time to time on application, on allotment, on various calls such as First Call, Second Call, and Final Call etc. The remaining part of subscribe capital not yet called up is known as Uncalled Capital. The Uncalled Capital may be converted, by passing a special resolution, into Reserve Capital; Reserve Capital can be called up only in case of winding up of the company, to meet the liabilities arising then.

(e) Paid-up Capital: The Called-up Capital may not be fully paid. Some Shareholders may pay only part of the amount required to be paid or may not pay at all. Paid-up Capital is the part of called-up capital which is actually paid by the shareholders. The remaining part indicates the default in payment of calls by some shareholders, known as Calls in Arrears. Thus, Paid-up Capital is Called-up Capital – Calls in Arrears.

SHARE

DEFINITION A "share" has been defined by the Indian Companies Act, under sec.2(46) as "A share is the share in the Capital of the Company".

TYPES OF SHARES: A Company can issue two types of shares – Equity and Preference.

(a) Equity Shares: Equity shares means that part of the share capital which is not a Preference share capital. It means all such shares which are not Preference shares. Equity shares are also called as Ordinary Shares.

(b) Preference Shares: Preference shares are those shares which fulfill both the following two conditions: (i) They carry preferential share right in respect of dividend at a fixed rate, (ii) They also carry preferential right in regard to payment of capital on winding up of the company. Preference shares can be further classified as follows:

(1) Cumulative and Non – Cumulative : If in any year the profits are insufficient to pay the preference dividend then in case of cumulative preference shares this dividend can be paid in the subsequent year before any other dividend is paid. In other words the right to receive the dividend goes on accumulating till it is paid. In case of Non – cumulative preference shares the dividend can be paid only in that year. If there are insufficient profits then such preference shareholders do not get any dividend for that year.

(2) Participating & Non-Participating Preference Shares: Participating preference shares are entitled to participate in the surplus profits remaining after the payment of (a) Fixed dividend to Preference shareholders and (b) Dividend to the equity shareholders. They are also entitled to participate in the surplus funds remaining at the time of winding of the company after payment of (a) Preference share capital & (b) Equity Share Capital. Non – participating preference share

are not entitled to participate in the surplus profits or surplus funds left over at the time of winding off.

PROCEDURE FOR ISSUE OF SHARES:

(a) Issue of Prospectus: Whenever shares are to be issued to the public the company must issue a prospectus. Prospectus means an open invitation to the public to take up the shares of the company thus a private company need not issue prospectus. Even a Public Company issuing its shares privately need not issue a prospectus. However, it is required to file a "Statement in lieu of Prospectus" with the register of companies. The Prospectus contains relevant information like names of Directors, terms of issue, etc. It also states the opening date of subscription list, amount payable on application, on allotment & the earliest closing date of the subscription list.

(b) Application of Shares: A person intending to subscribe to the share capital of a company has to submit an application for shares in the prescribed form, to the company along with the application money before the last date of the subscription mentioned in the prospectus.

- **Over Subscription:** If the no. of shares applied for is more than the no. of shares offered to the public then that is called as over Subscription.
- **Under Subscription:** If the no. of shares applied for is less then the no. of shares offered to the public then it is called as Under Subscription.

(c) Allotment of Shares: After the last date of the receipt of applications is over, the Directors, proceed with the allotment work. However, a company cannot allot the shares unless the minimum subscription amount mentioned in the prospectus is collected within a stipulated period. The Directors pass resolution in the board meeting for allotment of shares indicating clearly the class & no. of shares allotted with the distinctive numbers. Then Letters of Allotment are sent to the concerned applicants. Letters of Regret are sent to those who are not allotted any shares & application money is refunded to them.

- **Partial Allotment:** In partial allotment the company rejects some application totally, refunds their application money & allots the shares to the remaining applicants.
- **Pro-rata Allotment:** When a company makes a pro-rata allotment, it allots shares to all applicants but allots lesser shares then applied for E.g. If a person has applied for three hundred shares he may get two hundred shares.

(d) Calls on Shares: The remaining amount of shares may be collected in installments as laid down in the prospectus. Such installments are called calls on Shares. They may be termed as "Allotment amount, First Call, Second Call, etc."

(e) Calls–in–Arrears: some shareholders may not pay the money due from them. The outstanding amounts are transferred to an account called up as "Calls-in-Arrears" account. The Balance of calls-in-arrears account is deducted from the Called-up capital in the Balance Sheet.

(f) Calls–in–Advance: According to sec.92 of the Companies Act, a Company may if so authorized by it‟s articles, accept from a shareholder either the whole or part of the amount remaining unpaid on any shares held by them, as Calls in advance. No dividend is paid on such calls in advance. However, interest has to be paid on such calls in advance.

TERMS OF ISSUE OF SHARES: A limited company may issue the shares on following different terms.

(a) Issue of Shares for Consideration other than cash or for cash or on capitalization of reserves.

(b) Issue of Shares at par i.e. at face value or at nominal value.

(c) Issue of Shares at a Premium i.e. at more than face value.

(d) Issue of Shares at a Discount i.e. at less than the face value.

ISSUE OF SHARES AT A PREMIUM: When the shares are issued at a price higher than the nominal value of the shares then it is called as shares issued at a premium. The amount of premium is decided by the board of Directors as per the guide lines issued by SEBI. Such share premium collected by the company is credited to a separate A/c called as "Securities Premium A/c". Although Securities Premium is a profit to the company, it is not a revenue profit, it is treated as capital profit, which can be utilized only for the following purposes as per sec. 78 of the Companies Act –

(a) Issue of fully paid bonus shares to the existing shareholders.

(b) Writing off the preliminary expenses of the company.

(c) Writing off the expenses of issue or the commission paid or discount allowed on any issue of shares / debentures.

(d) Providing the premium payable on redemption of preference shares or debentures. The company can utilize the security Premium for any other purpose only on obtaining the sanction of the court.

ISSUE OF SHARES AT A DISCOUNT: The Companies Act, permits issue of shares at a discount subject to the following conditions. (sec. 79) –

(a) The issue must be of a class of shares already issued.

(b) Not less than 1 year has at the date of issue elapsed since the date on which the company became entitled to commence business.

(c) The issue at a discount is authorized by a resolution passed by the company in the general meeting & sanctioned by the company law board.

(d) The maximum rate of discount must not exceed 10% or such rate as the company law board may permit.

(e) The shares to be issued at a discount must be issued within two months of the sanction by the company law board or within such extended time as the company law board may allow.

ACCOUNTING ENTRIES:

For receipt of application money

Bank A/c………………………………Dr.

To Share Application A/c

On Allotment

Transfer of Application money to Share Capital

Share Application A/c..………….. Dr.

To Share Capital A/c

Amount due to on Allotment

Share Allotment A/c………………Dr.

To Share Capital A/c

To Securities Premium Account

Refund of excess Application money on rejected application

Share Application A/c……………..Dr.

To Bank Alc

Adjustment of excess application money towards allotment money due.

Share Application A/c…………….Dr.

To Share Allotment A/c

Receipt of Allotment money.

Bank A/c…………………………….Dr.

To Share Allotment A/c

For making First Call

Share First Call A/c……………………..Dr.

To Share Capital A/c

For receipt of First Call Money

Bank A/c…………………………………Dr.

To Share First Call A/c

For calls in arrears

Calls in Arrears A/c……………………..Dr.

To Share First Call A/c

For receipt if calls in advance

Bank A/c…………………………………Dr.

To Calls in Advance A/c

ISSUE OF SHARES TO VENDORS FOR CONSIDERATION OTHER THAN CASH

A Company may take over a running business i.e. assets & liabilities of another business. The Sellers of the business are known as Vendors. The company may offer shares to the Vendors in settlement of the purchase price of the business. The buying company does not receive any cash for shares offered to them. The following entries are passed in case of such takeover of the business:

(a) For recording takeover of the business

Sundry Assets A/c Dr. xxx

To Sundry liabilities A/c xxx

To Vendor A/c xxx

(b) For issue of shares to Vendor

Vendor A/c Dr. xxx

Discount of Issue of shares A/c Dr. (if any) xxx

To Share Capital A/c xxx

To Securities Premium A/c (if any) xxx

FORFEITURE OF SHARES:

When shares are allotted to an applicant, it becomes a contract between the shareholder & the company. The shareholder is bound to contribute to the capital and the premium if any of the company to the extent of the shares he has agreed to take. as & when the Directors make the calls. If the fails to pay the calls then his shares may be forfeiture by the directors if authorised by the Articles of Association of the company. The Forfeiture can be only for non-payment of calls on shares and not for any other reasons. When the directors forfeiture the shares the person looses his membership in the company as well as the amount already paid by him towards the share capital and premium. His name is removed from the register of members. The directors must observe strictly all the legal formalities required by the Articles of Association before forfeiting the shares.

ACCOUNTING ENTRIES

Share Capital A/c Dr. xxx (no of forfeited shares*amount called up per shares)

Security Premium A/c Dr. xxx (to the extent premium not received)

To Calls in Arrears A/c xxx

To Share Forfeiture A/c xxx (amount received towards share received)

Note: Once the security premium is collected it cannot be cancelled later on. Therefore if he Forfeited shares were issued at a premium and the premium money is already received on those Forfeited shares, security premium A/c will not be cancelled or debited.

FORFEITURE OF SHARE ISSUED AT A DISCOUNT: If the Forfeited shares are issued at a discount, the proportion amount of discount allowed on such shares should be cancelled if the discount of shares has already been debited.

RE-ISSUE OF FORFEITED SHARES: The Directors may reissue the Forfeited shares at par, at premium or at a reissued at a discount; the maximum discount is restricted to the amount Forfeited on these shares + the original discount.

Accounting Entries

Bank A/c Dr. xxx

Share Forfeited A/c Dr. xxx

To Share Capital A/c xxx

Any profit on reissue of Forfeited shares represents capital profit & hence it should be transferred to capital reserve.

Share Forfeiture A/c Dr. xxx

To Capital Reserve No. xxx

ISSUE OF DEBENTURES

A Debenture is a document acknowledging a loan to company and executed under the common seal of the company, usually containing provisions as to payment, of interest and the repayment of principal amount and giving a charge on the assets of a such a company, which may give security for the payment over the some or all the assets of the company. Issue of Debentures is one of the most common method of raising the funds available to the company. It is a important source of finance.

DEFINITION: Debenture may be defined as a certificate issued by company under it‟s seal acknowledging a debt due by to it‟s holder. The essential characteristic of debentures is indebtedness Sec.2(12) of the Companies Act. 1956 a Debenture includes debenture stock bonds any other securities of a company whether constituting a charge on company assets or not.

A person who purchases a debenture is called a debenture holder.

FEATURES: A Debenture has the following basic features:- (a) It is document which creates or acknowledges a debt. (b) It is in the form of certificate issued under the seal of the company. (c) It usually shows the amount & date of repayment of the loan. (d) If shows the rate of interest & date of interest payment. (e) Normally debentures are secured & issued against the assets of the company.

TYPES OF DEBENTURES: Different types of debentures can be classified as follows:-

I) **ON THE BASIS OF SECURITY:**

a) **Naked Debentures:** These Debentures are not secured against any assets of the Co. In case of winding of the company, debentures holders holding unsecured debentures treated as unsecured creditors.

b) **Secured Debentures:** These Debentures are secured by a charge on the assets of the company. These debentures are secured either on a particular assets called fixed charge or on the general assets of the company called floating charge. The debentures holder has a right to recover outstanding loan & interest out of such charge assets. These debentures are issued by the company under an agreement which is called "Mortgage Deed". Such mortgage is registered with Register of Companies.

II) **ON THE BASIS OF PERFORMANCE:**

a) **Redeemable Debentures:** The debentures are redeemed by repayment of the amount of debentures after a specified date, as per terms & conditions issued.

b) **Irredeemable Debentures:** In this case the issuing company does not fix any date by which debentures should be redeemed & the debentures holder cannot demand repayment of the sum of debenture from the company so long as it is going concern.

III) **ON THE BASIS OF PRIORITY:**

a) **First debentures:** As the name implies this type of debentures are repaid before the repayment of other debentures.

b) **Second debentures:** These debentures are paid after payment of first debentures.

IV) **ON THE BASIS OF CONVERTIBILITY:**

a) **Convertible debentures:** Holders of such debentures are given option to convert the debentures fully or partly into equity shares or preference shares or new debentures after a specified time.

b) **Nonconvertible debentures:** The holders of this type of debentures do not have any right to convert them into equity shares etc.

v) **On the basis of Records:** a) Bearer debentures: Just like bearer cheques these debentures can be transferred freely. Payment of interest is made on productions of coupons attached with debentures. b) Registered debentures: These are transferred only by transfer deed. The complete particulars in regard to such debentures are entered into register & the interest is paid only to those whose name appears in the register.

Distinction between Share and Debenture

Share capital is an ownership capital.	Debentures capital is creditorship capital i.e. borrowing.
A shareholder is the owner of the company.	A debenture holder is the creditor of the company.
Share capital is not returnable in the life time of the company. However, the redeemable preference shares are refunded during the life-time of the company.	Debenture capital returnable during the lifetime of the company. The exception is the irredeemable debentures which are not redeemable during the life-time of the company.

Shareholders enjoy the voting rights.	Debentures holders do not have the voting rights.
Dividend is payable on shares & it is an appropriation of profits	Interest on debentures is payable at a fixed rate on specified date irrespective of profits of the company.
Dividend depends on the profit of the company.	Interest is paid on debentures & it is a charge on the revenue of the company.
Shares are unsecured.	Debentures are generally secured.
In the event of winding up of the company shareholders are the last person in re-fund of their capital. .	Debenture holder being the creditors are paid prior to the shareholders. If secured they have priority even over the unsecured creditors.

DEBENTURE INTEREST:

Debentures being borrowed capital, they carry a specific rate of interest payable on specified date Debentures interest is expenditure & it is payable as an when interest is due whether there is a profit or loss. It is usually paid half-yearly. The amount of interest is calculated & paid on nominal value i.e., face value of Debentures.

The following Journal entries are passed.

a) When debentures interest is due:

Debenture Interest A/c Dr. (Gross amt.)

To Tax Deducted as source (With income tax)

To Debentures holder A/c (Net amt. payable)

b)When net amount due is paid:

Debentures Holder A/c Dr.

To Bank A/c

b) At the end of the year balance in debenture interest being expense transferred to P & L A/c

P & L A/c Dr.

To Debenture Interest A/c

ISSUE OF DEBENTURES:

Debentures can, be issued in three ways.

a) **At par:** Debenture is said to have been issued at par when the amount collected for it is equal to the nominal value of debentures. e.g. the issue of debentures of Rs. 100/- for Rs. 100/-.

b) **At Discount:** Debenture is said to have been issued at discount when the amount collected is less than the nominal value, for e.g., issue of debentures of Rs. 100/- for Rs. 95/-. The difference of Rs. 5/- is the discount and is called discount on issue of Debentures. This discount on issue of debentures is a capital loss & it is charged to P & L A/c over the period of its benefit to the company & it is shown under the head "Miscellaneous Expenditure" on the assets side of the Balance Sheet.

c) **At Premium:** When the price charged is more than it‟s nominal value, debentures is said to be issued at a premium. e.g., issue of debentures of Rs. 100 each for Rs. 120, the excess amount over the nominal value i.e., Rs. 20 is the premium on issue of debentures. Premium received on issue of debentures is a capital gain & it is credited to "Securities Premium A/c". Premium on issue of debentures cannot be utilized for distribution of dividend. Premium on debentures is shown under the head Reserves & Surplus on the liability side of the Balance Sheet.

ISSUE OF DEBENTURES FOR CASH: Debentures may be issue for cash at a par, at a discount or at a premium. When amount is payable in installments entries will be similar to the issue of shares. Any premium or discount on issue of debentures is usually adjusted at the time of making allotment. Premium payable on redemption of debentures is also adjusted at the time of issue of debentures.

ISSUE OF DEBENTURES FOR NON-CASH CONSIDERATION Debentures may be issued for consideration other than cash such as acquisition of business, or assets. It should be noted that ouch debentures may be issue at par or at a premium or at a discount.

ISSUE OF DEBENTURES AS A COLLATERAL SECURITY

Debentures can be issued as collateral security against a loan or overdraft from bank or other financial institution. Collateral Security means an additional or parallel security. Debentures issued as collateral security is a contingent liability. However, it can become a definite liability only in the invent of default by the company in repaying the loan. No interest is payable on such debentures. Normally no entry is passed in the books for issue of such debentures. Only a note is given under loan concerned that such loans are secured by way of collateral security by issue of debentures. Normally no entry is passed in the books for issue of such debentures. Only a note, however, the following entry may be passed in the books in the issue of such debentures:

Debentures Suspense A/c Dr.

To Debentures A/c

On repayment & release of debenture, the entry pass is

Debentures A/c Dr.

To Debentures Suspense A/c

TERMS OF REDEMPTION: Debentures may be redeemed (repaid) a) at a par b) at a premium or c) at a discount.

a) **Redeemable at par:** When debentures are to be redeemed at their face value they are said to be redeemable at par.

b) **Redeemable at a premium:** When debentures are to be redeemed at an amount higher than their face value they said to be redeemable at a premium. Premium payable on redemption of debentures is a capital loss for the company. Such premium even though payable on redemption must be provided as a liability at a time of issue of debentures. Loss on issue of debentures should be charged to the P & L A/c over the period of it‟s benefits to the company & it is shown under the head Miscellaneous Expenditure on the assets of the Balance Sheet.

c) **Redeemable at a discount:** When debentures are to be redeemed at an amount lower than their face value, they are said to be redeemable at a discount such discount is a capital profit for the company.

ACCOUNTING ENTRIES

1)	Issue for cash (collection in installments)	
	a) Receipt of application money	Bank A/c Dr. To Debentures Application A/c
	b) Transfer of application money to debentures	Debentures Application A/c Dr. To Debentures A/c
	c) Allotment money due	Debentures Allotment A/c Dr. To Debentures A/c
	d) For receipt of allotment money	Bank A/c Dr. To Debenture Allotment A/c
	e) Call money due	Debenture Call A/c Dr. To Debentures A/c
	f) Receipt of call money	Bank A/c Dr. To Debenture Call A/c
Note: Discount or premium on issue of debentures should be adjusted at the time of making allotment entries for such will be the similar to the issue of shares.		
2	Issue for cash (collection in lump sum)	
	a) Issue at par redeemable at par	Bank A/c Dr. To Debentures A/c
	b) Issue at discount redeemable at par.	Bank A/c Dr. Discount on issue of Debentures A/c Dr. To Debentures A/c
	c) Issued at premium redeemable at par.	Bank A/c Dr. To Debentures A/c To Securities Premium A/c
	d) Issued at par redeemable at premium.	Bank A/c Dr

		Loss on issue of debentures A/c Dr. To Debentures A/c To Premium on redemption of debentures A/c
	e) Issued at a discount redeemable at premium.	Bank A/c Dr. Loss on issue of debentures A/c Dr. To Debentures A/c To Premium on redemption of debentures A/c.
3	Issue of Debentures for Non-cash consideration	
	a) On purchase of business	Sundry Assets A/c Dr. *Goodwill A/c Dr. To Sundry Liabilities A/c To Vendor A/c To Capital Reserve A/c
	b) On issue of Debentures to Vendor	
	(i) Issue at per redeemable at par	Vendor A/c Dr. To Debentures A/c
	(ii) Issued at discount redeemable at par	Vendor A/c Dr. Discount on issue of Debentures A/c Dr. To Debentures A/c
	(iii) Issued at premium redeemable at par	Vendor A/c Dr. To Debentures A/c To Securities Premium A/c
	(iv) Issued at par redeemable at premium.	Vendor A/c Dr. Loss on issue of debenture A/c Dr. To Debentures A/c To Premium on redemption of debentures A/c
	(v) Issued at a discount redeemable at premium	Vendor A/c Dr. Loss on issue of debentures A/c Dr To Debentures A/c To Premium on redemption of debentures A/c
4)	Issue of Debenture as collateral security	No Entry

TREATMENT OF DISCOUNT ON ISSUE OF DEBENTURES :

Discount on issue of debentures is a capital loss & such loss is written off from books of account as early as possible. Following journal entries passed to write off discount.

P & L A/c Dr.

To Discount on issue of Debentures A/c

Balance on discount is shown in the balance sheet on the assets side under the head "Miscellaneous Expenditure". The amount of discount is written off in the following ways.

a) When debentures are redeemed after certain period. In this case total discount on debentures is written off equally each year over the period of debenture tenure.

Discount to be written off=Total Discount/ No.of years after which debentures will be redeemed.

BUY BACK OF SHARES

The term Buy Back of Shares means buying or purchasing by a company of it own Shares / Securities. U/s 77 of the Companies Act, 1956, a company limited by shares and a company limited guarantee and having a Share Capital cannot buy it own shares unless the consequent reduction of capital is effected and sanctioned in accordance with provisions of the Act. The Companies (Amendment) Act 1999 introduced section 77A, 77AA and 77B, now permits to Buy Back its own Shares subject to fulfillment of certain conditions.

PURPOSES OF BUY-BACK OF OWN SHARES

Buying back of Equity Shares may be carried out, with the following purposes:

i) Higher Earnings per Shares for the remaining shareholders.

ii) Reduction of excess Share Capital

iii) Increase in Intrinsic value of Shares

iv) Utilization of Surplus idle funds lying in the company

v) Increase share holding of promoters.

vi) Financial restructuring of the business.

vii) Maintaining market value of Shares in the situation of slow down in economy.

The Buy-Back of Shares leads to the following benefits to the concerned company :

i) Share Capital Structure can be re-organised suitably.

ii) It reduces capital base and thus return on Equity Capital and Earning Per Share can be increases.

iii) By sub-division of shares and Buy-Back of Shares, company can avoid Corporate Divided Tax as cash resources are used for Buy-Back of Share.

iv) Holding of promoters can be increased.

v) Promoters can keep their control on the company due to buy back as less shares available for sale in the market.

vi) Buy-Back helps family rearrangements, as claims dissatisfied members can be settled.

LEGAL PROVISIONS FOR BUY-BACK OF SHARES

Section 77A permits Buy-Back of own Shares only if following conditions are fulfilled.

1) The Buy-Back is authorized by the Articles of Association of the Company.

2) A special resolution has been passed in a General Meeting of the shareholders wherein such Buy-Back is authorized. Companies (Amendment) Act 2001 permits Board of Directors to Buy-Back up to 10% of total Equity Capital & Reserves of the company, without special resolution.

3) Only fully Paid-up Shares can be bought back.

4) If shares are listed on any stock exchange, then the guidelines of SEBI have to be complied with.

5) The Board of Directors must file a declaration of solvency with SEBI of Registrar of Companies in Form 4A.

6) After Buy-Back is completed, the company shall have to within 15 days extinguish & physically destroy the Securities / Shares so bought back. Buyback of shares for the purpose of investment is not allowed. 187

7) A further issue of shares of same kind is not permitted within a period of 6 months. The exception is a) Bonus issue, b) Discharge of obligation such as issue for conversion of securities or warrant, stock option scheme.

8) The company has to maintain Register of securities so bough back mentioning the necessary details in the form 4B.

9) Purchase of its own share, may be in the form of buy-back from existing shareholders on proportionate basis or purchase from open market or purchase of odd lots or acquisition of stock option or Sweat Equity issued to employees. But purchase of its own Shares through as Subsidiary Company or Investment Company is not allowed.

10) Buy-back of shares by a defaulter company is in matter of repayment of Deposit, Term Loans, Debentures or Preference Shares in pending or Interest / Dividend thereon.

11) A company can buy back its shares out of Free Reserves, Securities Premium Account or proceeds of any shares or other specified Security, but of not the same kind of shares.

LIMITS OF BUY-BACK OF OWN SHARES. As per section 77A Company can buy back its own shares within the following limits.

1) Buy-back should not exceed more than 25% of the Paid-up Equity Capital in any financial year

2) Buy-back should not exceed 25% of the Paid-up Capital, Free Reserves & Securities Premium of the company. This is the upper limit in any financial year for a company to buyback its own shares.

3) Maximum account payable on buyback is 25% of Paid-up Capital & Free Reserves.

4) After buyback is completed, the Debt Equity Ratio should not be more than 2:1. The word debt includes all Secured and Unsecured Loan or Debts except Working Capital Loan (Short Term Loans).

SOURCES OF BUY-BACK

As per section 77A (1) buyback or purchase of own shares can be done only out of – 1) Its Free Reserves 2) Securities Premium Account 3) Proceeds of any shares or specified securities

FREE RESERVES The term Free Reserves are those reserves which as per latest audited Balance Sheet are free for distribution as Dividend & includes balance in Securities Premium Account. Free Reserves should be net amount of Free Reserve after adjusting Fictitious Asset and revaluation was of Long Term Investment and Tangible Assets not provide for.

SECURITIES PREMIUM ACCOUNT The term Security Premium Account represents premium received on account of shares, debenture & other financial instruments. Security Premium Account after making adjusting in respect of Miscellaneous Expenditure (not written off) forms of Free Reserves for the purpose of buyback.

PROCEEDS OF ANY EARLIER ISSUED OF SHARES OR SPECIFIED SECURITIES It is provided that buy back of own shares can be made from out of the proceeds of an earlier issue of shares or any specified securities. Buy back of shares of any kind is not allowed out of the fresh issue of shares of same kind. Thus for buy back of Equity Shares, earlier issue of Preference Shares, Debentures etc. would be possible.

MODES OF BUYBACK

There are three important ways of buy-back.

BUYBACK THROUGH TENDER OFFER

A company can buy back its share from the existing shareholders on proportionate basis. A company has to make a public announcement of buy-back in new papers, or it should 189 contain information as given, it as requires as per SEBI Buy Back Regulations. A company required to comply with SEBI Buy-back Regulations as follows procedure; within time limits.

BUY-BACK THROUGH OPEN MARKET OPERATIONS

After passing special resolution for buy-back, Maximum price to be offered should be specified. Company"s appoints merchant banker for buy-back of shares through stock exchange operations.

ACQUISITION OF STOCK OPTION / SWEAT EQUITY

The buy-back of own Equity Shares can be done by acquisition of odd lots (only for quoted shares and or by acquisition of stock option / sweat shares from employees.

Module-IV

You have learnt about the financial statements (Income Statement and Balance Sheet) of companies. Basically, these are summarized financial reports which provide the operating results and financial position of companies, and the detailed information contained therein is useful for assessing the operational efficiency and financial soundness of a company. This requires proper analysis and interpretation of such information for which a number of techniques (tools) have been developed by financial experts. In this chapter we will have an overview of these techniques.

Meaning of Analysis of Financial Statements

The process of critical evaluation of the financial information contained in the financial statements in order to understand and make decisions regarding the operations of the firm is called 'Financial Statement Analysis'. It is basically a study of relationship among various financial facts and figures as given in a set of financial statements, and the interpretation thereof to gain an insight into the profitability and operational efficiency of the firm to assess its financial health and future prospects. The term 'financial analysis' includes both 'analysis and interpretation'. The term analysis means simplification of financial data by methodical classification given in the financial statements. Interpretation means explaining the meaning and significance of the data. These two are complimentary to each other. Analysis is useless without interpretation, and interpretation without analysis is difficult or even impossible.

Financial statement analysis is a judgmental process which aims to estimate current and past financial positions and the results of the operation of an enterprise, with primary objective of determining the best possible estimates and predictions about the future conditions. It essentially involves regrouping and analysis of information provided by financial statements to establish relationships and throw light on the points of strengths and weaknesses of a business enterprise, which can be useful in decision-making involving comparison with other firms (cross sectional analysis) and with firms' own performance, over a time period (time series analysis).

Significance of Analysis of Financial Statements

Financial analysis is the process of identifying the financial strengths and weaknesses of the firm by properly establishing relationships between the various items of the balance sheet and the statement of profit and loss. Financial analysis can be undertaken by management of the firm, or by parties outside the firm, viz., owners, trade creditors, lenders, investors, labour unions, analysts and others. The nature of analysis will differ depending on the purpose of the analyst. A technique frequently used by an analyst need not necessarily serve the purpose of other analysts because of the difference in the interests of the analysts. Financial analysis is useful and significant to different users in the following ways:

(a) *Finance manager:* Financial analysis focuses on the facts and relationships related to managerial performance, corporate efficiency, financial strengths and weaknesses and creditworthiness of the company. A finance manager must be well-equipped with the different tools of analysis to make rational decisions for the firm. The tools for analysis help in studying accounting data so as to determine the continuity of the operating policies, investment value of the business, credit ratings and testing the efficiency of operations. The techniques are equally important in the area of financial control, enabling the finance manager to make constant reviews of the actual financial operations of the firm to analyze the causes of major deviations, which may help in corrective action wherever indicated.

(b) *Top management:* The importance of financial analysis is not limited to the finance manager alone. It has a broad scope which includes top management in general and other functional managers. Management of the firm would be interested in every aspect of the financial analysis. It is their overall responsibility to see that the resources of the firm are used most efficiently and that the firm's financial condition is sound. Financial analysis helps the management in measuring the success of the company's operations, appraising the individual's performance and evaluating the system of internal control.

(c) *Trade payables:* Trade payables, through an analysis of financial statements, appraises not only the ability of the company to meet its short-term obligations, but also judges the probability of its continued ability to meet all its financial obligations in future. Trade payables are particularly interested in the firm's ability to meet their claims over a very short period of time. Their analysis will, therefore, evaluate the firm's liquidity position.

(d) *Lenders:* Suppliers of long-term debt are concerned with the firm's long-term solvency and survival. They analyze the firm's profitability over a period of time, its ability to generate cash, to be able to pay interest and repay the principal and the relationship between various sources of funds (capital structure relationships). Long-term lenders analyze the historical financial statements to assess its future solvency and profitability.

(e) *Investors:* Investors, who have invested their money in the firm's shares, are interested about the firm's earnings. As such, they concentrate on the analysis of the firm's present and future profitability. They are also interested in the firm's capital structure to ascertain its influences on firm's earning and risk. They also evaluate the efficiency of the management and determine whether a change is needed or not. However, in some large companies, the shareholders' interest is limited to decide whether to buy, sell or hold the shares.

(f) *Labour unions:* Labour unions analyse the financial statements to assess whether it can presently afford a wage increase and whether it can absorb a wage increase through increased productivity or by raising the prices.

(g) *Others:* The economists, researchers, etc., analyse the financial statements to study the present business and economic conditions. The government agencies need it for price regulations, taxation and other similar purposes.

Objectives of Analysis of Financial Statements

Analysis of financial statements reveals important facts concerning managerial performance and the efficiency of the firm. Broadly speaking, the objectives of the analysis are to apprehend the information contained in financial statements with a view to know the weaknesses and strengths of the firm and to make a forecast about the future prospects of the firm thereby, enabling the analysts to take decisions regarding the operation of, and further investment in the firm. To be more specific, the analysis is undertaken to serve the following purposes (objectives):

- to assess the current profitability and operational efficiency of the firm as a whole as well as its different departments so as to judge the financial health of the firm.
- to ascertain the relative importance of different components of the financial position of the firm.
- to identify the reasons for change in the profitability/financial position of the firm.

- to judge the ability of the firm to repay its debt and assessing the short-term as well as the long-term liquidity position of the firm.

Through the analysis of financial statements of various firms, an economist can judge the extent of concentration of economic power and pitfalls in the financial policies pursued. The analysis also provides the basis for many governmental actions relating to licensing, controls, fixing of prices, ceiling on profits, dividend freeze, tax subsidy and other concessions to the corporate sector.

Tools of Analysis of Financial Statements

The most commonly used techniques of financial analysis are as follows:

1. *Comparative Statements:* These are the statements showing the profitability and financial position of a firm for different periods of time in a comparative form to give an idea about the position of two or more periods. It usually applies to the two important financial statements, namely, balance sheet and statement of profit and loss prepared in a comparative form. The financial data will be comparative only when same accounting principles are used in preparing these statements. If this is not the case, the deviation in the use of accounting principles should be mentioned as a footnote. Comparative figures indicate the trend and direction of financial position and operating results. This analysis is also known as 'horizontal analysis'.

2. *Common Size Statements:* These are the statements which indicate the relationship of different items of a financial statement with a common item by expressing each item as a percentage of that common item. The percentage thus calculated can be easily compared with the results of corresponding percentages of the previous year or of some other firms, as the numbers are brought to common base. Such statements also allow an analyst to compare the operating and financing characteristics of two companies of different sizes in the same industry. Thus, common size statements are useful, both, in intra-firm comparisons over different years and also in making inter-firm comparisons for the same year or for several years. This analysis is also known as 'Vertical analysis'.

3. *Trend Analysis:* It is a technique of studying the operational results and financial position over a series of years. Using the previous years' data of a business enterprise, trend analysis can be done to observe the percentage changes over time in the selected data. The trend percentage is the percentage relationship, in which each item of different years bear to the same item in the base year. Trend analysis is important because, with its long run view, it may point to basic

changes in the nature of the business. By looking at a trend in a particular ratio, one may find whether the ratio is falling, rising or remaining relatively constant. From this observation, a problem is detected or the sign of good or poor management is detected.

4. *Ratio Analysis:* It describes the significant relationship which exists between various items of a balance sheet and a statement of profit and loss of a firm. As a technique of financial analysis, accounting ratios measure the comparative significance of the individual items of the income and position statements. It is possible to assess the profitability, solvency and efficiency of an enterprise through the technique of ratio analysis.

5. *Cash Flow Analysis:* It refers to the analysis of actual movement of cash into and out of an organisation. The flow of cash into the business is called as cash inflow or positive cash flow and the flow of cash out of the firm is called as cash outflow or a negative cash flow. The difference between the inflow and outflow of cash is the net cash flow. Cash flow statement is prepared to project the manner in which the cash has been received and has been utilized during an accounting year as it shows the sources of cash receipts and also the purposes for which payments are made. Thus, it summarises the causes for the changes in cash position of a business enterprise between dates of two balance sheets. In this chapter, we shall have a brief idea about the first three techniques, viz., comparative statements, common size statements and trend analysis.

Comparative Statements

As stated earlier, these statements refer to the statement of profit and loss and the balance sheet prepared by providing columns for the figures for both the current year as well as for the previous year and for the changes during the year, both in absolute and relative terms. As a result, it is possible to find out not only the balances of accounts as on different dates and summaries of different operational activities of different periods, but also the extent of their increase or decrease between these dates. The figures in the comparative statements can be used for identifying the direction of changes and also the trends in different indicators of performance of an organisation.

The following steps may be followed to prepare the comparative statements:

Step 1 : List out absolute figures in rupees relating to two points of time

Step 2 : Find out change in absolute figures by subtracting the first year (Col.2) from the second year (Col.3) and indicate the change as increase (+) or decrease (–) and put it in column 4.

Step 3 : Preferably, also calculate the percentage change as follows and put it in column 5.

Common Size Statement

Common Size Statement, also known as component percentage statement, is a financial tool for studying the key changes and trends in the financial position and operational result of a company. Here, each item in the statement is stated as a percentage of the aggregate, of which that item is a part. For example, a common size balance sheet shows the percentage of each asset to the total assets, and that of each liability to the total liabilities. Similarly, in the common size statement of profit and loss, the items of expenditure are shown as a percentage of the net revenue from operations. If such a statement is prepared for successive periods, it shows the changes of the respective percentages over a period of time. Common size analysis is of immense use for comparing enterprises which differ substantially in size as it provides an insight into the structure of financial statements. Inter-firm comparison or comparison of the company's position with the related industry as a whole is possible with the help of common size statement analysis. The following procedure may be adopted for preparing the common size statements.

1. List out absolute figures in rupees at two points of time, say year 1, and year 2
2. Choose a common base (as 100). For example, revenue from operations may be taken as base (100) in case of statement of profit and loss and total assets or total liabilities (100) in case of balance sheet.
3. For all items of Col. 2 and 3 work out the percentage of that total. Column 4 and 5

Trend Analysis

The financial statements may be analysed by computing trends of series of information. Trend analysis determines the direction upwards or downwards and involves the computation of the percentage relationship that each item bears to the same item in the base year. In case of comparative statement, an item is compared with itself in the previous year to know whether it has increased or decreased or remained constant. Common size analysis is to ascertain whether the proportion of an item (say cost of revenue from operations) is increasing or decreasing in the common base (say revenue from operations). But in case of trend analysis, we learn about the behaviour of the same item over a given period, say, during the last 5 years. Take for example, administrative expenses, whether they are exhibiting increasing tendency or decreasing tendency or remaining constant over the period of comparison. Generally trend analysis is done for a reasonably long period. Many companies present their financial data for a period of 5 or 10 years in various forms in their annual reports.

Procedure for Calculating Trend Percentage

One year is taken as the base year. Generally, the first year is taken as the base year. The figure of base year is taken as 100. The trend percentages are calculated in relation to this base year. If a figure in other year is less than the figure in base year, the trend percentage will be less than 100 and it will be more than 100 if figure is more than the base year figure. Each year's figure is divided by the base year figure. The accounting procedures and conventions used for collecting data and preparation of financial statements should be similar; otherwise the figures will not be comparable.

Limitations of Financial Analysis

Though financial analysis is quite helpful in determining financial strengths and weaknesses of a firm, it is based on the information available in financial statements. As such, the financial analysis also suffers from various limitations of financial statements. Hence, the analyst must be conscious of the impact of price level changes, window dressing of financial statements, changes in accounting policies of a firm, accounting concepts and conventions, personal judgement, etc. Some other limitations of financial analysis are:

1. Financial analysis does not consider price level changes.
2. Financial analysis may be misleading without the knowledge of the changes in accounting procedure followed by a firm.
3. Financial analysis is just a study of reports of the company.
4. Monetary information alone is considered in financial analysis while non-monetary aspects are ignored.
5. The financial statements are prepared on the basis of accounting concept, as such, it does not reflect the current position.

Ratio Analysis

Financial statements aim at providing financial information about a business enterprise to meet the information needs of the decision-makers. Financial statements prepared by a business enterprise in the corporate sector are published and are available to the decision-makers. These statements provide financial data which require analysis, comparison and interpretation for taking decision by the external as well as internal users of accounting information. This act is termed as financial statement analysis. It is regarded as an integral and important part of accounting. As indicated in the previous chapter, the most commonly used techniques of financial statements analysis are comparative statements, common size statements, trend analysis, accounting ratios and cash flow analysis. The first three have been discussed in detail in the previous chapter. This chapter covers the technique of accounting ratios for analysing the information contained in financial statements for assessing the solvency, efficiency and profitability of the enterprises.

Objectives of Ratio Analysis

Ratio analysis is indispensable part of interpretation of results revealed by the financial statements. It provides users with crucial financial information and points out the areas which require investigation. Ratio analysis is a technique which involves regrouping of data by application of arithmetical relationships, though its interpretation is a complex matter. It requires a fine understanding of the way and the rules used for preparing financial statements. Once done effectively, it provides a lot of information which helps the analyst:

a. To know the areas of the business which need more attention;
b. To know about the potential areas which can be improved with the effort in the desired direction;
c. To provide a deeper analysis of the profitability, liquidity, solvency and efficiency levels in the business;
d. To provide information for making cross-sectional analysis by comparing the performance with the best industry standards; and
e. To provide information derived from financial statements useful for making projections and estimates for the future.

Advantages of Ratio Analysis

The ratio analysis if properly done improves the user's understanding of the efficiency with which the business is being conducted. The numerical relationships throw light on many latent aspects of the business. If properly analyzed, the ratios make us understand various problem areas as well as the bright spots of the business. The knowledge of problem areas help management take care of them in future. The knowledge of areas which are working better helps you improve the situation further. It must be emphasized that ratios are means to an end rather than the end in themselves. Their role is essentially indicative and that of a whistle blower. There are many advantages derived from ratio analysis. These are summarized as follows:

1. Helps to understand efficacy of decisions: The ratio analysis helps you to understand whether the business firm has taken the right kind of operating, investing and financing decisions. It indicates how far they have helped in improving the performance.

2. Simplify complex figures and establish relationships: Ratios help in simplifying the complex accounting figures and bring out their relationships. They help summaries the financial information effectively and assess the managerial efficiency, firm's credit worthiness, earning capacity, etc.

3. Helpful in comparative analysis: The ratios are not be calculated for one year only. When many year figures are kept side by side, they help a great deal in exploring the trends visible in the business. The knowledge of trend helps in making projections about the business which is a very useful feature.

4. Identification of problem areas: Ratios help business in identifying the problem areas as well as the bright areas of the business. Problem areas would need more attention and bright areas will need polishing to have still better results.

5. Enables SWOT analysis: Ratios help a great deal in explaining the changes occurring in the business. The information of change helps the management a great deal in understanding the current threats and opportunities and allows business to do its own SWOT (Strength Weakness-Opportunity-Threat) analysis.

6. Various comparisons: Ratios help comparisons with certain bench marks to assess as to whether firm's performance is better or otherwise. For this purpose, the profitability, liquidity, solvency, etc. of a business, may be compared: (i) over a number of accounting periods with itself (Intra-firm Comparison/Time Series Analysis), (ii) with other business enterprises (Inter-firm Comparison/Cross-sectional Analysis) and (iii) with standards set for that firm/industry (comparison with standard (or industry expectations).

Limitations of Ratio Analysis

Since the ratios are derived from the financial statements, any weakness in the original financial statements will also creep in the derived analysis in the form of ratio analysis. Thus, the limitations of financial statements also form the limitations of the ratio analysis. Hence, to interpret the ratios, the user should be aware of the rules followed in the preparation of financial statements and also their nature and limitations. The limitations of ratio analysis which arise primarily from the nature of financial statements are as under:

1. Limitations of Accounting Data: Accounting data give an unwarranted impression of precision and finality. In fact, accounting data "reflect a combination of recorded facts, accounting conventions and personal judgements which affect them materially. For example, profit of the business is not a precise and final figure. It is merely an opinion of the accountant based on application of accounting policies. The soundness of the judgement necessarily depends on the competence and integrity of those who make them and on their adherence to Generally Accepted Accounting Principles and Conventions". Thus, the financial statements may not reveal the true state of affairs of the enterprises and so the ratios will also not give the true picture.

2. Ignores Price-level Changes: The financial accounting is based on stable money measurement principle. It implicitly assumes that price level changes are either non-existent or minimal. But the truth is otherwise. We are normally living in inflationary economies where the power of money declines constantly. A change in the price-level makes analysis of financial statement of different accounting years meaningless because accounting records ignore changes in value of money.

3. Ignore Qualitative or Non-monetary Aspects: Accounting provides information about quantitative (or monetary) aspects of business. Hence, the ratios also reflect only the monetary aspects, ignoring completely the non-monetary (qualitative) factors.

4. Variations in Accounting Practices: There are differing accounting policies for valuation of inventory, calculation of depreciation, treatment of intangibles Assets definition of certain financial variables etc., available for various aspects of business transactions. These variations leave a big question mark on the cross-sectional analysis. As there are variations in accounting practices followed by different business enterprises, a valid comparison of their financial statements is not possible.

5. Forecasting: Forecasting of future trends based only on historical analysis is not feasible. Proper forecasting requires consideration of non-financial factors as well

Types of Ratios

There is a two way classification of ratios: (1) traditional classification, and (2) functional classification. The traditional classification has been on the basis of financial statements to which the determinants of ratios belong. On this basis the ratios are classified as follows:

1. 'Statement of Profit and Loss Ratios: A ratio of two variables from the statement of profit and loss is known as statement of profit and loss ratio. For example, ratio of gross profit to revenue from operations is known as gross profit ratio. It is calculated using both figures from the statement of profit and loss.

2. Balance Sheet Ratios: In case both variables are from the balance sheet, it is classified as balance sheet ratios. For example, ratio of current assets to current liabilities known as current ratio. It is calculated using both figures from balance sheet.

3. Composite Ratios: If a ratio is computed with one variable from the statement of profit and loss and another variable from the balance sheet, it is called composite ratio. For example, ratio of credit revenue from operations to trade receivables (known as trade receivables turnover ratio) is calculated using one figure from the statement of profit and loss (credit revenue from operations) and another figure (trade receivables) from the balance sheet. Although accounting ratios are calculated by taking data from financial statements but classification of ratios on the basis of financial statements is rarely used in practice. It must be recalled that basic purpose of accounting is to throw light on the financial performance (profitability) and financial position (its capacity to raise money and invest them wisely) as well as changes occurring in financial position (possible explanation of changes in the activity level). As such, the alternative classification (functional classification) based on the purpose for which a ratio is computed, is the most commonly used classification which is as follows:

1. Liquidity Ratios: To meet its commitments, business needs liquid funds. The ability of the business to pay the amount due to stakeholders as and when it is due is known as liquidity, and the ratios calculated to measure it are known as 'Liquidity Ratios'. These are essentially short-term in nature.

2. Solvency Ratios: Solvency of business is determined by its ability to meet its contractual obligations towards stakeholders, particularly towards external stakeholders, and the ratios calculated to measure solvency position are known as 'Solvency Ratios'. These are essentially long-term in nature.

3. Activity (or Turnover) Ratios: This refers to the ratios that are calculated for measuring the efficiency of operations of business based on effective utilization of resources. Hence, these are also known as 'Efficiency Ratios'.

4. Profitability Ratios: It refers to the analysis of profits in relation to revenue from operations or funds (or assets) employed in the business and the ratios calculated to meet this objective are known as 'Profitability Ratios'

Liquidity Ratios Liquidity ratios are calculated to measure the short-term solvency of the business, i.e. the firm's ability to meet its current obligations. These are analyzed by looking at the amounts of current assets and current liabilities in the balance sheet. The two ratios included in this category are current ratio and liquidity ratio.

Current Ratio Current ratio is the proportion of current assets to current liabilities. It is expressed as follows

: Current Ratio = Current Assets: Current Liabilities or Current Assets/Current Liabilities

Current assets include current investments, inventories, trade receivables (debtors and bills receivables), cash and cash equivalents, short-term loans and advances and other current assets such as prepaid expenses, advance tax and accrued income, etc. Current liabilities include short-term borrowings, trade payables (creditors and bills payables), other current liabilities and short-term provisions.

Quick Ratio

It is the ratio of quick (or liquid) asset to current liabilities. It is expressed as

Quick ratio = Quick Assets : Current Liabilities or Quick Assets/Current Liabilities

The quick assets are defined as those assets which are quickly convertible into cash. While calculating quick assets we exclude the inventories at the end and other current assets such as prepaid expenses, advance tax, etc., from the current assets. Because of exclusion of non-liquid current assets it is considered better than current ratio as a measure of liquidity position of the business. It is calculated to serve as a supplementary check on liquidity position of the business and is therefore, also known as 'Acid-Test Ratio'.

Solvency Ratios

The persons who have advanced money to the business on long-term basis are interested in safety of their periodic payment of interest as well as the repayment of principal amount at the end of the loan period. Solvency ratios are calculated to determine the ability of the business to service its debt in the long run. The following ratios are normally computed for evaluating solvency of the business.

1. Debt-Equity Ratio;
2. Debt to Capital Employed Ratio;
3. Proprietary Ratio;
4. Total Assets to Debt Ratio;
5. Interest Coverage Ratio.

Debt-Equity Ratio

Debt-Equity Ratio measures the relationship between long-term debt and equity. If debt component of the total long-term funds employed is small, outsiders feel more secure. From security point of view, capital structure with less debt and more equity is considered favourable as it reduces the chances of bankruptcy.

Normally, it is considered to be safe if debt equity ratio is 2: 1. However, it may vary from industry to industry. It is computed as follows:

Debt-Equity Ratio = Long-term Debts/Shareholders' Funds

Shareholders' Funds (Equity) = Share capital + Reserves and Surplus +Money received against share warrants

Share Capital = Equity share capital + Preference share capital

or

Shareholders' Funds (Equity) = Non-current assets + Working capital –Non-current liabilities

Working Capital = Current Assets – Current Liabilities

Significance: This ratio measures the degree of indebtedness of an enterprise and gives an idea to the long-term lender regarding extent of security of the debt. As indicated earlier, a low debt equity ratio reflects more security. A high ratio, on the other hand, is considered risky as it may put the firm into difficulty in meeting its obligations to outsiders. However, from the perspective of the owners, greater use of debt (trading on equity) may help in ensuring higher returns for them if the rate of earnings on capital employed is higher than the rate of interest payable.

Debt to Capital Employed Ratio

The Debt to capital employed ratio refers to the ratio of long-term debt to the total of external and internal funds (capital employed or net assets). It is computed as follows:

Debt to Capital Employed Ratio = Long-term Debt/Capital Employed (or Net Assets)

Proprietary ratio expresses relationship of proprietor's (shareholders) funds to net assets and is calculated as follows :

Proprietary Ratio = Shareholders, Funds/Capital employed (or net assets)

Total Assets to Debt Ratio

This ratio measures the extent of the coverage of long-term debts by assets. It is calculated as

Total assets to Debt Ratio = Total assets/Long-term debts

The higher ratio indicates that assets have been mainly financed by owner's funds and the long-term loans are adequately covered by assets. It is better to take the net assets (capital employed) instead of total assets for computing this ratio also. It is observed that in that case, the ratio is the reciprocal of the debt to capital employed ratio.

Significance: This ratio primarily indicates the rate of external funds in financing the assets and the extent of coverage of their debts are covered by assets.

Interest Coverage Ratio

It is a ratio which deals with the servicing of interest on loan. It is a measure of security of interest payable on long-term debts. It expresses the relationship between profits available for payment of interest and the amount of interest payable. It is calculated as follows:

Interest Coverage Ratio = Net Profit before Interest and Tax/Interest on long-term debts

Significance: It reveals the number of times interest on long-term debts is covered by the profits available for interest. A higher ratio ensures safety of interest on debts.

Activity (or Turnover) Ratio

These ratios indicate the speed at which, activities of the business are being performed. The activity ratios express the number of times assets employed, or, for that matter, any constituent of assets, is turned into sales during an accounting period. Higher turnover ratios a mean better utilization of assets and signifies improved efficiency and profitability, and as such are known as efficiency ratios.

The important activity ratios calculated under this category are

1. Inventory Turnover;
2. Trade receivable Turnover;
3. Trade payable Turnover;
4. Investment (Net assets) Turnover
5. Fixed assets Turnover; and

6. Working capital Turnover.

Inventory Turnover Ratio

It determines the number of times inventory is converted into revenue from operations during the accounting period under consideration. It expresses the relationship between the cost of revenue from operations and average inventory.

The formula for its calculation is as follows:

Inventory Turnover Ratio = Cost of Revenue from Operations / Average Inventory

Where average inventory refers to arithmetic average of opening and closing inventory, and the cost of revenue from operations means revenue from operations less gross profit.

Significance: It studies the frequency of conversion of inventory of finished goods into revenue from operations. It is also a measure of liquidity. It determines how many times inventory is purchased or replaced during a year. Low turnover of inventory may be due to bad buying, obsolete inventory, etc., and is a danger signal. High turnover is good but it must be carefully interpreted as it may be due to buying in small lots or selling quickly at low margin to realize cash. Thus, it throws light on utilization of inventory of goods.

Trade Receivables Turnover Ratio

It expresses the relationship between credit revenue from operations and trade receivable. It is calculated as follows :

Trade Receivable Turnover ratio = Net Credit Revenue from Operations/Average Trade Receivable

Where Average Trade Receivable = (Opening Debtors and Bills Receivable + Closing Debtors and Bills Receivable)/2

It needs to be noted that debtors should be taken before making any provision for doubtful debts.

Significance: The liquidity position of the firm depends upon the speed with which trade receivables are realized. This ratio indicates the number of times the receivables are turned over and converted into cash in an accounting period. Higher turnover means speedy collection from trade receivable. This ratio also helps in working out the average collection period. The ratio is calculated by dividing the days or months in a year by trade receivables turnover ratio.

i.e., Number of days or Months/Trade receivables turnover ratio

Trade Payable Turnover Ratio

Trade payables turnover ratio indicates the pattern of payment of trade payable. As trade payable arise on account of credit purchases, it expresses relationship between credit purchases and trade payable. It is calculated as follows:

Trade Payables Turnover ratio = Net Credit purchases/Average trade payable

Where Average Trade Payable = (Opening Creditors and Bills Payable +Closing Creditors and Bills Payable)/2

Average Payment Period =No. of days/month in a year/Trade Payables Turnover Ratio

Significance: It reveals average payment period. Lower ratio means credit allowed by the supplier is for a long period or it may reflect delayed payment to suppliers which is not a very good policy as it may affect the reputation of the business. The average period of payment can be worked out by days/months in a year by the Trade Payable Turnover Ratio.

Net Assets or Capital Employed Turnover Ratio

It reflects relationship between revenue from operations and net assets (capital employed) in the business. Higher turnover means better activity and profitability.

It is calculated as follows:

Net Assets or Capital Employed Turnover ratio =Revenue from Operation/Capital Employed

Capital employed turnover ratio which studies turnover of capital employed (or Net Assets) is analysed further by following two turnover ratios :

(a) Fixed Assets Turnover Ratio : It is computed as follows:

Fixed asset turnover Ratio =Net Revenue from Operation/Net Fixed Assets

(b) Working Capital Turnover Ratio: It is calculated as follows:

Working Capital Turnover Ratio = Net Revenue from Operation/Working Capital

Significance: High turnover of capital employed, working capital and fixed assets is a good sign and implies efficient utilisation of resources. Utilisation of capital employed or, for that matter, any of its components is revealed by the turnover ratios. Higher turnover reflects efficient utilisation resulting in higher liquidity and profitability in the business.

Profitability Ratios

The profitability or financial performance is mainly summarized in the statement of profit and loss. Profitability ratios are calculated to analyze the earning capacity of the business which is the outcome of utilisation of resources employed in the business. There is a close relationship between the profit and the efficiency with which the resources employed in the business are utilized. The various ratios which are commonly used to analyse the profitability of the business are:

1. Gross profit ratio
2. Operating ratio
3. Operating profit ratio
4. Net profit ratio
5. Return on Investment (ROI) or Return on Capital Employed (ROCE)
6. Return on Net Worth (RONW)
7. Earnings per share
8. Book value per share
9. Dividend payout ratio
10. Price earning ratio.

Gross Profit Ratio

Gross profit ratio as a percentage of revenue from operations is computed to have an idea about gross margin. It is computed as follows:

Gross Profit Ratio = Gross Profit/Net Revenue of Operations × 100

Significance: It indicates gross margin on products sold. It also indicates the margin available to cover operating expenses, non-operating expenses, etc.

Change in gross profit ratio may be due to change in selling price or cost of revenue from operations or a combination of both. A low ratio may indicate unfavorable purchase and sales policy. Higher gross profit ratio is always a good sign.

Operating Ratio

It is computed to analyse cost of operation in relation to revenue from operations.

It is calculated as follows:

Operating Ratio = (Cost of Revenue from Operations + Operating Expenses)/Net Revenue from Operations × 100

Operating expenses include office expenses, administrative expenses, selling expenses, distribution expenses, depreciation and employee benefit expenses etc. Cost of operation is determined by excluding non-operating incomes and expenses such as loss on sale of assets, interest paid, dividend received, loss by fire, speculation gain and so on.

Operating Profit Ratio

It is calculated to reveal operating margin. It may be computed directly or as a residual of operating ratio.

Operating Profit Ratio = 100 – Operating Ratio

Alternatively, it is calculated as under:

Operating Profit Ratio = Operating Profit/ Revenue from Operations × 100

Where Operating Profit = Revenue from Operations – Operating Cost

Significance: Operating ratio is computed to express cost of operations excluding financial charges in relation to revenue from operations. A corollary of it is 'Operating Profit Ratio'. It helps to analyse the performance of business and throws light on the operational efficiency of the business. It is very useful for inter-firm as well as intra-firm comparisons. Lower operating ratio is a very healthy sign.

Net Profit Ratio

Net profit ratio is based on all inclusive concept of profit. It relates revenue from operations to net profit after operational as well as non-operational expenses and incomes. It is calculated as under:

Net Profit Ratio = Net profit/Revenue from Operations × 100

Generally, net profit refers to profit after tax (PAT).

Significance: It is a measure of net profit margin in relation to revenue from operations. Besides revealing profitability, it is the main variable in computation of Return on Investment. It reflects the overall efficiency of the business, assumes great significance from the point of view of investors.

Return on Shareholders' Funds

This ratio is very important from shareholders' point of view in assessing whether their investment in the firm generates a reasonable return or not. It should be higher than the return on investment otherwise it would imply that company's funds have not been employed profitably. A better measure of profitability from shareholders point of view is obtained by determining return on total shareholders' funds, it is also termed as Return on Net Worth (RONW) and is calculated as under : Return on Shareholders' Fund = Profit after Tax/Shareholders' Funds× 100

Earnings per Share

The ratio is computed as:

EPS = Profit available for equity shareholders/Number of Equity Shares In this context, earnings refer to profit available for equity shareholders which is worked out as

Profit after Tax – Dividend on Preference Shares.

This ratio is very important from equity shareholders point of view and also for the share price in the stock market. This also helps comparison with other to ascertain its reasonableness and capacity to pay dividend.

Book Value per Share

This ratio is calculated as:

Book Value per share = Equity shareholders' funds/Number of Equity Shares Equity shareholder fund refers to Shareholders' Funds – Preference Share Capital. This ratio is again very important from equity shareholders point of view as it gives an idea about the value of their holding and affects market price of the shares.

Dividend Payout Ratio

This refers to the proportion of earning that are distributed to the shareholders.

It is calculated as –

Dividend Payout Ratio = Dividend per share/ Earnings per share

This reflects company's dividend policy and growth in owner's equity.

Price / Earnings Ratio

The ratio is computed as – P/E Ratio = Market Price of a share/earnings per share

CASH FLOW STATEMENT

In the previous lesson, you have learnt various types of analysis of financial statements and its tools such as comparative statements, common size statement and trend analysis, etc. You have also learnt various kinds of accounting ratios such as liquidity, activity, profitability, solvency, etc. You have learnt that accounts are mainly maintained on accrual basis but cash also plays significant role. Cash is mainly generated for operating activities which is buying assets and discharging liabilities. Cash is also raised from the issue of shares and debentures or loans but adequate cash should be available for use in time and no cash should remain idle. For this another tool of analysis is used which is cash flow statement.. In this lesson, you will learn about cash flow statement and its methods of preparation.

Meaning and Objective

Cash plays a very important role in the economic life of a business. A firm needs cash to make payment to its suppliers, to incur day-to-day expenses and to pay salaries, wages, interest and dividends etc. In fact, what blood is to a human body, cash is to a business enterprise. Thus, it is very essential for a business to maintain an adequate balance of cash. For example, a concern operates profitably but it does not have sufficient cash balance to pay dividends, what message does it convey to the shareholders and public in general. Thus, management of cash is very essential. There should be focus on movement of cash and its equivalents. Cash means, cash in hand and demand deposits with the bank. Cash equivalent consists of bank overdraft, cash credit, short term deposits and marketable securities. Cash Flow Statement deals with flow of cash which includes cash equivalents as well as cash.

This statement is an additional information to the users of Financial Statements. The statement shows the incoming and outgoing of cash. The statement assesses the capability of the enterprise to generate cash and utilize it. Thus a Cash-Flow statement may be defined as a summary of receipts and disbursements of cash for a particular period of time. It also explains reasons for the changes in cash position of the firm. Cash flows are cash inflows and outflows. Transactions which increase the cash position of the entity are called as inflows of cash and those which decrease the cash position as outflows of cash. Cash flow Statement traces the various sources which bring in cash such as cash from operating activities, sale of current and fixed assets, issue of share capital and debentures etc. and applications which cause outflow of cash such as loss from operations, purchase of current and fixed assets, redemption of debentures, preference shares and other long-term debt for cash. In short, a cash flow statement shows the cash receipts and disbursements during a certain period. The statement of cash flow serves a number of objectives which are as follows:

a. Cash flow statement aims at highlighting the cash generated from operating activities.
b. Cash flow statement helps in planning the repayment of loan schedule and replacement of fixed assets, etc.
c. Cash is the centre of all financial decisions. It is used as the basis for the projection of future investing and financing plans of the enterprise.

d. Cash flow statement helps to ascertain the liquid position of the firm in a better manner. Banks and financial institutions mostly prefer cash flow statement to analyse liquidity of the borrowing firm.
e. Cash flow Statement helps in efficient and effective management of cash.
f. The management generally looks into cash flow statements to understand the internally generated cash which is best utilized for payment of dividends.
g. Cash Flow Statement based on AS-3 (revised) presents separately cash generated and used in operating, investing and financing activities.
h. It is very useful in the evaluation of cash position of a firm.

Cash and relevant terms as per AS-3 (revised) As per AS-3 (revised) issued by the Accounting Standards Board

1. (a) Cash fund : Cash Fund includes

(i) Cash in hand

(ii) Demand deposits with banks, and

(iii) Cash equivalents.

(b) Cash equivalents are short-term, highly liquid investments, readily convertible into cash and which are subject to insignificant risk of changes in values.

Classification of Activities for the Preparation of Cash Flow Statement You know that various activities of an enterprise result into cash flows (inflows or receipts and outflows or payments) which is the subject matter of a cash flow statement. As per AS-3, these activities are to be classified into three categories:

(1) Operating,

(2) Investing, and

(3) Financing activities so as to show separately the cash flows generated (or used) by (in) these activities. This helps the users of cash flow statement to assess the impact of these activities on the financial position of an enterprise and also on its cash and cash equivalents.

Cash from Operating Activities: Operating activities are the activities that constitute the primary or main activities of an enterprise. For example, for a company manufacturing garments, operating activities are procurement of raw material, incurrence of manufacturing expenses, sale of garments, etc. These are the principal revenue generating activities (or the main activities) of the enterprise and these activities are not investing or financing activities. The amount of cash from operations' indicates the internal solvency level of the company, and is regarded as the key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, paying dividends, making of new investments and repaying of loans without recourse to external source of financing. Cash flows from operating activities are primarily derived from the main activities of the enterprise. They generally result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are:

Cash Inflows from operating activities

- Cash receipts from sale of goods and the rendering of services.
- Cash receipts from royalties, fees, commissions and other revenues.

Cash Outflows from operating activities

- Cash payments to suppliers for goods and services.
- Cash payments to and on behalf of the employees.
- Cash payments to an insurance enterprise for premiums and claims, annuities, and other policy benefits.
- Cash payments of income taxes unless they can be specifically identified with financing and investing activities.

The net position is shown in case of operating cash flows. An enterprise may hold securities and loans for dealing or for trading purposes. In either case they represent Inventory specifically held for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to main activity of that enterprise.

Cash from Investing Activities: As per AS-3, investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Investing activities relate to purchase and sale of long-term assets or fixed assets such as machinery, land and building, etc. Transactions related to long-term investment are also investing activities. Separate disclosure of cash flows from investing activities is important because they represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

Cash Outflows from investing activities

- Cash payments to acquire fixed assets including intangibles and capitalised research and development.
- Cash payments to acquire shares, warrants or debt instruments of other enterprises other than the instruments those held for trading purposes.
- Cash advances and loans made to third party (other than advances and loans made by a financial enterprise wherein it is operating activities).

Cash Inflows from Investing Activities

- Cash receipt from disposal of fixed assets including intangibles.
- Cash receipt from the repayment of advances or loans made to third parties (except in case of financial enterprise).
- Cash receipt from disposal of shares, warrants or debt instruments of other enterprises except those held for trading purposes. l Interest received in cash from loans and advances.
- Dividend received from investments in other enterprises.

Cash from Financing Activities: As the name suggests, financing activities relate to long-term funds or capital of an enterprise, e.g., cash proceeds from issue of equity shares, debentures, raising long-term bank loans, repayment of bank loan, etc. As per AS-3, financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in case of a company) and borrowings of the enterprise. Separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of financing activities are:

Cash Inflows from financing activities

- Cash proceeds from issuing shares (equity or/and preference).
- Cash proceeds from issuing debentures, loans, bonds and other short/ long-term borrowings.

Cash Outflows from financing activities

- Cash repayments of amounts borrowed.
- Interest paid on debentures and long-term loans and advances.

- Dividends paid on equity and preference capital.

It is important to mention here that a transaction may include cash flows that are classified differently. For example, when the installment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities. Moreover, same activity may be classified differently for different enterprises. For example, purchase of shares is an operating activity for a share brokerage firm while it is investing activity in case of other enterprises.

Treatment of Some Peculiar Items

Extraordinary items

Extraordinary items are not the regular phenomenon, e.g., loss due to theft or earthquake or flood. Extraordinary items are non-recurring in nature and hence cash flows associated with extraordinary items should be classified and disclosed separately as arising from operating, investing or financing activities. This is done to enable users to understand their nature and effect on the present and future cash flows of an enterprise.

Interest and Dividend

In case of a financial enterprise (whose main business is lending and borrowing), interest paid, interest received and dividend received are classified as operating activities while dividend paid is a financing activity. In case of a non-financial enterprise, as per AS-3, it is considered more appropriate that payment of interest and dividends are classified as financing activities whereas receipt of interest and dividends are classified as investing activities.

Taxes on Income and Gains

Taxes may be income tax (tax on normal profit), capital gains tax (tax on capital profits), dividend tax (tax on the amount distributed as dividend to shareholders). AS-3 requires that cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. This clearly implies that:

- Tax on operating profit should be classified as operating cash flows.
- Dividend tax, i.e., tax paid on dividend should be classified as financing activity along with dividend paid.

- Capital gains tax paid on sale of fixed assets should be classified under investing activities.

Non-cash Transactions

As per AS-3, investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Examples of such transactions are – acquisition of machinery by issue of equity shares or redemption of debentures by issue of equity shares. Such transactions should be disclosed elsewhere in the financial statements in a way that provide all the relevant information about these investing and financing activities. Hence, assets acquired by issue of shares are not disclosed in cash flow statement due to non-cash nature of the transaction.

Cash Flow Statement

(Main heads only)

(A) Cash flows from operating activities	xxx
(B) Cash flows from investing activities	xxx
(C) Cash flows from financing activities	xxx
Net increase (decrease) in cash and cash Equivalents (A + B + C)	xxx
+ Cash and cash equivalents at the beginning	xxx
= Cash and cash equivalents at the end	xxx

Ascertaining Cash Flow from Operating Activities

Operating activities are the main source of revenue and expenditure in an enterprise. Therefore, the ascertainment of cash flows from operating activities need special attention. As per AS-3, an enterprise should report cash flows from operating activities either by using :

- Direct method whereby major classes of gross cash receipts and gross cash payments are disclosed; or
- Indirect method whereby net profit or loss is duly adjusted for the effects of (1) transactions of a non-cash nature, (2) any deferrals or accruals of past/future operating cash receipts, and (3) items of income or expenses associated with investing or financing cash flows. It is important to mention here that under indirect method, the starting point is net profit/loss before taxation and extra ordinary items as per Statement of Profit and

Loss of the enterprise. Then this amount is for non-cash items, etc., adjusted for ascertaining cash flows from operating activities.

Accordingly, cash flow from operating activities can be determined using either the direct method or the indirect method. These methods are discussed in detail as follows.

Direct Method

As the name suggests, under direct method, major heads of cash inflows and outflows (such as cash received from trade receivables, employee benefits expenses paid, etc.) are considered.

It is important to note here that items are recorded on accrual basis in statement of profit and loss. Hence, certain adjustments are made to convert them into cash basis such as the following :

1. Cash receipts from customers = Revenue from operations + Trade receivables in the beginning – Trade receivables in the end.

2. Cash payments to suppliers = Purchases + Trade Payables in the beginning – Trade Payables in the end.

3. Purchases = Cost of Revenue from Operations – Opening Inventory + Closing Inventory.

4. Cash expenses = Expenses on accrual basis + Prepaid expenses in thebeginning and Outstanding expenses in the end – Prepaid expenses in the end and Outstanding expenses in the beginning.

However, the following items are not to be considered:

1. Non-cash items such as depreciation, discount on shares, etc., be written-off.

2. Items which are classified as investing or financing activities such as interest received, dividend paid, etc.

As per AS-3, under the direct method, information about major classes of gross cash receipts and cash payments may be obtained either–

- from the accounting records of the enterprise, or
- by adjusting revenue from operation, cost of revenue from operations and other items in the statement of profit or loss for the following:
- changes during the period in inventories and trade receivables and payables;
- other non-cash items; and
- Other items for which cash effects are investing or financing cash flows.

Cash Flows from Operating Activities (Direct Method)

Cash flows from operating activities:	
Cash receipts from customers	xxx
(–) Cash paid to suppliers and employees	(xxx)
= Cash generated from operations	**xxx**
(–) Income tax paid	(xxx)
= Cash flow before extraordinary items	**xxx**
+/– Extraordinary items	xxx
= Net cash from operating activities	**xxxx**

Illustration 1

From the following information, calculate cash flow from operating activities using direct method.

Statement of Profit and Loss for the year ended on March 31, 2015

Particulars Note Figures for Current reporting period	
i) Revenue from operations	2,20,000
ii) Other Income	-----
iii) Total revenue (i+ii)	2,20,000
iv) Expenses	
Cost of materials consumed	1,20,000
Employees benefits expenses	30,000
Depreciation	20,000
Other expenses	
Insurance Premium	8,000
Total expenses	1,78,000
v) Profit before tax (iii-iv)	42,000
Less Income tax	(10,000)
vi) Profit after tax	32,000

Particulars	*2014*	*2015*
Trade receivables	33,000	36,000
Trade payables	17,000	15,000
Inventory	22,000	27,000
Outstanding employees benefits	2,000	3,000

expenses		
Prepaid insurance	5,000	5,500
Income tax outstanding	3,000	2,000

Solution:

Cash Flows from Operating Activities

Particulars (Rs)	
Cash receipts from customers	2,17,000
Cash Paid to suppliers	(1,27,000)
Cash Paid to employees	(29,000)
Cash Paid for Insurance premium	(8,500)
Cash generated from operations	52,500
Income Tax paid	(11,000)
Net Cash Inflow from Operations	**41,500**

Working Notes:

1. Cash Receipts from Customers is calculated as under :

Cash Receipts from Customers = Revenue from Operations + Trade Receivables in the beginning – Trade Receivables in the end

= Rs 2,20,000 + Rs 33,000 – Rs 36,000 = Rs 2,17,000

2. Purchases = Cost of Revenue from Operations – Opening Inventory + Closing Inventory

= Rs 1,20,000 – Rs 22,000 + Rs 27,000 = Rs 1,25,000

3. Cash payment to suppliers = Purchases + Trade Payables in the beginning – Trade Payables in the end = Rs 1,25,000 + Rs 17,000 – Rs 15,000 = Rs 1,27,000

4. Cash Expenses = Expenses on Accrual basis – Prepaid Expenses in the beginning and Outstanding Expenses in the end + Prepaid Expenses in the end and Outstanding Expenses in the beginning

5. Cash Paid to Employees = Rs 30,000 + Rs 2,000 – Rs 3,000 = Rs 29,000

6. Cash Paid for Insurance Premium = Rs 8,000 – Rs 5,000 + Rs 5,500 = Rs 8,500

7. Income Tax Paid = Rs 10,000+Rs 3,000 – Rs 2,000 = Rs 11,000

8. It is important to note here that there are no extraordinary items.

Indirect Method

Indirect method of ascertaining cash flow from operating activities begins with the amount of net profit/loss. This is so because statement of profit and loss incorporates the effects of all operating activities of an enterprise. However, Statement of Profit and Loss is prepared on accrual basis (and not on cash basis). Moreover, it also includes certain non-operating items such as interest paid, profit/loss on sale of fixed assets, etc.) and non-cash items (such as depreciation, goodwill to be written-off, etc.. Therefore, it becomes necessary to adjust the amount of net profit/loss as shown by Statement of Profit and Loss for arriving at cash flows from operating activities. Let us look at the example :

Statement of Profit and Loss Account for the year ended March 31, 2015

i) Revenue from Operations	1,00,000
ii) Other Income	1 2,000
iii) Total Revenues (i+ii)	1,02,000
iv) Expenses	
Cost of Materials Consumed	30,000
Purchases of stock-in-trade	10,000
Employees Benefits Expenses	10,000
Finance Costs	5,000
Depreciation	5,000
Other Expenses	12,000
	72,000
v) Profit before Tax (iii-iv)	30,000

Note: Other income includes profit on sale of land.

The above Statement of Profit and Loss shows the amount of net profit of Rs 30,000. This has to be adjusted for arriving cash flows from operating activities. Let us take various items one by one.

1. *Depreciation* is a non-cash item and hence, Rs 5,000 charged as depreciation does not result in any cash flow. Therefore, this amount must be added back to the net profit.

2. *Finance costs* of Rs 5,000 is a cash outflow on account of financing activity. Therefore, this amount must also be added back to net profit while calculating cash flows from operating activities. This amount of finance cost will be shown as an outflow under the head of financing

activities.

3. *Other income includes profit on sale of land:* It is cash inflow from investing activity. Hence, this amount must be deducted from the amount of net profit while calculating cash flows from operating activities.

The above example gives you an idea as to how various adjustments are made in the amount of net profit/loss. Other important adjustments relate to changes in working capital which are necessary (i.e., items of current assets and current liabilities) to convert net profit/loss which is based on accrual basis into cash flows from operating activities. Therefore, the increase in current assets and decrease in current liabilities are deducted from the operating profit, and the decrease in current assets and increase in current liabilities are added to the operating profit so as to arrive at the exact amount of net cash flow from operating activities.

As per AS-3, under indirect method, net cash flow from operating activities is determined by adjusting net profit or loss for the effect of :

- Non-cash items such as depreciation, goodwill written-off, provisions, deferred taxes, etc., which are to be added back.
- All other items for which the cash effects are investing or financing cash flows. The treatment of such items depends upon their nature. All investing and financing incomes are to be deducted from the amount of net profits while all such expenses are to be added back. For example, finance cost which is a financing cash outflow is to be added back while other income such as interest received which is investing cash inflow is to be deducted from the amount of net profit.
- Changes in current assets and liabilities during the period. Increase in current assets and decrease in current liabilities are to be deducted while increase in current liabilities and decrease in current assets are to be added up.

The direct method provides information which is useful in estimating future cash flows. But such information is not available under the indirect method. However, in practice, indirect method is mostly used by the companies for arriving at the net cash flow from operating activities.

Cash Flows from Operating Activities (Indirect Method)

Net Profit/Loss before Tax and Extraordinary Items

+ Deductions already made in Statement of Profit and Loss on account of xxx

Non-cash items such as Depreciation, Goodwill to be Written-off. + Deductions already made in Statement of Profit and Loss on Account of Non-operating items such as Interest. xxx

– Additions (incomes) made in Statement of Profit and Loss on Account of Non-operating items such as Dividend received, Profit on sale of Fixed Assets. xxx

Operating Profit before Working Capital changes		xxx
+ Increase in Current liabilities	xxx	
+ Decrease in Current assets	xxx	
– Increase in Current assets	xxx	
– Decrease in Current Liabilities	xxx	
Cash Flows from Operating Activities before Tax and Extraordinary Items	xxx	
– Income Tax Paid	xxx	
+/– Effects of Extraordinary Items	xxx	
Net Cash from Operating Activities	**xxx**	

Illustration 2

Using the data given in Illustration 1, calculate cash flows from operating activities using indirect method.

Solution:

Cash Flows from Operating Activities

Particulars (Rs)	
(Net Profit before Taxation and Extraordinary Items (Note 1)	42,000
Adjustments for–	
+ Depreciation	20,000
= Operating Profit before working capital changes	62,000
– Increase in Trade Receivables	(3,000)
– Increase in Inventories	(5,000)
– Increase in Prepaid Insurance	(500)
– Decrease in Trade Payables	(2,000)
+ Increase in Outstanding Employees Benefits Expenses	+1,000
= Cash generated from Operations	52,500
– Income tax paid	(11,000)
= *Net cash from Operating Activities*	**41,500**

Working Notes :

The net profit before taxation and extraordinary items has been worked out as under:

Net Profit = Rs 32,000 + Income Tax = Rs 10,000

= Net Profit before Tax and Extraordinary Items = Rs 42,000

Preparation of Cash Flow Statement

As stated earlier cash flow statement provides information about change in the position of Cash and Cash Equivalents of an enterprise, over an accounting period. The activities contributing to this change are classified into operating, investing and financing. The methodology of working out the net cash flow (or use) from all the three activities for an accounting period has been explained in details and a brief format of Cash Flow Statement has also been given in Exhibit 6.2. However, while preparing a cash flow statement, full details of inflows and outflows are given under these heads including the net cash flow (or use). The aggregate of the net 'cash flows (or use) is worked out and is shown as 'Net Increase/Decrease in cash and Cash Equivalents' to which the amount of 'cash and cash equivalent at the beginning' is added and thus the amount of 'cash and cash equivalents at the end' is arrived at as shown in Exhibit 6.2. This figure will be the same as the total amount of cash in hand, cash at bank and cash equivalants (if any) given in the balance sheet (see Illustrations 7 to 10). Another point that needs to be noted is that when cash flows from operating activities are worked out by an indirect method and shown as such in the cash flow statement, the statement itself is termed as 'Indirect method cash flow statement'. Thus, the Cash flow statements prepared in Illustrations 7, 8 and 9 fall under this category as the cash flows from operating activities have been worked out by indirect method. Similarly, if the cash flows from operating activities are worked by direct method while preparing the cash flow statement, it will be termed as 'direct method Cash Flow Statement'. Illustration 10 shows both types of Cash Flow Statement. However, unless it is specified clearly as to which method is to be used, the cash flow statement may preferably be prepared by an indirect method as is done by most companies in practice.

Cash flow statement: How to interpret?

- Identify the major sources of cash inflows and cash outflows.
- Compare capital expenditure with depreciation number.
- See how operating cash flows are being utilized.
- Find out whether the enterprise is growing. If yes, whether organically or inorganically

UNDERSTANDING COMPANY FINANCIAL STATEMENTS

- Financial statements provide the fundamental information that we use to analyze and answer valuation questions. It is important, therefore, that we understand the principles governing these statements by looking at four questions: · How valuable are the assets of a firm? The assets of a firm can come in several forms – assets with long lives such as land and buildings, assets with shorter lives such inventory, and intangible assets that still produce revenues for the firm such as patents and trademarks. ·
- How did the firm raise the funds to finance these assets? In acquiring these assets, firms can use the funds of the owners (equity) or borrowed money (debt), and the mix is likely to change as the assets age.
- How profitable are these assets? A good investment, we argued, is one that makes a return greater than the hurdle rate. To evaluate whether the investments that a firm has already made are good investments, we need to estimate what returns we are making on these investments.
- How much uncertainty (or risk) is embedded in these assets? While we have not directly confronted the issue of risk yet, estimating how much uncertainty there is in existing investments and the implications for a firm is clearly a first step.

We will look at the way accountants would answer these questions, and why the answers might be different when doing valuation. Some of these differences can be traced to the differences in objectives – accountants try to measure the current standing and immediate past performance of a firm, whereas valuation is much more forward looking.

The Basic Accounting Statements

There are three basic accounting statements that summarize information about a firm. The first is the balance sheet, which summarizes the assets owned by a firm, the value of these assets and the mix of financing, debt and equity, used to finance these assets at a point in time.

The next is the income statement, which provides information on the revenues and expenses of the firm, and the resulting income made by the firm, during a period. The period can be a quarter (if it is a quarterly income statement) or a year (if it is an annual report).

Maruti Suzuki Ltd
Consolidated Balance Sheet Rs. In Crores

	Mar 16	Mar 15	Mar 14	Mar 13	Mar 12
EQUITIES AND LIABILITIES					
SHAREHOLDER'S FUNDS					
Equity Share Capital	151.00	151.00	151.00	151.00	144.50
Total Share Capital	**151.00**	**151.00**	**151.00**	**151.00**	**144.50**
Reserves and Surplus	27,597.70	24,167.40	21,345.40	18,876.80	15,530.00
Total Reserves and Surplus	**27,597.70**	**24,167.40**	**21,345.40**	**18,876.80**	**15,530.00**
Total Shareholders Funds	**27,748.70**	**24,318.40**	**21,496.40**	**19,027.80**	**15,674.50**
Minority Interest	14.40	13.40	12.20	10.60	0.00
NON-CURRENT LIABILITIES					
Long Term Borrowings	147.10	278.30	627.40	704.90	169.80
Deferred Tax Liabilities [Net]	475.10	484.40	596.20	417.60	306.90
Other Long Term Liabilities	122.40	105.90	247.60	112.10	102.80
Long Term Provisions	302.10	295.80	200.70	225.90	168.30
Total Non-Current Liabilities	**1,046.70**	**1,164.40**	**1,671.90**	**1,460.50**	**747.80**
CURRENT LIABILITIES					
Short Term Borrowings	90.70	52.50	1,237.90	863.90	1,092.40
Trade Payables	7,127.10	5,656.80	4,999.80	4,286.80	3,466.10
Other Current Liabilities	2,407.80	1,916.60	1,320.50	1,179.30	1,593.90
Short Term Provisions	1,834.50	1,356.50	672.70	641.90	524.60
Total Current Liabilities	**11,460.10**	**8,982.40**	**8,230.90**	**6,971.90**	**6,677.00**
Total Capital And Liabilities	**40,269.90**	**34,478.60**	**31,411.40**	**27,470.80**	**23,099.30**
ASSETS					
NON-CURRENT ASSETS					
Tangible Assets	12,625.10	12,194.70	10,849.30	9,797.70	7,534.00
Intangible Assets	350.80	294.80	184.40	224.00	211.50
Capital Work-In-Progress	1,013.40	1,890.10	2,639.50	1,967.90	612.20
Fixed Assets	**13,989.30**	**14,379.60**	**13,673.20**	**11,989.60**	**8,357.70**
Non-Current Investments	17,511.70	9,991.80	1,521.20	2,146.00	1,790.90
Long Term Loans And Advances	1,355.50	1,366.60	1,653.90	1,286.50	1,676.30
Other Non-Current Assets	9.10	44.20	9.50	894.60	32.40
Total Non-Current Assets	**32,865.60**	**25,782.20**	**16,857.80**	**16,316.70**	**11,857.30**
CURRENT ASSETS					
Current Investments	874.80	3,305.90	9,005.90	5,275.40	4,754.10
Inventories	3,199.80	2,674.40	1,763.20	1,887.20	1,837.80
Trade Receivables	1,387.30	1,144.30	1,489.10	1,489.20	1,006.60
Cash And Cash Equivalents	76.80	43.20	648.60	814.80	2,463.40
Short Term Loans And Advances	1,595.70	1,201.70	1,283.20	1,134.30	799.00
OtherCurrentAssets	269.90	326.90	363.60	553.20	381.10

Total Current Assets	**7,404.30**	**8,696.40**	**14,553.60**	**11,154.10**	**11,242.00**
Total Assets	**40,269.90**	**34,478.60**	**31,411.40**	**27,470.80**	**23,099.30**
OTHER ADDITIONAL INFORMATION					
CONTINGENT LIABILITIES, COMMITMENTS					
Contingent Liabilities	10,659.50	6,982.60	5,322.10	5,502.20	3,333.90
BONUS DETAILS					
NON-CURRENT INVESTMENTS					
Non-Current Investments Unquoted Book Value	17,358.10	9,992.30	1,461.80	2,124.60	1,790.90
CURRENT INVESTMENTS					
Current Investments Unquoted Book Value	874.80	3,305.90	9,005.90	5,275.40	4,754.10

Maruti Suzuki India

Consolidated Profit & Loss account — **in Rs. Cr.**

	Mar '16	Mar '15	Mar '14	Mar '13	Mar '12
Income					
Sales Turnover	66,226.40	56,052.30	49,709.30	49,885.50	40,049.60
Excise Duty	7,614.40	5,250.90	5,258.70	5,581.10	3,959.70
Net Sales	58,612.00	50,801.40	44,450.60	44,304.40	36,089.90
Other Income	471.50	865.00	830.50	830.10	844.30
Stock Adjustments	-6.30	460.90	-20.40	-19.20	133.30
Total Income	**59,077.20**	**52,127.30**	**45,260.70**	**45,115.30**	**37,067.50**
Expenditure					
Raw Materials	39,586.20	36,255.60	31,997.30	33,218.00	28,736.30
Power & Fuel Cost	694.10	713.80	595.70	495.10	229.50
Employee Cost	2,060.20	1,671.00	1,423.70	1,120.20	877.90
Miscellaneous Expenses	7,146.40	5,777.80	5,209.70	5,123.50	3,854.40
Total Expenses	49,486.90	44,418.20	39,226.40	39,956.80	33,698.10
	Mar '16	**Mar '15**	**Mar '14**	**Mar '13**	**Mar '12**
	12 mths	12 mths	12 mths	12 mths	12 mths
Operating Profit	**9,118.80**	**6,844.10**	**5,203.80**	**4,328.40**	**2,525.10**
PBDIT	9,590.30	7,709.10	6,034.30	5,158.50	3,369.40
Interest	93.70	217.80	184.50	198.70	61.60
PBDT	9,496.60	7,491.30	5,849.80	4,959.80	3,307.80
Depreciation	2,867.00	2,515.30	2,116.00	1,889.70	1,162.70
Profit Before Tax	6,629.60	4,976.00	3,733.80	3,070.10	2,145.10
PBT (Post Extra-ord Items)	6,629.60	4,976.00	3,733.80	3,070.10	2,145.10
Tax	1,998.70	1,185.40	902.20	621.50	511.50
Reported Net Profit	**4,630.90**	**3,790.60**	**2,831.60**	**2,448.60**	**1,633.60**
Minority Interest	1.00	1.20	1.60	1.30	0.00
Share Of P/L Of Associates	-68.90	-18.00	-22.90	-21.90	-47.40
Net P/L After Minority Interest & Share Of Associates	4,698.80	3,807.40	2,852.90	2,469.20	1,681.00
Total Value Addition	9,900.70	8,162.60	7,229.10	6,738.80	4,961.80
Equity Dividend	1,057.30	755.20	362.50	241.70	216.70
Corporate Dividend Tax	215.20	153.80	61.60	41.10	35.10
Per share data (annualised)					
Shares in issue (lakhs)	3,020.80	3,020.80	3,020.80	3,020.80	2,889.10
Earning Per Share (Rs)	**153.30**	**125.48**	**93.74**	**81.06**	**56.54**
Book Value (Rs)	918.59	805.03	711.61	629.89	542.54