FINANCIAL ACCOUNTING AND AUDITING COLLECTION
Scott Showalter and Jan Williams, *Editors*

Accounting for People Who Think They Hate Accounting

Anurag Singal

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Dedicated to my grandfather, Late Shri Anand Prakash Agarwal, who laid strong foundations of accountancy from the very beginning.

Abstract

The book *Accounting for People Who Think They Hate Accounting* is inspired by my IIM Ahmedabad days when grappling with accountancy suddenly becomes the "numero uno" priority of MBA Semester-1.

Financial statements serve as a report card for a business through which managers and entrepreneurs can know their exact financial positions. These financial statements are prepared only through financial accounting. The main purpose of financial accounting is to help entrepreneurs exercise control over their business activities by controlling total costs incurred so that they are able to earn higher profits.

So, in order to understand where exactly the business stands financially, knowledge of financial accounting is imperative.

What is financial accounting?

Why do I need to understand it?

How will it help me in my business?

Why is it important to me? Or

Is it important to me?

These are some of the questions that surface in the minds of young and aspiring entrepreneurs when they start their business or are on the verge of starting one. This book aims to answer them in the most practical and comprehensible manner possible so that accounting is no longer a nightmare for them.

Keywords

accounting, accounting for beginners, accounting convention, accounting for dummies, balance sheet and profit and loss account, bookkeeping, business and money, corporate accounting, entrepreneurship and small business, financial statements

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Preface

Accounting has been a subject that runs in our veins; my grandfather was an astute accountant of his times and we were onto journals and ledgers since Class 3. After Chartered Accountancy and stints across Deloitte, ITC, Tata Steel, and Aditya Birla Group, I landed in IIM Ahmedabad in April 2014 for a one year full-time MBA. It is there that the book found its genesis. I wanted to create something for my friends who were coming from a non-finance background and were hit by the monster called Accountancy in the first semester.

This book aims to simplify things. It will take you from the basics and if all goes well, you shall be able to get a fair idea of financial statements by the time you reach the end.

"The proof of the pudding lies in the eating". So let the pages make their sales pitch themselves.

I hope that my endeavors shall benefit the vast majority of people.

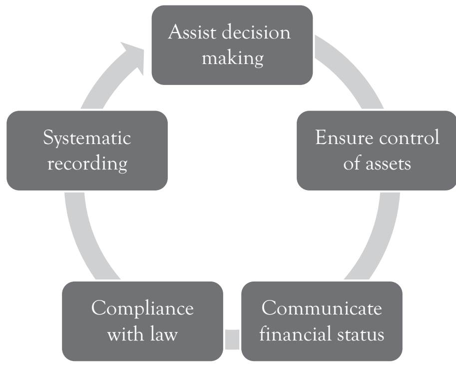
Introduction

The initial stage of starting any business or venture is procurement of funds and investment of capital.

Means of financing has to be decided much before one can even think of what kind of business he has to start.

The next stage comprises of deployment of these funds in the best possible manner so that highest return on investment is achieved.

In order to keep a track of the cost of procurement of funds, the return earned on investment done, expenses incurred, and income received in the business, it becomes essential for one to understand financial accounting.



CHAPTER 1

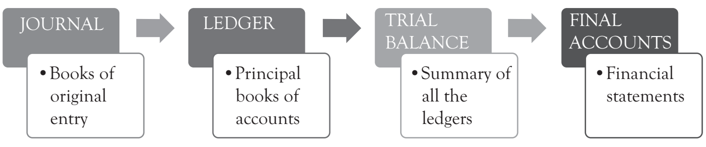
What Is Financial Accounting?

Financial accounting is the process of recording all financial transactions undertaken in a business. Here, "all" implies those transactions that are material enough so as to have an impact on the decision making of the entrepreneur.

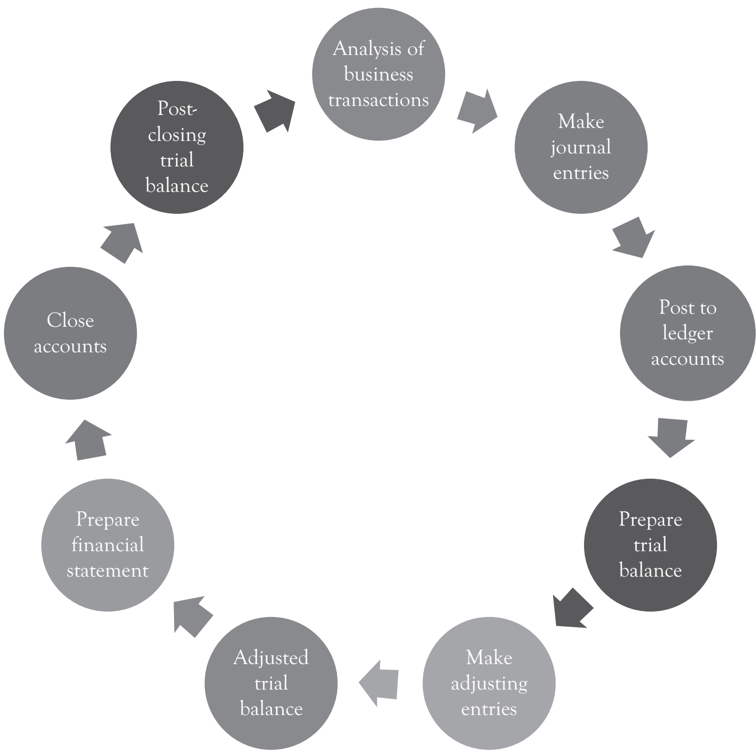
Once the transactions are recorded, they are summarized to make them fit for analysis and interpretation by managers and users.

The entire accounting process comprises the following stages.

1. Recording of transactions in the books of original entry, that is, *journal*
2. Posting them to the appropriate *ledger*
3. Preparation of *trial balance*
4. Preparation of *final accounts*



The whole of the accounting process has been shown below.



We will try to understand the above process step by step. But before that, we will first talk about the assumptions on which the whole financial accounting is based.

Accounting Concepts

Accounting concepts define the basic assumptions on the basis of which the whole financial accounting is done. These assumptions are said to be followed by default in the preparation of financial statements.

These assumptions are as follows:

- Going concern
- Consistency
- Accrual

Let us understand the meaning of these three assumptions.

i. **Going Concern:** Under this assumption, an entity will continue its operations in the foreseeable future and has no intention of shutting down or liquidating its business. Treatment of many items in financial accounting is based on the assumption that the entity will continue in the long run.

   Examples:
   - Possible losses that could arise in the event of closure of business are not anticipated and recorded by the management.
   - Prepayments and excess depreciation are carried forward to be matched against future profits.
   - Fixed assets are recorded at cost and not at market value because they are not intended to be sold in the near future.

ii. **Consistency:** It is further assumed and expected that an entity is following and will follow the same accounting policies from one period to another without any change. This should be so to maintain comparability and uniformity in the financial statements of the entity between different years.

   Examples:
   - If a company follows straight line depreciation in one period, it should continue to follow it in succeeding periods and not change to the reducing balance method.
   - Similarly, if a company adopts the first in first out (FIFO) method of stock valuation in a period, it should continue to follow it in another period as well.

iii. **Accrual:** This assumption states that all the financial transactions and their effects are recorded on a mercantile basis, that is, when they occur and not when they are paid or received. According to this assumption, the transactions are recorded in the period to which they relate whether they have been actually paid, received or not.

Examples:

- Expense incurred in the current period, such as salary but not paid, should be recorded as outstanding or accrued under current liabilities.
- Payments such as insurance made in advance for the next period should not be taken into account in the current period, but should be recorded as prepaid under current assets.

We will now study the basics of accounting concepts. They are as follows.

1. **Entity Concept**

   It states that a business enterprise and its owner have separate identities and should be treated differently. Their transactions should be recorded separately.

   Examples:

   - If the owner purchases something, such purchases should be treated separately and should not be mixed with that of the business. It will *not* be treated as a business purchase.
   - Similarly, the owner's property should *not* be included in the premises account of the business.
   - Moreover, any payment made for the personal expense of the owner will be treated as drawings and will not be included in the business expense.

CAUTION

Never Mix Personal Transactions with Business

This is what most entrepreneurs practice. It violates the entity assumption. Such expenses are considered as personal expense. In other words, "Don't dip your cookie in the company's coffee."

2. **Money Measurement Concept**

   This concept states that only those transactions that can be measured in monetary terms should be recorded in financial accounting. Qualitative factors are not taken into account.

Example:

- Market conditions, technological changes, and efficiency of management and workers are not recorded.

3. **Periodicity Concept**

According to this, accounts of an entity should be prepared for every predefined period and not at the end of its life. For example, in India it is April 1 to March 31; that is, its results should be prepared for a shorter period and not until its final liquidation. Generally the period accepted is 12 months.

Example:

- The financial statements are prepared generally from April 1 to March 31, that is, for 12 months.

4. **Accrual Concept**

This concept has already been discussed.

5. **Matching Concept**

This concept states that if any revenue is recognized in the accounting books then all the expenses incurred to earn that revenue should also be recognized simultaneously.

Examples:

- If income from rent is recognized in a period, then all the expenses incurred on the property from where such rent is derived should also be taken into account.
- Similarly, if a company recognizes sales all the expenses incurred on such sales—the selling expenses—should also be recorded.

6. **Going Concern Concept**

This concept has already been discussed.

7. **Cost Concept**

Under this concept, the assets purchased in an entity should be recorded only at its "historical cost," that is, the cost at which it was purchased. No other measurement method should be used amongst the multiple alternatives that are available to us, there being many of them.

Examples:

- If furniture was purchased for Rs. 30,000 and Rs. 2,000 was incurred on freight and installation costs, then it would be recorded as Rs. 32,000 in the books, that is, the total cost incurred to prepare the asset for its intended use.
- Depreciation will be provided on such cost.

8. **Realization Concept**

According to this concept, any upward change in the value of an asset should not be recorded unless it is realized and should continue to be shown at historical cost, whereas any decrease in value of the asset should be provided for, that is, revenues should be recognized when major economic activities have been completed.

Example:

- Sales are only recognized when goods are sold and delivered to the customers and not when they are pending for approval.

9. **Dual Aspect Concept**

This concept implies that every accounting transaction has an effect on two elements, namely assets and liabilities. It increases one element and decreases the other or may increase or decrease both the elements; in other words, it has a dual effect.

Examples:

- Payment is made for a certain item or expense like rent. It would affect two accounts, which are rent account and cash account, since cash is paid.
- Similarly, if a loan is given by the company, it would affect the account of the person to whom the loan is given as well as the cash account since cash is received.

10. **Conservatism**

According to this concept, all probable gains should be ignored and all probable losses should be provided for in the preparation of financial statements; for asset valuation, the method that leads to lesser value should always be chosen. This is done to minimize the profits and prevent inflated profits.

Examples:

- Provision of doubtful debts is made for those receivables whose realization is uncertain and is deducted from receivables to show the actual value.
- Stock is valued at *lower* of cost or net realizable value so that the profits are not inflated unnecessarily.

11. **Consistency**

This has been discussed previously.

12. **Materiality**

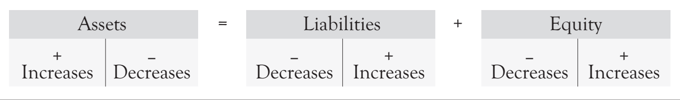
This concept states that only those items should be recorded in the books of accounts that are significant enough to have a financial effect on the business. Any insignificant item that would have no significant financial effect on the entity should be ignored.

Examples:

- Cost of small valued items such as paper clips and pencil sharpeners should be written off in the profit and loss statement, though they can last for more than one accounting period since the amount involved is very small and cannot be said to be material.
- Small payments for cleaning and similar expenses should not be disclosed separately as they are not so material. They should be clubbed with sundry expenses.

Concept of Debit and Credit

The whole of the accounting process follows the double entry path. According to this, each transaction has a twofold aspect: debit and credit. That is, if something comes in, something has to go, or we can also say that for every increase in something, there is a decrease in a corresponding thing. This is based on the following equation:



Assets		=	Liabilities		+	Equity	
+ Increases	– Decreases		– Decreases	+ Increases		– Decreases	+ Increases

If there is a change in one side of the equation, the other side is bound to change.

An account is debited if there is an increase and credited if there is a decrease.

Let us take an example:

Transactions	Assets (debit)	=Capital (credit)	+ Liabilities (credit)
1. Started business with cash Rs. 10,000	↑ Cash Rs. 10,000	↑ Capital Rs. 10,000	
2. Borrowed Rs. 5,000	↑ Cash Rs. 5,000		↑ Loan Rs. 5,000
3. Purchased machinery Rs. 15,000	↑ Machinery Rs. 15,000 ↓ Cash Rs. 15,000		
4. Loan repaid Rs. 1,000	↓ Cash Rs. 1,000		↓ Loan Rs. 1,000

Notes:
↑ denotes increase in asset or liability
↓ denotes decrease in asset or liability

Further, increase in assets is recorded on the left-hand side and decrease on the right-hand side, while increase in liabilities is recorded on the right-hand side and decrease on the left-hand side.

Hence, put together we get a T-shaped account where the left-hand side is called "debit side" and the right-hand side is called "credit side."

DEBIT	CREDIT
• Increase in assets • Decrease in liabilities	• Decrease in assets • Increase in liabilities

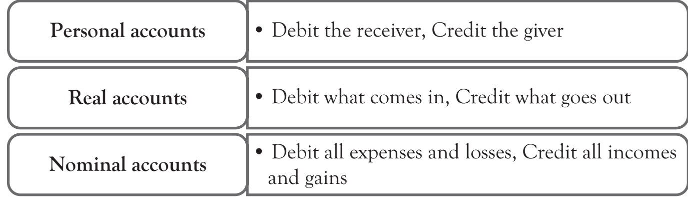
Types of Accounts

Before we go on to the golden rules of accounting, we first need to know about the types of accounts. There are three types of accounts.

1. **Personal Accounts:** They are in the name of the person itself and represent an individual or a company or any organization. It also includes capital account since it is also in the name of the proprietor.
2. **Real Accounts:** These accounts relate to the assets of the firm but not debt, for example, cash, land, and building.
3. **Nominal Accounts:** They are temporary accounts that relate to losses, gains, expenses, and profits. Their net result is transferred to the profit and loss account.

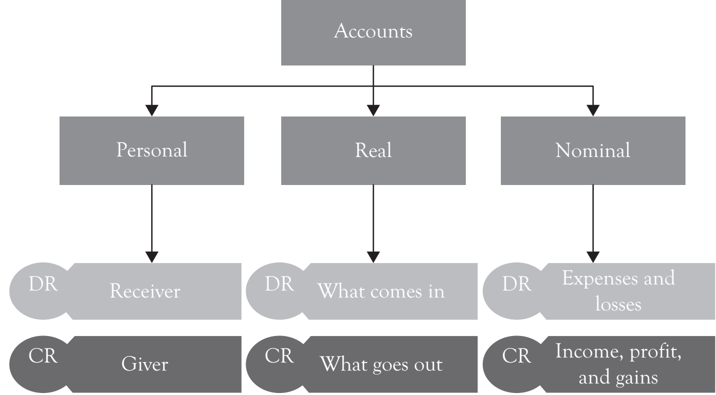
The Three Golden Rules of Accounting

The whole of financial accounting is based on three golden rules, which form the basis of the double entry system and also determine which account has to be debited and which has to be credited.



Personal accounts	• Debit the receiver, Credit the giver
Real accounts	• Debit what comes in, Credit what goes out
Nominal accounts	• Debit all expenses and losses, Credit all incomes and gains

We can summarize it as follows:



CHAPTER 2

Classification of Expenditure and Receipt into Revenue and Capital Categories

Let us learn about the difference between a revenue item and a capital item.

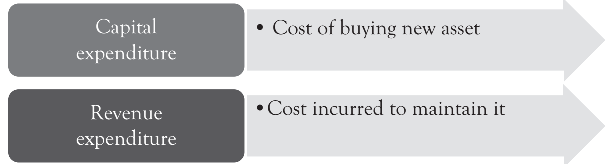
We will first look at expenditure.

"Capital expenditure" can be defined as follows.

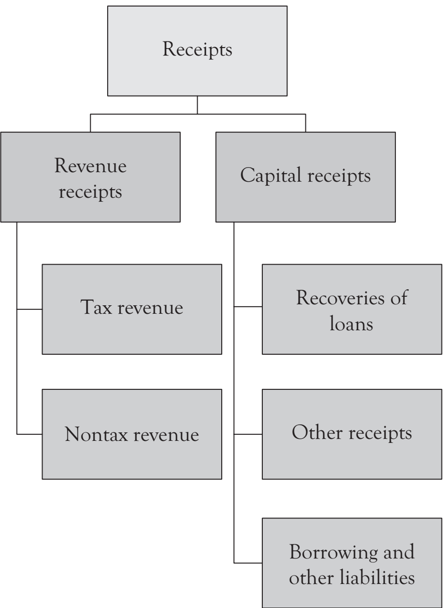
> Any expenditure that is incurred in construction or purchase of property that is intended to assist in generating profits or permanently enlarge, extend, or improve existing property, so that its profit earning capacity is increased. Its direct benefit extends over several accounting periods and it replaces cash by permanent asset.

Whereas "revenue expenditure" has the following characteristics.

- Its effect is temporary, that is, benefit is received within the accounting year.
- Neither has a new asset been acquired nor has the value of an existing asset been increased for the foreseeable future.
- It has no physical existence because it is incurred on items that are used by the business.
- It is recurring and regular.



We now move on to receipts.



"Revenue receipts" are:

- Generated in the normal course of business
- Recognized on accrual basis
- Credited to profit and loss account

"Capital receipts" are those that arise from the sale of capital assets and have nothing to do with the day-to-day working of the business.

The difference between revenue expenditure and capital expenditure can be summarized as follows.

Revenue expenditure	Capital expenditure
1. Expenditure incurred for day-to-day running of the business normally used for less than one accounting period and hence temporarily increases the profit-making capacity of the business.	1. Expenditure incurred on assets that last for a longer term and permanently increase the profit-making capacity of the business.
2. Charged to profits in the profit and loss statement.	2. Appears in the balance sheet as increase in total value of assets.
3. Examples: all day-to-day running expenses such as rent, interest, and depreciation.	3. Examples: purchase of land, vehicles, premises, and renovation to premises.

CHAPTER 3

Journal

As discussed in Chapter 1, the journal is a book of original entry; that is, any material financial transaction is first and foremost recorded in the journal. It is based on the concept of double entry where one account is debited and one account is credited. It is also possible that multiple accounts are debited or credited as per the nature of the transaction.

We will take an example for better understanding.

Let us journalize the following transactions.

1. Gaurav invested Rs. 50,000 in business.
2. He deposited Rs. 10,000 in the bank.
3. Furniture was purchased for Rs. 20,000.
4. Loan taken from Sahil was Rs. 15,000.
5. Salaries paid for the month total Rs. 25,000, and Rs. 5,000 is still outstanding.

Sl no.	Transaction analysis	Type and nature of accounts involved	Rule	Journal entry
1.	Cash of Rs. 50,000 is invested in the business by the owner, that is, cash comes in from the owner.	Cash—Real Capital - Personal	Debit what comes in Credit the giver	Cash - Debit Capital - Credit Cash A/c Dr. 50,000 Capital A/c Cr. 50,000
2.	Rs. 10,000 is deposited by him in the bank, that is, the bank receives cash and cash goes out.	Bank - Personal Cash - Real	Debit the receiver Credit what goes out	Bank - Debit Cash - Credit Bank A/c Dr. 10,000 Cash A/c Cr. 10,000

(Continued)

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Sl no.	Transaction analysis	Type and nature of accounts involved	Rule	Journal entry
3.	Furniture for Rs. 20,000 is purchased, that is, furniture comes in and cash goes out.	Furniture - Real Cash - Real	Debit what comes in Credit what goes out	Furniture - Debit Cash - Credit Furniture A/c Dr. 20,000 Cash A/c Cr. 20,000
4.	Company takes loan from Sahil of Rs. 15,000, that is, cash comes in and Y pays it, thus creating a liability for the company.	Cash - Real Y's Loan -Personal	Debit what comes in Credit the giver	Cash - Debit Y's Loan - Credit Cash A/c Dr. 15,000 Y's Loan A/c Cr. 15,000
5.	Salary of Rs. 25,000 has been paid for the month but Rs. 5,000 is still payable. Here, salary for the month is an expense. Cash goes out. Outstanding salary becomes liability for the company.	Salary - Nominal Cash - Real Salary Outstanding - Personal	Debit all expenses Credit what goes out Credit the giver	Salary - Debit Cash - Credit Salary O/s - Credit Salary A/c Dr. 30,000 Cash A/c Cr. 25,000 Salary O/s Cr. 5,000

Note:

- The total debit should always be equal to the total credit.
- The transactions should always be journalized from the company's point of view.
- A note supporting each entry, which should be a precise explanation of the transaction, for its proper understanding, should be given. This is called narration.

We will discuss one more example for a better understanding.

Example

Journalize the following transactions for Beta Ltd.

1. Wages of Rs. 8,000 paid for installation of machinery.
2. Goods purchased for Rs. 2,000 from Ravi. Ten percent trade discount and Rs. 50 cash discount allowed.
3. Rent of Rs. 20,000 paid of which Rs. 5,000 is advance.
4. Sales of Rs. 25,000 to Ram made on credit.
5. Drew Rs. 5,000 from the bank.
6. Received Rs. 24,500 from Ram. Balance allowed as discount.

Answer

Step I

1. First, understand the transaction given, as in the above question.
2. Company has paid wages of Rs. 8,000 for installation of machinery.
3. Purchases are made by the company of Rs. 2,000 in value, on which 10 percent trade discount is given. Further, Rs. 50 additional cash discount is also given.
4. Rent of Rs. 20,000 is paid in cash, out of which Rs. 5,000 is prepaid, that is, it does relate to the current period.
5. Credit sales of Rs. 25,000 are made to Ram, a customer.
6. Cash of Rs. 5,000 has been withdrawn from the bank.
7. Rs. 24,500 has been received from Ram against Rs. 25,000 due from him. That means Rs. 500 has been allowed as discount.

Step II

Once a basic understanding of the transaction is gained, identify the accounts that are affected by the transaction, such as the following.

Sl no.	Accounts affected
1.	Machinery A/c and Cash A/c
2.	Purchases A/c, Cash A/c, and Discount received A/c

(*Continued*)

(Continued)

Sl no.	Accounts affected
3.	Rent A/c, Cash A/c, and Prepaid rent A/c
4.	Sales A/c and Ram's A/c
5.	Cash A/c and Bank A/c
6.	Cash A/c, Ram's A/c, and Discount allowed A/c

Step III

Now, identify which account has to be debited and which one has to be credited. For this, it is essential to know:

- Who is the "receiver" and who is the "giver"?
- What "comes in" and what "goes out" in the said transaction?
- What is "income" for the company and what is an "expense" for it?

So, let us do this!

Sl no.	Increase in asset or decrease in liability or receiver or expense	*Analysis*	Decrease in assets, increase in liability, giver, income	*Analysis*
	Debit		Credit	
1.	Machinery A/c Rs. 8,000	*Value of machinery* ↑	Cash A/c Rs. 8,000	*Cash goes down* ↓
2.	Purchase A/c Rs. 1,800	*Goods come in* ←	Cash A/c Rs. 1,750	*Cash goes out* →
			Discount Received A/c Rs. 50	*Credit all incomes*
3.	Rent A/c Rs. 20,000	*Debit all expenses*	Cash A/c Rs. 15,000	*Cash goes out* →
			Prepaid Rent A/c Rs. 5,000	*Credit the giver since it is a personal A/c*
4.	Ram's A/c Rs. 25,000	*Debit the receiver*	Sales A/c Rs. 25,000	*Goods go out* →

Sl no.	Increase in asset/ decrease in liability/ receiver/expense	*Analysis*	Decrease in assets/increase in liability/giver/ income	*Analysis*
	Debit		Credit	
5.	Cash A/c Rs. 5,000	*Cash comes in* ←	Bank A/c Rs. 5,000	*Bank balance goes down* ↓
6.	Cash A/c Rs. 24,500	*Cash comes in* ←	Ram's A/c Rs. 25,000	*Credit the giver*
	Discount allowed A/c Rs. 500	*Debit all expenses*		

Step IV

That is it!

Now we have to only present it appropriately:

Journal of Beta Ltd

Sl no.	Particulars		Debit	Credit
1.	Machinery A/c	Dr.	8,000	
	To Cash A/c			8,000
	(Cash paid for installation of machine)			
2.	Purchase A/c	Dr.	1,800	
	To Cash			1,750
	To Discount Received			50
	(Cash purchases made and discount received Rs. 50)			
3.	Rent A/c	Dr.	20,000	
	To Cash A/c			15,000
	To Prepaid Rent A/c			5,000
	(Rent paid Rs. 15,000 for current year and Rs. 5,000 in advance)			
4.	Ram	Dr.	25,000	
	To Sales A/c			25,000
	(Credit sales made to Ram)			

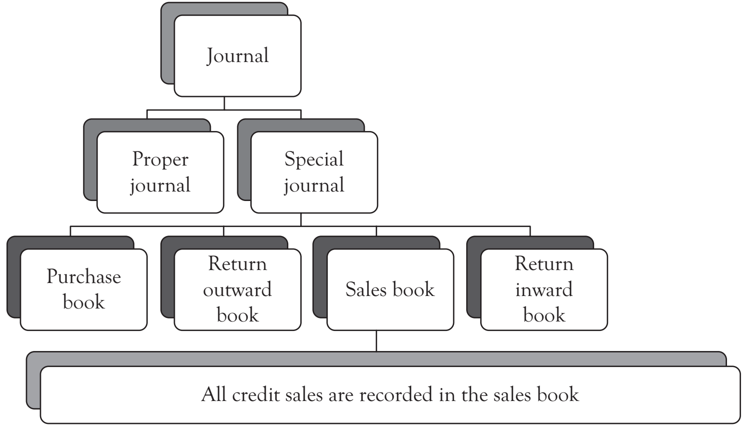
(*Continued*)

(Continued)

Sl no.	Particulars		Debit	Credit
5.	Cash A/c	Dr.	5,000	
	To Bank A/c			5,000
	(Cash withdrawn from bank)			
6.	Cash A/c	Dr.	24,500	
	Discount Allowed	Dr.	500	
	To Ram			25,000
	(Cash received from Ram in full settlement)			

Moving on, there are two types of journals:

1. Special journal
   - Sales journal—to record all credit sales
   - Sales return journal—to record all sales returns that were sold on credit
   - Purchase journal—to record all credit purchases
   - Purchase return journal—to record all purchase returns originally purchased on credit
2. General journal—all transactions other than the above are recorded here.



We have just finished learning the basics of financial accounting. We now move on to the next step: the ledger.

CHAPTER 4

Ledgers

After recording the transactions in the journal, the entries are then posted to the principal books of accounts, which are called ledgers. Since each account is affected multiple times in multiple ways, by different transactions, it becomes necessary to ascertain the net account-wise balance at the end of the period. This is determined by ledgers.

Some points to note are as follows.

- The process of transferring debit and credit items from the journal to the ledger is called posting.
- The account debited in the journal will be debited in the ledger and the one credited will also be credited in the ledger.
- To debit an account, we will use "To" and the name of the account credited. For example, if rent is paid in cash then rent A/c will be debited using "To Cash."
- Similarly, to credit an account we will use "By" and the name of the account debited. Like in the above case, cash A/c will be credited using "By Rent."

At the end of the period, the ledgers of all the accounts are "balanced," that is, the ultimate balance is ascertained.

It should be noted that nominal accounts are not balanced. Their balance is transferred to the Profit and Loss A/c. However, for real and personal accounts:

- If Debit > Credit, this means debit balance and should be written as "By balance c/f" on the credit side with the excess amount.

- If Debit < Credit, this means credit balance and should be written as "To balance c/f" on the debit side with the difference amount.

A ledger is a T-shaped A/c with debit on the left-hand side column and credit on the right-hand side.

Example

If we take the previous example of the journal, let us see how we can prepare the ledger from it.

Machinery A/c					
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
05-06-2014	To Cash	8,000	30-06-2014	By balance c/f	8,000
		8,000			**8,000**
01-04-2015	To balance b/d	8,000			

Cash A/c					
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
16-06-2014	To Bank	5,000	05-06-2014	By Machinery	8,000
23-06-2014	To Ram	24,500	12-06-2014	By Purchases	1,750
			30-06-2014	By Rent	15,000
			30-06-2014	By balance c/f	4,750
		29,500			**29,500**
01-07-2014	To balance c/d	4,750			

Purchase A/c					
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
12-06-2014	To Cash	1,750	30-06-2014	By P/L A/c	1,800
12-06-2014	To Discount	50			
	allowed				
		1,800			**1,800**

Rent A/c					
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
30-06-2014	To Cash	15,000	30-06-2014	By P/L A/c	20,000
12-06-2014	To Prepaid				
	Rent	5,000			
		20,000			**20,000**

Ram A/c					
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
20-06-2014	To Sales	25,000	23-06-2014	By Cash	24,500
			23-06-2014	By Discount	
				allowed	500
		25,000			**25,000**

Similarly, all ledgers of all the accounts can be made and the net balance can be ascertained.

The Cheat Sheet!

There are certain transactions that are routine and occur most commonly. They are accounted for in the same manner every time they occur. So you just have to keep this sheet close to you or memorize it at best!

Transaction	Account I	Account II
Invoicing a client	Asset: Accounts receivable	Income
Depositing a client's cheque	Asset: Cheque account	Asset: Accounts receivable
Receiving a bill	Expense: Appropriate category	Liability: Accounts payable
Paying a bill	Liability: Accounts payable	Asset: Cheque account
Buying supplies by cheque	Expense: Appropriate category	Asset: Cheque account
Buying an asset by cheque	Asset: Equipment	Asset: Cheque account
Buying supplies by credit card	Expense: Appropriate category	Liability: Credit card
Paying a credit card in full by cheque	Liability: Credit card	Asset: Cheque account

Note:

Balance of:

- Personal Accounts ⟶ carried forward to the next period
- Nominal Accounts ⟶ transferred to Profit and Loss A/c
- Real Accounts ⟶ carried forward to the next period

If no balance is left in a ledger, that is, both asset and liability sides are equal, as in Ram's A/c in the above case, this means that there is nothing due from or to the party. The account is settled.

CHAPTER 5

Trial Balance

This is the third stage in the accounting process after ledgers. Here, the balances of all the ledgers that are carried forward either to the Profit and Loss A/c or to the next period are shown. It has a debit side and a credit side. The respective balances are shown at the appropriate side.

The total amounts on the debit and the credit side should be equal. This certifies the arithmetical accuracy.

In fact, the main objective behind the preparation of trial balance is to ascertain that the accounts are free from arithmetical errors. This builds confidence. It is generally prepared at the end of the period.

The following Performa can be referred to:

Trial Balance As on ______

Sl. no.	Ledger accounts	Debit amount	Credit amount
	Total		

CHAPTER 6

Final Accounts

Congrats! We have reached the most interesting part of financial accounting, that is, Final Accounts.

These are in the true sense the financial statements of the company. It is compulsory for the Board of Directors of the company to present in its Annual General Meeting (AGM) the financial statements before the company. It reflects the financial position of the company at the end of the period.

The overall financial performance of the company, which is of main interest to the managers and corporates, is ascertained through Final Accounts.

Financial Statements include:

- Balance Sheet
- Profit and Loss A/c
- Cash Flow Statement
- Statement of changes in equity, if applicable
- Any explanatory note forming part of or annexed to the above statements

Financial Statements: A set of accounting documents prepared for a business entity that cover a particular time period and describe the financial health of the business.

Financial statements	Business activities
Income statement	Operating activities
Revenues	
Expenses	
Statement of cash flows	
Operating activities	Operating activities
Investing activities	Investing activities
Financing activities	Financing activities
Balance sheet	
Current assets	Operating activities
Long-term assets	Investing activities
Current liabilities	Operating activities
Long-term liabilities	Financing activities
Equity	Financing activities

It has to be prepared according to the format given in Schedule III of Companies Act 2013. Various accounting standards have to be followed in its preparation.

We will be dealing with the first three very important statements now.

The Cash Flow Statement

A Cash Flow Statement is a statement that describes the movement by way of net increase or decrease in cash and cash equivalents of an organization in a particular period. Cash equivalents are those short-term investments and securities that can be readily converted into cash, say, within a period of three months or less.

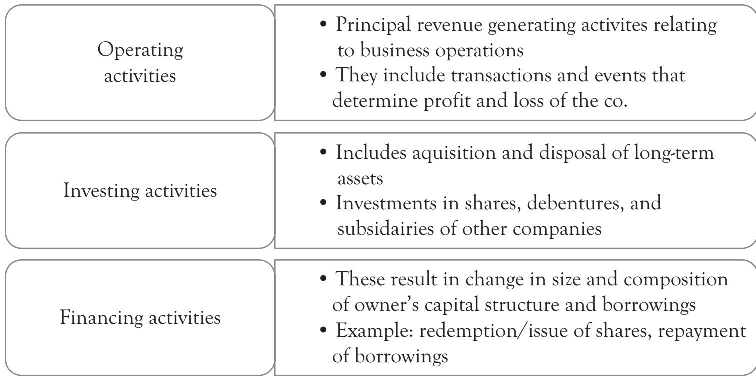
The first step comprises ascertaining the cash flow activities, that is, whether the activities caused "inflow" or "outflow" of cash.

The next step is to segregate such activities into three categories:

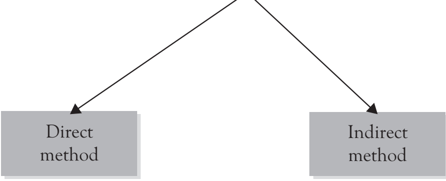
1. Operating activities
2. Investing activities
3. Financing activities

The total cash flow from, or used in, the above activities has to be calculated separately.

Let us look into each activity one by one.



There are two types of methods to ascertain cash flow of the company during the year.



Indirect Method

This method is preferably used and hence we will focus on gaining an understanding about it.

In this method, only the manner of calculating the cash flow from operating activities changes. Everything else remains the same as in the case of the direct method.

In this method, we just have to:

1. Determine the adjusted profit by adding or subtracting the noncash and nonoperating items to and from the net profit charged in the income statement
2. Make adjustments for net increase or decrease in current assets and current liabilities
3. Subtract direct taxes paid during the period
4. Adjust extraordinary items that normally do not occur in the business to ascertain true profit

That is it! We arrive at net cash flow from operating activities through the indirect method.

Cash flow from operating activities	
Cash inflow • Sale of goods and services	**Cash outflow** • Payments to suppliers • Payments to employees • Payments for taxes • Payments for other expenses

Cash flow from investing activities	
Cash inflow • Sale of plant, property, and equipment • Sale of debt or equity • Collection of principal on loans • Dividends from other securities	**Cash outflow** • Purchase of plant, property, and equipment • Purchase of debt or equity • Lending to others

Cash flow from financing activities	
Cash inflow • Sale of securities • Issue of debt instruments • Collection of principal on loans • Dividends from other securities	**Cash outflow** • Payment of dividend • Issue of long-term debt • Redemption of capital stock • Payment to lenders

Pro formas for preparation of cash flow will help in better understanding this.

Format for Cash Flow From Operating Activities—Indirect Method

Particulars	*Analysis (only for understanding)*	Amount (Rs.)
Net profit before tax and extraordinary items	*From income statement*	xxx
Adjustments for		
Depreciation	*Noncash item*	xxx
Foreign exchange investments	*Nonoperating item*	xxx
Investments	*Nonoperating item*	xxx
Gain or loss on sale of fixed assets	*Nonoperating item*	xxx
Interest dividend	*Nonoperating item*	xxx

(*Continued*)

(Continued)

Particulars	*Analysis (only for understanding)*	Amount (Rs.)
Operating profit before working capital changes		xxx
Adjustments for current assets or liabilities Trade and other receivables Inventories Trade payable	*Since decrease in working capital = cash inflow and increase in working capital = cash outflow*	 xxx xxx xxx
Cash generated from operations		xxx
(Add) Interest paid (Less) Direct taxes	*Nonoperating item* *Have to be deducted to arrive at operating profit*	xxx xxx
Cash before extraordinary items		xxx
Adjustments for extraordinary items	*Nonoperating item*	xxx
Net cash flow from operating activities		xxx

Cash Flow from Investing Activities

Particulars	*Analysis (only for understanding)*	Amount (Rs.)
(Less) Purchase of fixed assets (Add) Proceeds from sale of fixed assets (Add) Interest received (Add) Dividend received	 *Since it involves cash flows on acquisition or disposal of long-term investments* *Income from investments will go into investing activities*	xxx xxx xxx xxx
Net cash flow from investing activities		xxx

Cash Flows From Financing Activities

Particulars	*Analysis (only for understanding)*	Amount (Rs.)
(Add) Proceeds from issue of share capital (Add) Proceeds from long-term borrowings (Less) Repayment of long-term borrowings (Less) Interest paid (Less) Dividend paid	 *Since it results in change in size and composition of capital structure* *Payments made to sources of funds go into financing activities*	xxx xxx xxx xxx xxx
Net cash flows from financing activities		xxx

Consolidated Summary

Particulars	Amount (Rs.)
Cash flow from operating activities	xxx
(Add) Cash flow from investing activities	xxx
(Add) Cash flow from financing activities	xxx
Net increase or decrease in cash	**xxx**
(Add) Opening balance of cash and cash equivalents	xxx
Closing balance of cash and cash equivalents*	**xxx**

*Closing balance of cash at the end should match the closing balance as given in the Balance Sheet.

We will now consider a question for better understanding.

Question

The following data for Ryan Ltd are provided.

Income statement		**(Amount in Rs.)**
Sales		6,98,000
Cost of goods sold		(5,20,000)
Gross margin		1,78,000
Operating expenses (including depreciation expense of Rs. 37,000)		(1,47,000)
		31,000
Other income or expenses		
Interest expense paid	(23,000)	
Interest income received	6,000	
Gain on sale of investments	12,000	
Loss on sale of plant	(3,000)	(8,000)
		23,000
		(7,000)
Income tax		16,000

Comparative balance sheets

	March 31, 2015	March 31, 2014
Assets		
Plant assets	7,15,000	5,05,000
Less: Accumulated depreciation	(1,03,000)	(68,000)
	6,12,000	4,37,000
Investments (long term)	1,15,000	1,27,000
Current assets:		
Inventory	1,44,000	1,10,000
Accounts receivable	47,000	55,000
Cash	46,000	15,000
Prepaid expenses	1,000	5,000
	9,65,000	7,49,000
Liabilities		
Share capital	4,65,000	3,15,000
Reserves and surplus	1,40,000	1,32,000
Bonds	2,95,000	2,45,000
Current liabilities		
Accounts payable	50,000	43,000
Accrued liabilities	12,000	9,000
Income tax payable	3,000	5,000
	9,65,000	7,49,000

Analysis of selected accounts and transactions from 2014 to 2015

1. Purchased investments of Rs. 78,000
2. Sold investments for Rs. 1,02,000
3. Purchased plant assets for Rs. 1,20,000
4. Sold plant assets that cost Rs. 10,000 with accumulated depreciation of Rs. 2,000 for Rs. 5,000
5. Issued Rs. 1,00,000 of bonds at face value in exchange for plant assets on March 31, 2015
6. Repaid Rs. 50,000 bonds at face value at maturity
7. Issued Rs. 15,000 shares of Rs. 10 each
8. Paid cash dividend Rs. 8,000

Prepare Cash Flow Statement.

Answer

Step I

Relax! It is easy!

Step II

As discussed above, we will start with the net profit as per the Income Statement and adjust it for all noncash and nonoperating items.

Then, we will take each element of the Balance Sheet separately along with its given concerned additional information, in order to ascertain what effect it each has on the cash flows of the company—that is, whether it causes inflow or outflow of cash—while simultaneously segregating such elements into operating, investing, or financing activities.

Step III

So! Let us start with the Income Statement.

- The income statement shows net profit before tax as Rs. 23,000.

Adjustments for the following shall be made:

- Depreciation on plant assets is just the normal wear and tear that occurs with time and hence does not involve any cash outflow. So, we will add back Rs. 37,000 to the profits since it has been charged in the income statement to arrive at the profit.
- Gain on Sale of Investments can be said to be the profit earned from the sale of particular investments by the company. Since it is just a profit, it does not involve any cash flow directly. Moreover, since it is a nonoperating activity, Rs. 12,000 will be subtracted from the net profit.

- Loss on Sale of Plant, as mentioned above, is only a loss arising from the sale of its plant by the company, which again does not involve any cash flow directly. Hence, Rs. 3,000 will be added back since it has been subtracted to arrive at the profit in our cash flow statement.
- Interest Expense paid is the interest that is paid by the company to its various sources of finance, in the form of dividends, interest on loans, debentures, bonds, and so on. As it involves cash outflow, Rs. 23,000 will be classified as cash used in financing activities since it is the cost the company has to pay as a result of its financing activities.

  Hence, it will be added back to the profit to arrive at cash flow from operating activities since it is not an operating expense.
- Interest Income received is the interest received by the company on the investments done by it in the form of dividends, interest on loans given, and so on. Rs. 6,000 received would have involved cash inflow and hence we will include it as cash flow from investing activities.

  So, it will be subtracted from the profits to exclude it from operating activities.
- Income Tax in the income statement denotes total tax expense for the year, that is Rs. 7,000, which may or may not have been paid or partially paid and partially a new provision for next year would have been made. In this case, a provision of Rs. 3,000 has been made for the next year (as per Balance Sheet as on March 31, 2015).

  Additionally, tax payable of the previous year of Rs. 5,000 (as per Balance Sheet as on March 31, 2014) is paid in the current year. Hence we will only take into account income tax that is paid during the current year that sums up to Rs. 9,000 out of which Rs. 5,000 is rom the previous year and Rs. 4,000 is the current year's expense. We will include this under cash used in operating activities as it forms a part of the operational part of the business.

Step IV

Now, we move on to the Balance Sheet. Here, we will have to draw a comparison between the two given Balance Sheets to identify any increase or decrease in assets and liabilities that would involve movement of cash.

- **Plant Assets** are specifically given to have been purchased for Rs. 1,20,000, which would have involved outflow of cash. Hence we would take it as cash used in investing activities since it is a part of investing activities carried out by the company.

  Moreover, Plant was also sold for Rs. 5,000, as given in the additional information, which would have involved inflow of cash. Hence this would also be included as cash flow from investing activities.
- **Investments (Long Term)**, as given in the additional information, have been purchased for Rs. 78,000; this would have involved outflow of cash. So, accordingly, we will take it under cash used in investing activities.

  Similarly, Investments of Rs. 1,02,000 were also sold during the year as per the information given in the analysis of selected accounts. This would have caused cash inflow and so we will include it under cash flow from investing activities.

We now move on to Current Assets.

- Inventory has increased from Rs. 1,10,000 at the beginning of the year, that is as per Balance Sheet on March 31, 2014, to Rs. 1,44,000 by the end of the year, that is as per Balance Sheet on March 31, 2015. This means that we have increased our stock by Rs. 34,000, thereby blocking more funds. Thus, it would have caused outflow of cash indirectly, as the funds are blocked and cash inflow will not be possible until we sell our stock. It will be included as cash used in operating activities and deducted from the profit as it forms part of the working capital that is directly related to business operations.

- Accounts Receivable has decreased from Rs. 55,000 from the beginning of the year to Rs. 47,000 at the end of the year. This implies that we have received payment of Rs. 8,000 during the year, because of which our total accounts receivable has decreased. This process would have involved inflow of cash and hence we would include it under cash flow from operating activities and add it to the profit.
- Cash balance has increased from Rs. 15,000 at the beginning of the year to Rs. 46,000 at the end of the year due to cash flows from various activities as being discussed. Hence, the cash balance at the beginning of the year, adjusted with the net increase or decrease in cash during the year, should be equal to the cash balance at the end of the year. This would imply that we have worked out the question correctly.
- Prepaid Expenses have decreased from Rs. 5,000 at the beginning of the year to Rs. 1,000 at the end of the year. This means we have not paid for the current year expenses and the same has been adjusted from what we had paid in advance the previous year. Hence by not paying the current year expenses, we have saved our cash, which is equivalent to cash inflow. Rs. 4,000 will be thus included in cash flow from operating activities and would be added to the profit.

Next come the Liabilities.

- Share Capital has increased from Rs. 3,15,000 at the beginning of the year to Rs. 4,65,000 at the end of the year, that is, by Rs. 1,50,000. This implies that the company has issued 15,000 new shares of Rs. 10 each, as also given in the additional information. We would have received cash against such issue; hence, we will include it under cash flow from financing activities since the issue of shares is a source of finance for the company.
- Reserves and Surplus can also be known as retained earnings. These are appropriation of profits that, is, the company reinvests a certain amount of profit earned during the year with itself. It does not involve any movement of cash. Hence we will not consider it for our cash flow statement.

- Bonds have increased from Rs. 2,45,000 to Rs. 2,95,000, that is, by Rs. 50,000. It has also been provided that the company has issued bonds to the extent of Rs. 1,00,000 in exchange for Plant Assets. This implies that there must have been no cash inflow from the issue of such bonds. Further, it is also provided that bonds of value of Rs. 50,000 were repaid, which means there would have been a cash outflow of Rs. 50,000. Thus, the net increase in bonds involved no cash inflow. Only the repayment done will be taken under cash used in financing activities.

Next we move on to Current Liabilities.

- Accounts Payable have increased from Rs. 43,000 to 50,000. This implies that we have not made payments that were supposed to be made to the tune of Rs. 7,000, that is, we have saved our cash outflow, which can also be regarded indirectly as cash inflow. Hence we will record it under cash flow from operating activities and add the same to the profit.
- Accrued Liabilities have increased from Rs. 9,000 at the beginning of the year to Rs. 12,000 at the end. This means that we have not paid certain liabilities that were due, thereby saving on our cash outflow. Indirectly, we can say that there has been a cash inflow from operating activities since we have saved cash and cash saved is cash earned!
- Income Tax treatment has already been discussed above.

Step V

Check whether any item has been left unaccounted for, including in the additional information provided.

- Cash Dividend, of Rs. 8,000 like in this case, has been left to be included in our cash flow statement. Payment of cash dividend would have involved cash outflow; hence, it will be included in cash used in financing activities since the issue of shares is a means of finance for a Co and dividend is paid on the share capital.

Step VI

We are done!

Now we just need to present what we have discussed above in the following manner:

Ryan Ltd.
Cash Flow Statement
For the year ending March 31, 2015

Particulars	Amount (Rs.)	Amount (Rs.)
Cash flow from operating activities		
Net profit before taxation	23,000	
Adjustments for:		
(Add) Depreciation	37,000	
(Less) Gain on sale of investments	(12,000)	
(Add) Loss on sale of plant asset	3,000	
(Add) Interest expense	23,000	
(Less) Interest income	(6,000)	
Income tax paid	(9,000)	
Operating profit before working capital changes	**59,000**	
Increase in inventory	(34,000)	
Decrease in accounts receivable	8,000	
Decrease in prepaid expenses	4,000	
Increase in accounts payable	7,000	
Increase in accrued liabilities	3,000	
Cash flow from operating activities (a)		**47,000**
Investing activities		
Interest received	6,000	
Plant purchased	(1,20,000)	
Plant sold	5,000	
Investment purchased	(78,000)	
Investment sold	1,02,000	
Cash used in investing activities (b)		**(85,000)**
Financing activities		
Interest paid	(23,000)	
Share capital issued	1,50,000	

(Continued)

(Continued)

Particulars	Amount (Rs.)	Amount (Rs.)
Repayment of bonds	(50,000)	
Dividends paid	(8,000)	
Cash flow from financing activities(c)		**69,000**
Net cash flow during the year (a) + (b) + (c)		**31,000**
Cash balance at the beginning of the period (Balance as on March 31, 2014)		15,000
Cash balance at the end of the period (Balance as on March 31, 2015)		**46,000**

Let us take another example.

Question

The following information about Gamma Ltd. is given for the year 2014.

Particulars	Amount (Rs.)
Net profit	25,000
Dividend	8,535
Provision for income tax	5,000
Income tax paid during the year	4,248
Loss on sale of assets	40
Book value of assets sold	185
Depreciation charged to Profit and Loss A/c	20,000
Profit on sale of investments	100
Carrying amount of investments sold	27,765
Interest income on investment	2,506
Interest expenses of the year	10,000
Interest paid during the year	10,520
Increase in working capital (excluding cash and bank balance)	56,081
Purchase of fixed assets	14,560
Investment in joint venture	3,850
Expenditure on construction work in progress	34,740
Proceeds from calls in arrears	2
Receipt of grant for capital project	12

(Continued)

(Continued)

Particulars	Amount (Rs.)
Proceeds from long-term borrowings	25,980
Proceeds from short-term borrowings	20,575
Opening cash and bank balance	5,003
Closing cash and bank balance	6,988

Prepare Cash Flow Statement for the year 2014.

Answer

Let us crack it!

Step I

Start with the analysis of the question by taking each item one by one and identifying under which activity it will be placed.

So, let us start!

As discussed earlier, we will first start with profit before tax as per Income Statement and adjust it for nonoperating and noncash items. Hence to arrive at profit before tax, we will have to add back provision for income tax of Rs. 5,000 to the net profit as it would have been made from profit only.

Step II

Analyze each item to decide its treatment.

- Dividend ⟶ Financing activity
- Provision of income tax ⟶ Noncash item ⟶ Add back to profit
- Income tax paid ⟶ Deduct from operating profit as cash outflow
- Loss on sale of assets ⟶ Nonoperating ⟶ Add back to net profit
- Book value of assets sold ⟶ No treatment ⟶ Sale price (book value – loss) will be included in investing activities
- Depreciation ⟶ Noncash item ⟶ Add back to profit

- Profit on sale of investment ⟶ Nonoperating ⟶ Deduct from profit
- Carrying amount of investment sold ⟶ No treatment ⟶ Sale price (carrying amount + profit) will be included in investing activities
- Interest income on investment ⟶ Non-operating ⟶ Add back to profit ⟶ Investing activity
- Interest expense of the year ⟶ Nonoperating ⟶ Add back as it would have been charged to profit ⟶ Will not be included in financing activity since not paid
- Interest paid during the year ⟶ Financing activities
- Increase in working capital ⟶ Operating activities
- Purchase of fixed asset ⟶ Investing activity
- Investment in joint venture ⟶ Investing activity
- Expenditure on construction ⟶ Investing activity
- Proceeds from calls in arrears ⟶ Financing activities as it relates to financing through shares
- Receipt of grant for capital project ⟶ Financing activities
- Proceeds from long-term borrowing ⟶ Financing activities
- Proceeds from short-term borrowing ⟶ Financing activities

We will now present it according to the format.

Cash Flow Statement of Gamma Ltd.
For the year ended December 31, 2014

Particulars	Amount (Rs.)	Amount (Rs.)
Cash flows from operating activities		
Net profit before tax (25,000 + 5,000)	30,000	
Adjustments for:		
Depreciation	20,000	
Loss on sale of asset	40	
(Less) Profit on sale of investment	(100)	
(Less) Interest income on investment	(2,506)	
Interest expense	10,000	
Operating profit before working capital changes	**57,434**	

(*Continued*)

(Continued)

Particulars	Amount (Rs.)	Amount (Rs.)
Changes in working capital	(56,081)	
Cash generated from operations	1,353	
Income tax paid	(4,248)	
Net cash used in operating activities		**(2,895)**
Cash flows from investing activities		
Sale of assets (185 − 40)	145	
Sale of investments (27,765 + 100)	27,865	
Interest income on investment	2,506	
Purchase of fixed asset	(14,560)	
Investment in joint venture	(3,850)	
Expenditure on construction	(34,740)	
Net cash used in investing activity		**(22,634)**
Cash flows from financing activities		
Proceeds from calls in arrears	2	
Receipt of grant for capital project	12	
Proceeds from long-term borrowings	25,980	
Proceeds from short-term borrowings	20,575	
Interest paid	(10,520)	
Dividend	(8,535)	
Net cash used in financing activity		**27,514**
Net increase in cash and cash equivalent		**1,985**
Opening balance of cash and cash equivalent		5,003
Closing balance of cash and cash equivalent		**6,988**

That is it! We are done with Cash Flow!

Now we will move on to the next and the final level, that is, preparation of Profit and Loss A/c and Balance Sheet.

Direct Method

We shall now learn the direct method of presenting the Cash Flow Statement. In this method, only "Cash Flow from Operating Activities" is calculated differently as compared to the indirect method. Calculation of cash flow from investing and financing activities remains the same.

We directly take all the operating activities that involve cash flow instead of adjusting the net profit as in the indirect method.

Let us take an example to make it clearer.

Example

Prepare a Cash Flow Statement of X Ltd. from the following Summary Cash Account for the year ended March 31, 2013.

Summary Cash Account for the year ended 31.3.2013

	₹ '000		₹ '000
Balance on 1.4.2012	50	Payment to suppliers	2,000
Issue of equity shares	300	Purchase of fixed assets	200
Receipts from customers	2,800	Overhead expense	200
Sale of fixed assets	100	Wages and salaries	100
		Taxation	250
		Dividend	50
		Repayment of bank loan	300
		Balance on 31.3.2013	150
	3,250		3,250

Answer

Step I

We will first calculate cash flow from operating activities. For this, we will have to segregate all the operating activities that involve cash flow.

In the question, cash flow from operating activities will be calculated in the following manner through the direct method.

Cash Flow Statement of X Ltd.
For the year ended March 31, 2013

Cash flow from operating activities		**Amount**
Receipts from customers	*All the activities that pertain to the normal day-to-day business transactions.*	2,800
Less: Payment to suppliers		(2,000)
Less: Overhead expense		(200)
Less: Wages and salaries		(100)
Less: Income tax paid		(250)
Cash flow from operating activities (a)		250

Step II

We now move on to cash flow from investing and financing activities, which would be calculated in the same manner as in the *indirect method*.

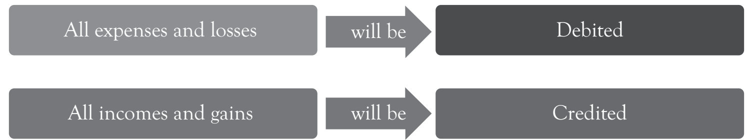
Cash flow from investing activities		**Amount**
Proceeds from sale of fixed assets Less: Payment for purchase of fixed assets	☞ *All investing activities undertaken by the company*	100 (200)
Net cash used in investing activities (b)		**(100)**
Cash flow from investing activities		
Proceeds from issue of shares Repayment of bank loan Payment of dividend	☞ *All payments to providers of finance and receipts from Co's financing activities*	300 (300) (50)
Net cash used in financing activities (c)		**(50)**
Net increase in cash (a) + (b) + (c) **Cash at the beginning of the period**	☞ *As per the cash account*	**100** 50
Cash at the end of the period	☞ *Should match with the closing balance as per the cash account*	**150**

Profit and Loss A/c

This is the Income Statement of a company. It shows the net profit earned or the loss incurred by the company through its business operations for the period. It can be said to be the "report card" of the business, which shows the net profit earned or loss incurred by the company as a result of its working.

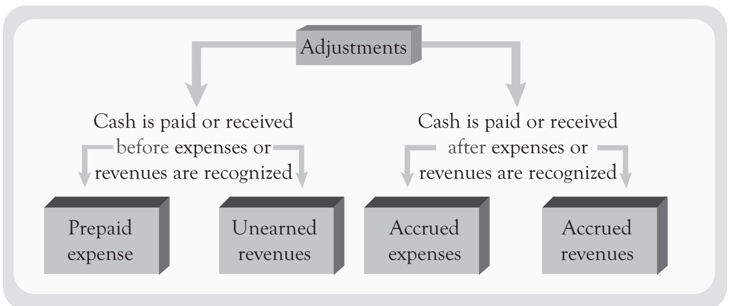
It is of the utmost importance to especially managers and entrepreneurs who are interested to know the ultimate result of their operations and management, that is, whether they have been successful in earning profits or they ended up making losses. Also, it helps them in ascertaining the exact amount of money spent on different expenses. This helps them in controlling costs, and increasing efficiency and profitability of the business.

As discussed earlier, the balance of all the nominal accounts are transferred to the Profit and Loss Account. All the incomes, gains, expenses, and losses are recorded here, which can be summed up as follows:



Points to note:

- Only items of revenue nature, that is, those that pertain to day-to-day working of the company and are only for the said period, are recorded here.
- Transactions relating only to business operations are included here. Transactions relating to financing and investing activities of the company are not included.
- All the expenses and incomes that have become due during the period, whether paid or not, are included here. This is as per the accrual system of accounting.
  i. **Outstanding expense** will be *added to the expense* as it *relates to the current period.*
  ii. **Prepaid expense** will be *subtracted from the expense* as it does *not relate to the current period.*
  iii. **Accrued income** will be *added to the income* as it *relates to the current period.*
  iv. **Prepaid income** will be *subtracted from the income* as it *does not relate to the current period.*



The Profit and Loss A/c is prepared as per the format prescribed by the statute. Companies have to strictly follow it and present it in the manner prescribed.

Whatever may be the presentation requirements, the basic essence remains that it shows the ultimate "result" of the business done by the company.

Let us now have a look at the format for the preparation of the Profit and Loss statement of a company.

Format

Name of the Company……………………

Profit and Loss Statement for the Year Ended ………………………

Rupees in …………

Particulars	Note No.	Figures for the current reporting period	Figures for the previous reporting period
i. Revenue from operation		x x	x x
ii. Other Income		x	x
iii. Total Revenue (i + ii)		x x x	x x x
iv. Expenses			
Cost of Materials Consumed		x	x
Purchases of Stock-in-Trade		x	x
Changes in inventories of Finished Goods, Work-in-Progress and Stock-in-Trade		x	x
Employee Benefit Expenses		x	x
Finance Costs		x	x
Depreciation and Amortisation Expenses		x	x
Other Expenses		x	x
Total expenses		xxx	xxx
v. Profit before Tax (iii – iv)		xxx	xxx
vi. Less Tax		(x)	(x)
vii. Profit after Tax (v – vi)		xx	xx

No need to get confused!

We will understand this in a detailed manner.

Before that, there are some points to be noted from the above Performa:

- The detailed analysis of the amounts reported in the Profit and Loss Statement has to be given in the Notes to Accounts as per Column 3, where the corresponding note number has to be given. We will look into such notes in the succeeding chapters.
- The previous years' figures also have to be reported along with the current year's figures as per Column 4.

Let us now analyze each item of the Profit and Loss Statement in the format.

Items Under Various Heads Appearing in Profit and Loss Statement

Revenue from operations

- Net sales
- Sale of scrap
- Trading commission received
- Cash discount received
- Revenue from services

Other income

- Rent received
- Dividend and interest received
- Profit on sale of fixed assets or investments

Cost of material consumed

- Opening stock of materials + net purchases – closing stock of materials

Purchases of stock-in-trade

- Net purchases

Changes in inventories of finished goods, work-in-progress, and stock-in-trade

- Opening stock – closing stock

Employee benefit expenses

- Wages
- Salaries
- Staff welfare expenses such as canteen expenses
- Contribution to provident funds and other staff welfare funds

Depreciation and amortization expenses

Finance costs

Amount of interest paid by the company on its borrowings

Other expenses

Includes expenses other than the above six heads of expenses. These could be:

- Telephone expenses
- Rents and taxes
- Selling and distribution expenses
- Advertisement expenses
- Loss on sale of fixed assets or investments
- Cash discount allowed
- Bad debts
- Provision of bad and doubtful debts

Provision for tax and tax rate

Let us take a question for better understanding.

Question

Prepare Profit and Loss Statement from the following Trial Balance of Zed Chemicals Ltd. for the year ended March 31st, 2015.

Hari Chemicals Ltd.
Trial Balance as on March 31, 2015

Particulars	Rs. In '000	Particulars	Rs. In '000
Inventory	680	Equity shares	
Furniture	200	Capital (Shares of Rs. 10 each)	2,500
Discount	40	11% Debentures	500
Loan to directors	80	Bank loans	645
Advertisement	20	Trade payables	281
Bad debts	35	Sales	4,268
Commission	120	Rent received	46
Purchases	2,319	Transfer fees	10
Plant and machinery	860	Profit and loss A/c	139
Rentals	25	Depreciation provision:	
Current account	45	Machinery	146
Cash	8		
Interest on bank loans	116		
Preliminary expenses	10		
Fixtures	300		
Wages	900		
Consumables	84		
Freehold land	1,546		
Tools and equipment	245		
Goodwill	265		
Trade receivables	440		
Dealer aids	21		
Transit insurance	30		
Trade expenses	72		
Distribution freight	54		
Debenture interest	20		
	8,535		**8,535**

Additional Information: Closing Inventory on March 31st, 2015: Rs. 8,23,000

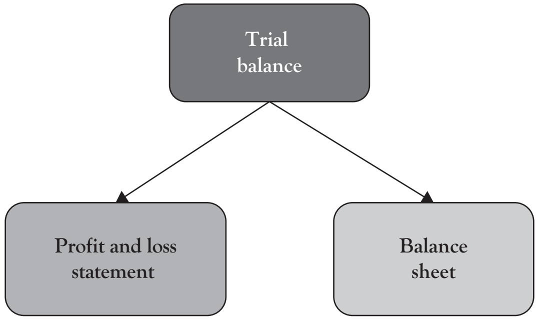
Answer

Each item in the Trial Balance will go either in the Profit and Loss Statement or Balance Sheet.

So, in order to prepare the Profit and Loss Statement, we have to follow the following steps:

Step I

First, identify all those incomes and expenses that will be a part of our Income Statement.



Let us make a list of them:

Expenses → Given on Debit side of Trial Balance

1. Changes in inventory
2. Discount
3. Advertisement
4. Bad debt
5. Commission
6. Purchases
7. Rentals
8. Interest on bank loan
9. Preliminary expenses
10. Wages
11. Consumables
12. Dealer aids
13. Transit insurance
14. Trade expenses
15. Distribution freight
16. Debenture interest

Incomes → Given on Credit side of Trial Balance

1. Sales
2. Rent received
3. Transfer fees

Step II

We will now start filling in the format the incomes and expenses at relevant places.

All the calculations and details *should not* be provided in the main Profit and Loss Statement but in the *Notes to Accounts*.

Let us see how it will be done.

Hari Chemicals Ltd.
Statement of Profit and Loss for the Year Ended March 31, 2015

Particulars	**Note No.**	**Figures as at the end of March 31, 2015**	
Revenue from operations		42,68,000	⟵ Sales
Other income	7	56,000	⟵ Rent + Transfer fees
Total revenue (A)		**43,24,000**	⟵ Includes all income as listed above
Expenses			
Cost of material consumed	8	23,19,000	⟵ Purchases
Change in inventory of finished goods	9	(1,43,000)	⟵ Opening inventory - Closing inventory
Employee benefit expenses	10	9,00,000	⟵ Wages considered to be direct that is directly used for production
Finance cost	11	1,36,000	⟵ Interest on bank loans + debenture interest
Other expenses	12	5,11,000	⟵ Remaining expenses from the list not included till now.
Total expenses (B)		**37,23,000**	
Profit before tax (A − B)		6,01,000	
Provision for tax		–	No information of tax is given
Profit for the period		**6,01,000**	

We have got the profit for the year! Was it not easy?

Now we just have to prepare the Notes to Accounts as mentioned earlier, which describes all the items on the face of the Profit and Loss Statement in detail.

Notes to Accounts

Particulars		Amount (Rs.)	Amount (Rs.)
7.	**Other Income**		46,000
	Rent received		10,000
	Transfer fees		56,000
8.	**Cost of materials consumed**		23,19,000
	Add: purchases		
9.	Changes in inventory of finished goods, WIP & Stock in trade		
	Opening inventory	6,80,000	
	Closing inventory	8,23,000	(1,43,000)
10.	**Employee benefit expense**		
	Wages		9,00,000
11.	**Finance cost**		1,16,000
	Interest on bank loans		20,000
	Debenture interest		1,36,000
12.	**Other Expenses**		
	Consumables		84,000
	Preliminary expenses		10,000
	Bad debts		35,000
	Discount		40,000
	Rentals		25,000
	Commission		1,20,000
	Advertisement		20,000
	Dealers' aids		21,000
	Transit insurance		30,000
	Trade expenses		72,000
	Distribution freight		54,000
			5,11,000

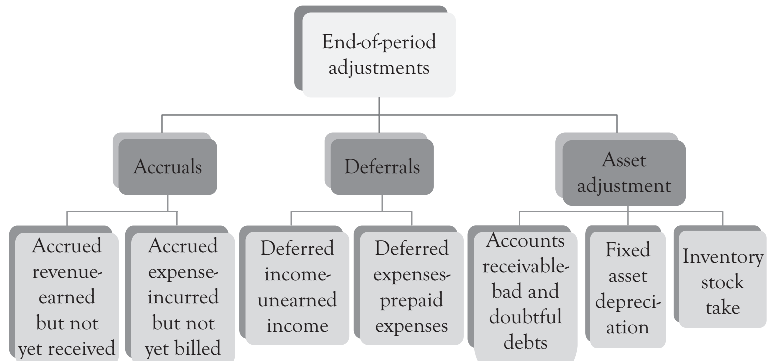
We can see that all the items we had included in Step I have been taken into consideration for the preparation of the Profit and Loss Statement.

Step III

Prepare the Balance Sheet from it!

Adjustments

There are certain adjusting entries that need to be made at the end of the year for appropriate presentation of accounts. They mostly are due to the difference between expense and expenditure and revenue and receipts.



Some cases are discussed here:

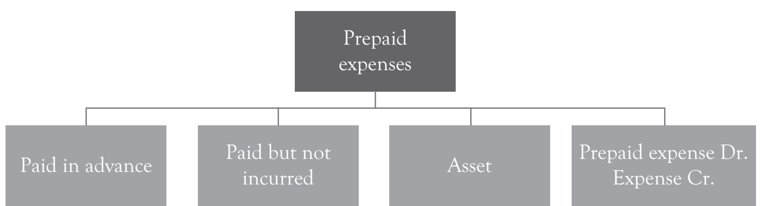
Case I

Prepaid expense, that is, recorded costs to be apportioned between two or more accounting periods.

For example, Rs. 5,000 is paid for insurance out of which Rs. 2,000 pertains to the following year.

Answer

Here, only Rs. 3,000 out of Rs. 5,000 shall be taken as expense of the current year. Hence, Rs. 2,000 will be deducted from Rs. 5,000 in the Profit and Loss account. The remaining Rs. 2,000 will be treated as a prepaid expense and taken to the Balance Sheet under current assets.



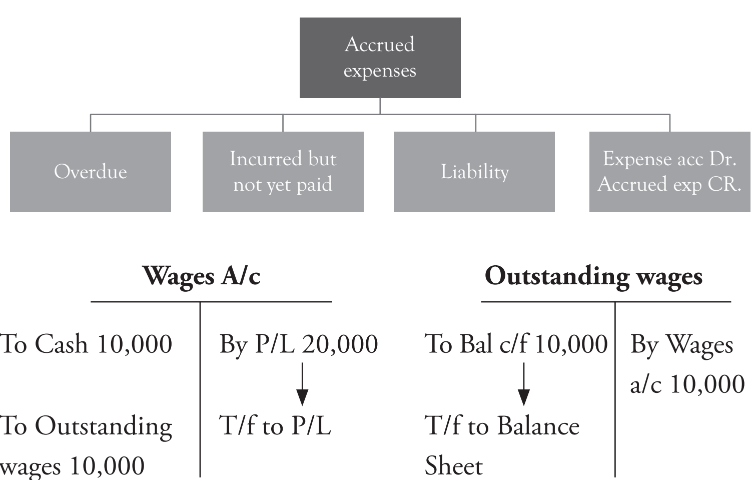
Case II

Outstanding expenses, that is, expenses incurred but not paid during the year.

For example, Rs. 20,000 wages have been earned by the employees but only Rs. 10,000 has been paid to them. The rest is still due.

Answer

In this case, the whole of Rs. 20,000 is the current year expense and hence it should be charged to the Profit and Loss A/c. But, since Rs. 10,000 has not been paid and is still due, this will be carried forward to the next period as outstanding expense in the Balance Sheet under current liabilities.



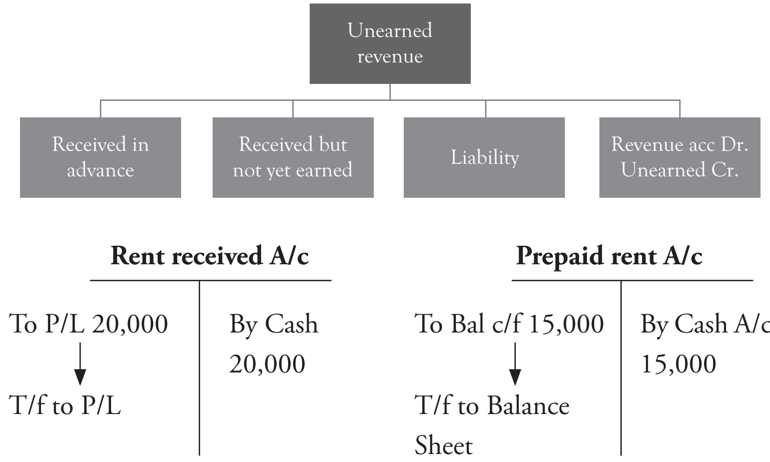
Case III

Unearned income, that is, income though received, not yet earned.

For example, Rs. 35,000 rent received out of which Rs. 15,000 is for the next year.

Answer

This means that only Rs. 20,000 is the income for the current year; the rest is income received but not yet earned, that is we have not yet earned the right to receive that income. Hence, Rs. 20,000 that pertains to the current year will be charged to the Profit and Loss A/c whereas Rs. 15,000 that is for the next year will be shown as prepaid income in the Balance Sheet under current liabilities.



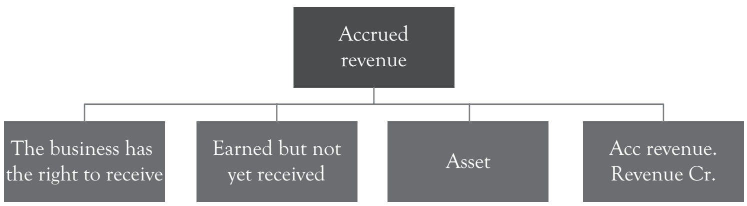
Case IV

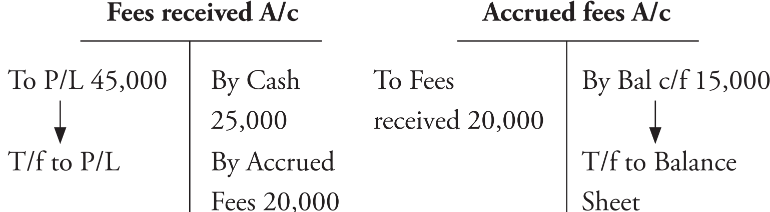
Accrued income, that is, income that is earned but not received.

For example, earned Rs. 45,000 as fees but received only Rs. 25,000.

Answer

Here, though the income we have earned for the current year is Rs. 45,000, we have received only Rs. 25,000. This means that Rs. 20,000 is accrued or due. Thus, we will treat the whole of Rs. 45,000 as income in the Profit and Loss A/c whether received or not and take the remaining Rs. 20,000 as accrued income in the Balance Sheet under current assets.





Fees received A/c

To P/L 45,000 ↓ T/f to P/L	By Cash 25,000 By Accrued Fees 20,000

Accrued fees A/c

To Fees received 20,000	By Bal c/f 15,000 ↓ T/f to Balance Sheet

Case V

Depreciation

It is the loss in the value of a fixed asset during its useful life due to normal wear and tear. Every year a certain amount of value of the asset is written off in the Profit and Loss A/c as an expense by the name of depreciation expense.

But, instead of subtracting the amount of depreciation from the asset, it is credited to a separate account known as **Accumulated Depreciation Account**. It has two advantages:

1. The asset is shown at the original cost in the Balance Sheet.
2. The total depreciation accumulated on such asset till date is also shown separately.

For example, depreciation is provided in the straight line method on the asset costing Rs. 30,000 having six years of useful life.

Answer

Here, we first need to calculate the depreciation amount to be written off in the Profit and Loss A/c. Being a straight line depreciation, the same amount of depreciation each year should be charged over its useful life. Hence in this case it would be: 30,000 divided by 6, which comes to Rs. 5,000 each year. It would have the following treatment:

Depreciation expense A/c

To Accumulated 5,000 Depreciation	By P/L 5,000 ↓ T/f to P/L

Accumulated depreciation A/c

To Bal c/f 5,000 ↓ T/f to Balance Sheet	By Depreciation 5,000 Expense

It would be presented in the following manner in the Balance Sheet:

Equipment, at cost	30,000
Less: Accumulated depreciation	5,000
Net equipment	25,000

There are the following methods and formulas to calculate depreciation:

Method	Explanation	Depreciation amount or formula
Straight line depreciation	Same amount is charged each year calculated on the useful life of the asset	Cost - Scrap ------------------------- Useful life
Diminishing value method	Depreciation amount is calculated as a percentage on written down value, that is, the depreciated value of the asset	

Example

A Machine Y costs 10,000 is depreciated at 20% per annum on the reducing balance method. Show depreciation for the first 3 years.

	Depreciation	Net Book Value
Year 1	$\frac{20}{100} \times 10{,}000 = 2{,}000$	10,000 – 2,000 = 8,000
Year 2	$\frac{20}{100} \times 8{,}000 = 1{,}600$	10,000 – 3,600 = 6,400
Year 3	$\frac{20}{100} \times 6{,}400 = 1{,}280$	10,000 – 4,880 = 5,120

Sum of years' digit method	Depreciation is calculated on the basis of number of years of the useful life of the asset	(Acquisition cost − Salvage value) × (Remaining useful life or Sum of years' digit)

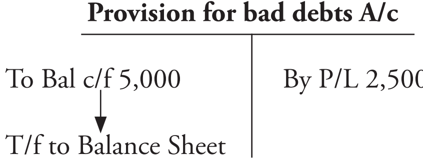
Case VI

Provision for bad or doubtful debts, that is, provision for receivables whose collection is uncertain.

For example, provision of 5 percent on debtors, which is Rs. 50,000, has to be made during the year.

Answer
Provision for doubtful debt is made by the company to prepare itself for uncertainties arising out of collections from debtors. This is done to present the debtors at their realizable value and not at an inflated value. Hence here, provision of 50,000 × 5 percent (Rs. 2,500) will be made and charged to the Profit and Loss A/c. The same amount will be shown as short-term provision under current liabilities in the Balance Sheet.

Provision for bad debts A/c



Case VII

Loss by fire or theft
For example, stock in the godown worth Rs. 35,000 was destroyed by fire. Insurance company accepted the claim for Rs. 30,000.

Answer
Loss by fire or theft in a company has two aspects.

- The total stock decreases or we can say that the purchases decrease because the loss takes place from the stock in the godown which as our purchase.
- If the stock was insured, the company can recover the amount insured from the insurance company. Hence, there would be no loss to the company up to the amount insured. Only the excess amount will be the actual loss.

Thus, only Rs. 5,000 in this case would be the loss of the company since the remaining amount would be paid by the insurance company.

The following journal entries will be passed.

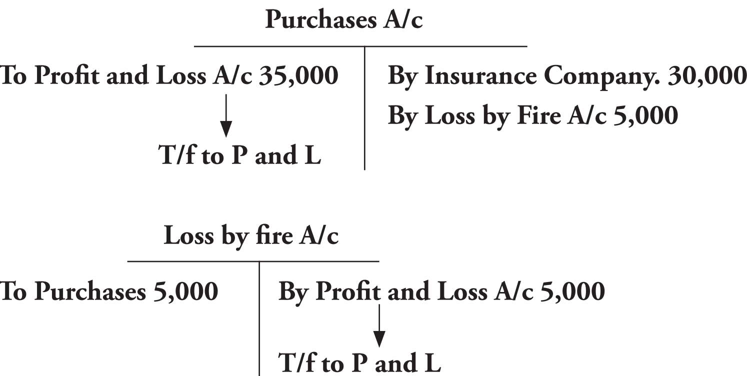
1. Insurance Company A/c Dr. 30,000
   Loss by Fire A/c Dr. 5,000
   To Purchases 35,000

   (Loss by fire recorded and insured amount receivable from insurance company.)
2. Profit and Loss A/c Dr. 5,000
   To Loss by Fire A/c 5,000

   (Loss transferred to Profit and Loss A/c)
3. Cash or Bank A/c Dr. 30,000
   To Insurance Company. 30,000

   (Amount received from Insurance company.)

Let us see its effect on the **ledgers**:



Purchases A/c

To Profit and Loss A/c 35,000	**By Insurance Company. 30,000**
↓	**By Loss by Fire A/c 5,000**
T/f to P and L	

Loss by fire A/c

To Purchases 5,000	**By Profit and Loss A/c 5,000**
	↓
	T/f to P and L

Insurance company A/c

To Purchases 30,000	**By Cash A/c 30,000**
Account Closed	

Balance Sheet

This is the ultimate statement that has to be prepared by a company to know the exact position of the business, that is, where it stands. It states what sources have been used by the company for financing and where such sources have been deployed.

It consists of Assets, Liabilities, and Equity, where

Assets = Liabilities + Equity
Uses of funds = Sources of funds

This always holds true since whatever funds are procured by the company should have been employed somewhere. This is stated by the Balance Sheet.

Given here for your reference is the format of the Balance Sheet:

Format of the Balance Sheet

Balance Sheet

Name of the Company..............
Balance Sheet as at..............

Particulars	Note No.	Figures at the end of the current reporting period	Figures at the end of the previous reporting period
1	2	3	4
I. EQOTY AND LIABILITIES			
1. Shareholders Funds			
(a) Share Capital			
(b) Reserves and Surplus			
(c) Money received against share warrants			
2. Share application money pending allotment			
3. Noncurrent Liabilities			
(a) Long-term borrowings			
(b) Deferred tax liabilities (Net)			
(c) Other Long term liabilities			
(d) Long-term provisions			
4. Current Liabilities			
(a) Short nam borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short term provisions			
TOTAL			

(*Continued*)

(Continued)

Particulars	**Note No.**	**Figures at the end of the current reporting period**	**Figures at the end of the previous reporting period**
II. ASSETS			
1. Non-Current Assets			
(a) Fixed Assets			
(i) Tangible Assets			
(ii) Intangible Assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under development			
(b) Non-current Investments			
(c) Deferred Tax Assets (Net)			
(d) Long term loans and advances			
(e) Other non-current assets			
2. **Current Assets**			
(a) Current Investments			
(b) Inventories			
(c) Trade Receivables			
(d) Cash and cash equivalents			
(e) Short-term loans and advances			
(f) Other current assets			
TOTAL			

Let us now consider the constituents of:

- Assets
- Equity
- Liability

Assets

It consists of the following:

1. **Noncurrent Assets: Those assets which are not current assets.**
   - **(a) Fixed Assets**
     - (i) **Tangible Assets:** Assets which can be physically seen and touched

- Land
- Building
- Plant and Equipment
- Furniture and Fixture
- Vehicles
- Office Equipment
- Others

  It is necessary to give the following information regarding each class or kind of fixed tangible asset.

  a. Original cost
  b. Addition (purchase)
  c. Deductions (sale)
  d. Total depreciation written off or provided for up to the end of the year.

(ii) Intangible Assets:

- Goodwill
- Brands or trademark
- Computer software
- Mastheads (name of newspaper or magazine printed at the top of the page) and publishing titles
- Mining rights
- Copyrights and patents
- Recipes, formulas, models, and designs
- Licenses and franchise

(iii) Capital Work-in-Progress:

Self-constructed item of property, plant, and equipment

(iv) Intangible Assets Under development:

Patents, intellectual property, and so on, which are being developed by the company

(b) Noncurrent Investments:

Investments that are held not with the purpose to resell but to retain them

(i) **Trade Investments:** Investments made by the company in shares or debentures of another company, not being its subsidiary, to promote its own trade and business

(ii) **Other Investments:** Those which are not trade investments.

- Investments in property
- In equity shares
- In preference shares
- In debentures
- In mutual funds
- In partnership firms
- In government securities

(c) Deferred Tax Asset (Net):

A deferred tax asset comes into force when taxable income is more than the accounting income.

(d) Long Term Loans and Advances:

Expected to be received back in cash or in kind after 12 months from the date of the B/S.

(i) Capital Advances: Advances for acquiring fixed assets

(ii) Security Deposits: Deposit for electricity, telephone, and so on given for a period beyond 12 months

(iii) Other loans and advances

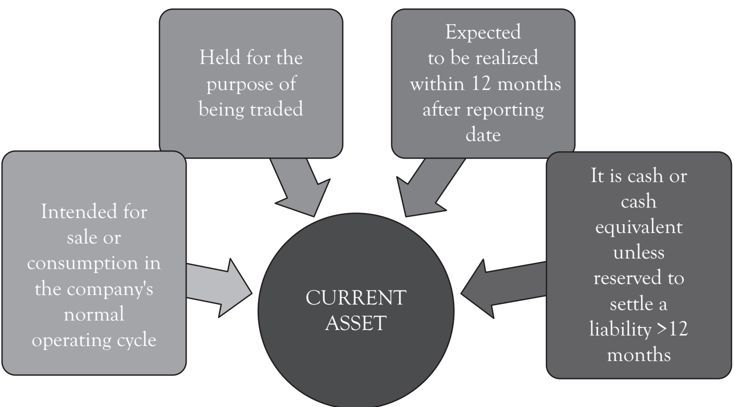
- Long-term loan to employees
- Long-term advance to suppliers , and so on

(e) Other Noncurrent Assets

- Long-term Trade Receivables–receivable 12 months from the date of the B/S if the operating cycle is less than 12 months or beyond the operating cycle if the operating cycle is more than 12 months
- Others
- Insurance claim receivable
- Debts due by directors or other officers of the company

- **Current Assets**

  Current assets are those that satisfy *any* of the following conditions:



(a) **Current Investments:** Those investments which are held to be converted into cash within a short period, that is, within 12 months from the date of purchase of the investment.

- Investments in partnership firms
- In equity shares
- In preference shares
- In debentures
- In mutual funds
- In government securities
- Short Term Investment
- Marketable Securities

(b) **Inventories:** Refers to stock held for the purpose of trade in the normal course of the business, that is, for manufacturing or trading of goods.

(i) Raw Materials
(ii) Work-in-Progress
(iii) Finished Goods
(iv) Stock-in-Trade
(v) Stores and Spares
(vi) Loose Tools
(vii) Goods-in – Transit

(c) Trade Receivables:

Refers to the amount due on account of goods sold or services rendered in the normal course of business. It includes:

- Debtors
- Bills Receivable

(d) Cash and Cash Equivalents:

- Balance with banks
- Cheques, drafts in hand
- Cash on hand
- Earmarked balances with banks (e.g., for unpaid divided)
- Balances with banks held as margin money.
- Bank deposits with more than 12 months maturity

(e) Short-term Loans and Advances:

Expected to be realized within 12 months from the B/S date or within the operating cycles, if the operating cycle is more than 12 months.

- Loans and advances to related parties
- Others

(f) Other Current Assets

- Prepaid expenses
- Dividend receivable
- Interest accrued on investments
- Advance Tax

3. Contingent Liabilities and Capital Commitments:

(a) Contingent Liabilities: These liabilities refer to the claims that are uncertain to arise because they are dependent on an incident in the future.

They are not recorded in the books of accounts **but disclosed in the Notes to Accounts**.

- Claim against the company not yet acknowledged as debt
- Liabilities for bills discounted
- Guarantee given by the company

(b) Capital Commitments

A future liability for capital expenditure in respect of which contracts have been made.

- Uncalled amount on partly paid up shares
- Estimated amount of capital contracts remaining to be executed and not provided for (penalty)
- Other commitments: For example, arrears of cumulative dividend

Equity

It consists of the following:

- **Shareholders' Funds**
  1. Share Capital—Both equity and preference
  2. Reserves and surplus that is earned capital—capital reserve, security premium, capital redemption reserve, revaluation reserve, balance in profit and loss, that is, surplus or retained earnings

	Beginning retained earnings
+	Net income (or − net loss)
−	Dividends
=	Ending retained earnings

  3. Money received against share warrants

- **Share application money whose allotment is pending**

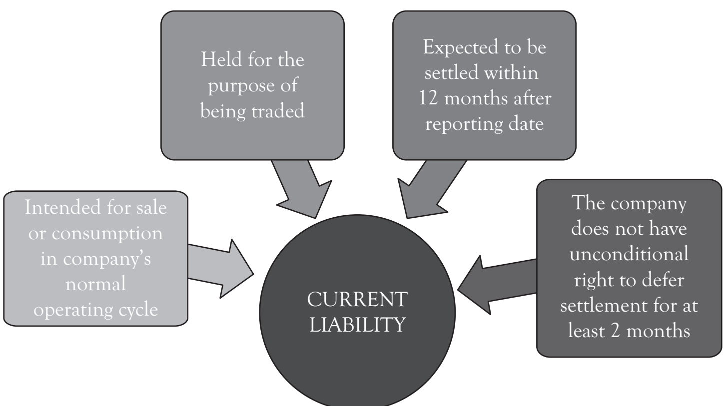
Liabilities

- **Noncurrent Liabilities**
  1. Long-term borrowings
  2. Deferred tax liabilities
  3. Other long-term liabilities
  4. Long-term Provisions

- **Current Liabilities**
  1. Short-term borrowings
  2. Trade payable

3. Other current liabilities
4. Short-term liabilities

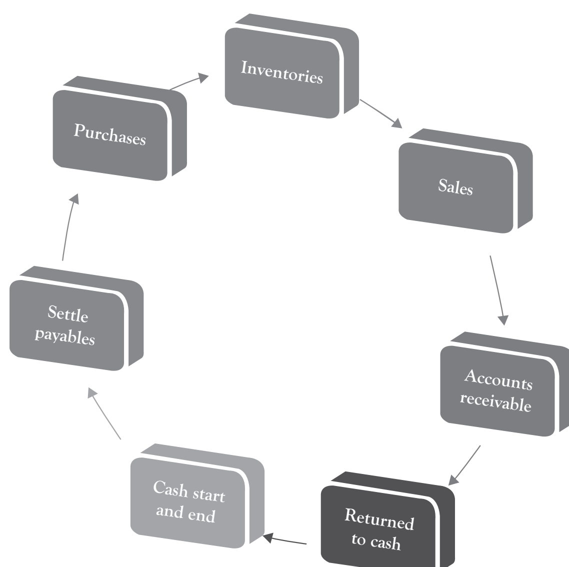
Current liabilities are those that satisfy *any* of the following conditions:



Working Capital = Current Assets – Current Liabilities

What is an *Operating Cycle?*

Operating cycle is the total time taken by a company to follow the whole process of converting its inventory into cash, that is, time taken to sell the inventory and realize cash.



Example

Let us continue with our previous question and prepare the Balance Sheet after the Profit and Loss Statement.

Answer

Those items in the Trial Balance that did not form part of the Profit and Loss Statement will become part of the Balance Sheet.

Step I

We will make a list of such items that should be included in the Balance Sheet.

Assets ⟶ From debit side of Trial Balance

1. Inventory
2. Furniture
3. Loan to directors
4. Plant and machinery
5. Current account
6. Cash
7. Fixtures
8. Freehold land
9. Tools and equipment
10. Goodwill
11. Trade receivables

Equity and liability ⟶ From credit side of trial balance

12. Equity share capital
13. Debentures
14. Bank loans
15. Trade payables
16. Profit and Loss Account
17. Depreciation provision

Step II

Place the above mentioned items in the list under appropriate heads in the Balance Sheet.

Again, the details of each item should be shown separately in the Notes to Accounts.

Hari Chemicals Ltd.
Balance Sheet as on March 31, 2015

		Note no.	Amount (Rs.)	***Analysis (only for understanding)***
	Equities and liabilities			
(1)	**Shareholders' funds**			
	(a) Share capital	1	25,00,000	⇐ *Equity share capital*
	(b) Reserves and surplus	2	7,40,000	⇐ *Opening balance of P/L + Current year profit*
(2)	**Noncurrent liabilities**			
	(a) Long-term borrowings	3	11,45,000	⇐ *Debentures + Bank loan*
(3)	**Current liabilities**			
	Trade payables		2,81,000	⇐ *Trade payables*
Total			**46,66,000**	
	Assets			
(1)	**Noncurrent assets**			
	Fixed assets:			
	(a) Tangible assets	4	30,05,000	⇐ *Total of fixed assets – Depreciation*
	(b) Intangible assets		2,65,000	⇐ *Goodwill*
(2)	**Current assets**			
	(a) Inventories		8,23,000	
	(b) Trade receivables		4,40,000	
	(c) Cash and cash equivalents	5	53,000	⇐ *Current account balance + Cash*
	(d) Short-term loans and advances	6	80,000	⇐ *Loan to directors*
Total			**46,66,000**	

Notes to Accounts

	₹
1. Share capital	
Authorized:	
Equity share capital of ₹ 10 each	25,00,000
Issued and Subscribed:	
Equity share capital of ₹ 10 each	25,00,000
2. Reserves and Surplus	
Balance as per last balance sheet	1,39,000
Balance in profit and loss account	6,01,000
	7,40,000
3. Long term Borrowings	
11% Debentures	5,00,000
Bank loans	6,45,000
	11,45,000

4. Tangible Assets

	Gross block	*Depreciation*	*Net Block*
Freehold land	15,46,000		15,46,000
Furniture	2,00,000		2,00,000
Fixtures	3,00,000		3,00,000
Plant and Machinery	8,60,000	1,46,000	7,14,000
Tools and Equipment	2,45,000		2,45,000
Total	31,51,000	1,46,000	30,05,000

5. Cash and cash equivalents	45,000
Current account balance	8,000
Cash	53,000
6. Short-term loans and Advances	
Loan to directors	80,000

Let us take one more example

Example

From the following particulars of Y Ltd., prepare its Balance Sheet as on March 31st, 2013 along with notes to accounts.

Particulars	**Amount**
Issued equity share capital 7,000 shares @ Rs. 10 each	70,000
Issued and subscribed 6% preference share capital Rs. 1,000 @ Rs. 100 each	1,00,000
Calls in arrear Rs. 3 on 100 shares	

500, 5% debentures of Rs. 1,000 each	5,00,000
Short term loan from bank	10,000
Debtors	5,000
Provision for doubtful debts	200
Provision for taxation	1,000
General reserve	4,000
Statement of P/L (Dr.)	6,000
Marketable securities	500

Answer

Step I

We will take each item one by one and identify the head under which it would be presented.

Equity share capital	☞	Share capital
Preference share capital	☞	Share capital
Calls in arrears	☞	Share capital (will be subtracted since it is not yet paid)
Debentures	☞	Noncurrent liabilities, since it is long term
Short-term loan from bank	☞	Current liabilities, since it is for short period
Debtors	☞	Current assets
Provision for doubtful debts	☞	Current liabilities, since it is only for current period
Provision for taxation	☞	Current liabilities, since it is only for current period
General reserve	☞	Reserves and surplus
Statement of P/L (Dr.)	☞	Reserves and surplus (will be shown as negative amount since it is a debit balance)
Marketable securities	☞	Current assets, since it is for short term

Step II

We will now present it in an appropriate manner along with the notes to accounts.

Balance Sheet of Y Ltd.
As on March 31, 2013

Particulars	Note No.	31.03.2013	31.03.2012
1	2	3	4
I. EQUITY AND LIABILITIES			
Shareholders Funds			
(a) Share Capital	1	1,39,700	
(b) Reserves and Surplus	2	(2,000)	
Non-Current Liabilities			
Long-term borrowings	3	5,00,000	
Current Liabilities			
(a) Short term borrowings	4	10,000	
(b) Short term provisions	5	1,200	
TOTAL			
II. ASSETS			
Current Assets			
(a) Current Investments	6	500	
(b) Trade Receivables	7	5,000	
TOTAL			

Notes to Accounts:

Particulars		Amount (Rs.)
1. **Share Capital**		
Subscribed and fully paid up		
1,000 6% Preference shares of ₹100 each		1,00,000
Subscribed but not fully paid up		
5,000 equity shares of ₹10 each, ₹8 called up	40,000	
Less calla-in-arrear	(300)	39,700
		1,39,700
2. **Reserves and Surplus**		
General Reserve	4,000	
Statement of P/L	(6,000)	(2,000)
3. **Noncurrent Liabilities**		
500, 5% Debentures of ₹ 1000 each		5,00,000
4. **Current Liabilities**		
Short-term borrowings		
Short-term loan from bank		10,000
5. **Current Liabilities**		
Short-term provision		
Provision for Tax	1,000	
Provision for Doubtful Debts	200	1,200

Particulars	Amount (Rs.)
6. Current Assets	
Current Investments	
Marketable Securities	500
7. Current Assets	
Trade Receivables	
Debtors	5000

CHAPTER 7

The Mega Question

Let us now do a full question on final accounts.

Question

From the following Trial Balance, prepare a Profit and Loss Statement and Balance Sheet along with notes to accounts for the year ending December 31, 2007.

Dr. Balances	Rs.	Cr. Balances	Rs.
Opening Stock	15,500	Capital	60,000
Land and Building	35,000	Loan From Mrs. Gurdeep Singh @ 9%	30,000
Machinery	50,000	Sundry Creditors	9,600
Furniture and Fixtures	5,000	Purchase Returns	2,100
Purchases	1,06,000	Sales	2,07,300
Salaries	11,000	Discount	1,200
General Expenses	2,500		
Rent	3,000		
Postage and Telegrams	1,400		
Stationery	1,300		
Wages	26,000		
Freight on Purchases	2,800		
Carriage on Sales	4,000		
Repairs	4,500		
Sundry Debtors	30,000		
Bad Debts	600		
Cash in Hand	100		
Cash at Bank	6,400		
Sales Returns	5,100		
	3,10,200		**3,10,200**

The following further information was given.

(a) Wages for December 2007 amounting to Rs. 2,100 have not yet been paid.

(b) Included in General Expenses is Insurance Premium Rs. 600, paid for the year ending March 31, 2008.
(c) A provision for doubtful debts @ 5% on debtors is necessary.
(d) Depreciation is to be charged as follows:
Land and Building 2%, Machinery 10%, and Furniture and Fixtures 15%.
(e) The loan from Mrs. Gurdeep Singh was taken on July 1, 2007. Interest has not been paid yet.
(f) The value of stock in hand on December 31, 2007 was Rs. 14,900.

Answer

Step I

We will take each item one by one and segregate them according to whether they will be transferred to the Profit and Loss Statement or shown in the Balance Sheet.

Simultaneously, we will also see how their relating adjustments are treated.

Let us start from the Debit side of the Trial Balance.

1. **Opening Stock**
   It is not taken directly to the Profit and Loss Statement but shown as increase or decrease in the inventory to arrive at the operating profit; that is, if
   closing stock > opening stock = increase in inventory
   closing stock < opening stock = decrease in inventory
   We can see in the adjustments that closing stock of Rs. 14,900 is given. Hence change in inventory to be taken to profit and loss account: opening stock – closing stock (15,500 – 14,900), which is Rs. 600 decrease in inventory.
   Further, closing stock of Rs. 14,900 will be shown as inventories under current assets in the Balance Sheet.
2. **Land and Building**
   It is given at Rs. 35,000 in the trial balance. But we can also see that depreciation @ 2 percent has to be provided as given in the adjustment. Hence, since Land and Building is fixed asset, it will be shown

at the original cost in the Balance Sheet and accumulated depreciation pertaining to it—that is, 2 percent of Rs. 35,000—which is Rs. 700 will be shown separately as deduction from the original cost. Simultaneously, the depreciation amount will also be charged to the profit and loss account.

3. **Machinery**

   This is given at Rs. 50,000 in the Trial Balance, and the adjustment relating to it states that depreciation @ 10 percent will be charged on it. Hence machinery will be shown at the original cost in the Balance Sheet under Fixed Assets and Accumulated Depreciation of Rs. 5,000, that is, 10 percent of Rs. 50,000 will be shown as deduction from it. Moreover, depreciation will also be charged to the profit and loss account as loss in the value of asset.

4. **Furniture and Fixtures**

   Similar to Land and Building, Furniture and Fixtures too will be shown at the original cost as fixed asset in the Balance Sheet. As per the adjustment given, depreciation @ 15 percent will also be charged, that is, Rs. 750 will be charged to the profit and loss account and shown as accumulated depreciation in the Balance Sheet as deduction from the original cost.

5. **Purchases**

   Total purchases of Rs. 1,06,000 will be shown in the Profit and Loss Statement as the expense is related to the normal business activities of the company.

6. **Salaries**

   Since it is a revenue expense, it will be charged to the profit and loss account.

7. **General Expenses**

   They are also operating expenses, and hence should be charged to the Profit and Loss Statement. But the adjustment says that out of Rs. 2,500, Rs. 600 is for the year ending March 31, 2008, that is, it is prepaid for three months from January to March 2008; this means Rs. 150 ($600 \times 3/12$) is prepaid. Hence, only Rs. 2,350 ($2,500 - 150$) will be charged to the profit and loss account since only this much amount relates to the current period. We will not take expense that is not of the current year into account.

Further, the prepaid expense of Rs. 150 will be shown as current asset in the Balance Sheet as we have not yet incurred it but have made the payment.

8. **Rent; Postage and Telegraph; and Stationery**

   These are also operating expenses incurred by the company in its normal course of business. Further, no additional information is given for these, so we will assume that they pertain to the current period. Hence, they too will be charged to the Profit and Loss Statement.

9. **Wages**

   Wages are also revenue expenditure to be charged to the profit and loss account but in the adjustments, it is given that out of Rs. 26,000, Rs. 2,100 has not yet been paid—that is, it is still outstanding. We will report the total expenditure incurred in the current year whether it is paid or not. Hence, in the Profit and Loss Statement, the amount of Rs. 28,100 (26,000 + 2,100) will be charged irrespective of whether or not payment is made, as long as it pertains to the current year.

   Further, outstanding wages of Rs. 2,100 will be shown under current liabilities in the Balance Sheet.

10. **Freight on Purchases, Carriage on Sales, and Repairs**

    Since these expenses are also revenue and pertain to the current period, they will be charged to the profit and loss account.

11. **Sundry Debtors**

    These are receivables for the company and hence will be shown under current assets in the **Balance Sheet**.

    Moreover, it has been provided in the adjustments that provision for doubtful debts should be made on the debtors @ 5 percent. This means that the company expects that the collection from 5 percent of debtors is uncertain. Hence provision of Rs. 1,500—that is 5 percent of 30,000—should be made by charging to the profit and loss account. Simultaneously, this provision will be shown under the head current liabilities in the Balance Sheet.

12. **Bad Debts**

    Bad debts are those receivables that cannot be recovered, that is, it is a loss for the company, and hence will be charged to the profit and loss account.

13. **Cash in Hand and Cash at Bank**

    Being an asset, both cash in hand and cash at bank will be shown under current assets in the Balance Sheet.

14. **Sales Returns**

    It will be subtracted from total sales to arrive at net sales in the profit and loss account.

Let us now proceed to the Credit side of the Trial Balance.

1. **Capital**

   It represents the owner's funds and hence will be shown under Equities in the Balance Sheet.

2. **Loan From Mrs. Gurdeep Singh @ 9 Percent**

   Being a liability, it will be shown under Long Term Liabilities in the Balance Sheet. Moreover, its interest of Rs. 1,350—that is, 9 percent of 30,000 for half year (since loan is taken on July 1, 2007) will be charged to profit and loss account. The fact that it is not paid does not make a difference since it is already due and has become payable. This outstanding interest will be shown under current liabilities in the Balance Sheet.

3. **Sundry Creditors**

   They are payables for the company and hence will be classified under Current Liabilities in the Balance Sheet.

4. **Purchase Returns**

   They are subtracted from purchases in the profit and loss account to arrive at net purchases.

5. **Sales**

   This is shown under Revenue From Operations in the Profit and Loss Statement since it is the primary source of income for the company generated from its operations.

6. **Discount**

   Since it is shown on the Credit side of the Balance Sheet, it is an income (credit all incomes), that is, discount received and hence will be shown as Other Income in the profit and loss account.

Step II

Now we just have to present it appropriately along with notes to accounts.

Balance Sheet

Balance Sheet of Y Ltd.					
for the year ending December 31, 2007					
Particulars		**Note No.**	**Note No.**	**Figures at the end of current reporting period**	**Figures at the end of previous reporting period**
I	**EQUITIES AND LIABILITIES**				
	1	**Shareholders' Funds**			
		(a) Share Capital		60,000	
		(b) Reserves and Surplus	1	30,550	
	2	**Noncurrent Liabilities**			
		(a) Long Term Borrowing	2	30,000	
	3	**Current Liabilities**			
		(a) Short Term Borrowings			
		(b)Trade Payables		9,600	
		© Other Current Liabilities	3	3,450	
		© Short Term Provisions	4	1,500	
TOTAL				**1,35,100**	
II	**ASSETS**				
	1	**Non Current Assets**			
		(a) Fixed Assets			
		(i) Tangible assets	5	83,550	
	2	**Current Assets**			
		(a) Current Investments		–	
		(b) Inventories		14,900	
		(c) Trade Receivables		30,000	
		(d) Cash and Cash Equivalents	6	6,500	
		(e) Short Term Loans and Advances		–	
		(f) Other Current Assets	7	150	
TOTAL				**1,35,100**	

Y Ltd. **Statement of Profit and Loss for the Year Ended December 31, 2007**			
Particulars	**Note No.**	**Figures at the end of current reporting period**	**Figures at the end of previous reporting period**
(i) Revenue From Operations	8	2,03,400	
(ii) Other Income			
(iii) Total Revenue (A)		203,400	
(iv) Expenses			
Cost of Material Consumed	9	1,06,700	
Change in Inventory of Finished Goods	10	600	
Employee Benefit expenses	11	39,100	
Depreciation and Amortization Expenses	12	6,450	
Finance Cost	13	1,350	
Other expenses	14	18,650	
Total Expenses (B)		1,72,850	
(v) Profit before Tax (A−B)		30,550	
(vi) Less: Provision for Tax		–	
(vii) Profit for the period		30,550	

Notes to Accounts

1	**Reserves and Surplus**	
	Profit and Loss A/c (Current year profit)	30,550
2	**Long Term Borrowing**	
	Loan From Gurdeep Singh @ 9 %	30,000
3	**Other Current Liabilities**	
	Outstanding Wages	2,100
	Outstanding Interest	1,350
		3,450
4	**Short Term Provision**	
	Provision for Doubtful Debts	1,500

5 Fixed Assets

Tangible

Machinery	50,000
Less: Accumulated Depreciation	5,000
	45,000
Land and Building	35,000
Less: Accumulated Depreciation	700
	34,300
Furniture and Fixture	5,000
Less: Accumulated Depreciation	750
	4,250
Total	**83,550**

6 Cash and Cash Equivalents

Cash in Hand	100
Cash at Bank	6,400
	6,500

7 Other Current Assets

Prepaid Expenses (Insurance Premium}	150

8 Revenue From operations

Sales	207,300
(Less) Sales Return	5,100
(Add) Cash Discount Received	1,200
	203,400

9 Cost of Material Consumed

Add: Purchases	106,000
Freight on Purchases	2,800
Less: Purchase Return	2,100
	106,700

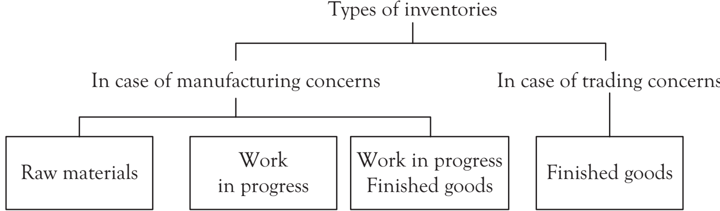
10	**Change in Inventory of Finished Goods**	
	Opening Inventory	15500
	Closing Inventory	14900
		600
11	**Employee Benefit expenses**	
	Wages	26000
	Add: Outstanding Wages	2100
	Salaries	11000
		39100
12	**Depreciation and Amortization Expenses**	
	Machinery	5000
	Land and Building	700
	Furniture and Fixture	750
		6450
13	**Finance Cost**	
	Interest on Bank Loan	1350
14	**Other Expenses**	
	General Expenses	2500
	Less: Prepaid	−150
	Rent	3000
	Postage and Telegrams	1400
	Stationery	1300
	Carriage on Sales	4000
	Repairs	4500
	Bad Debts	500
	Provision for Bad and Doubtful Debts	1500
		18650

Next, let us look into some other general topics.

CHAPTER 8

Valuation of Inventory

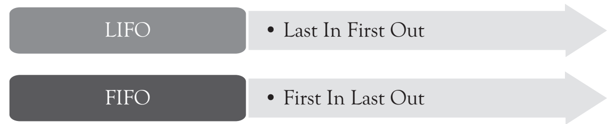
There are the following types of inventories:



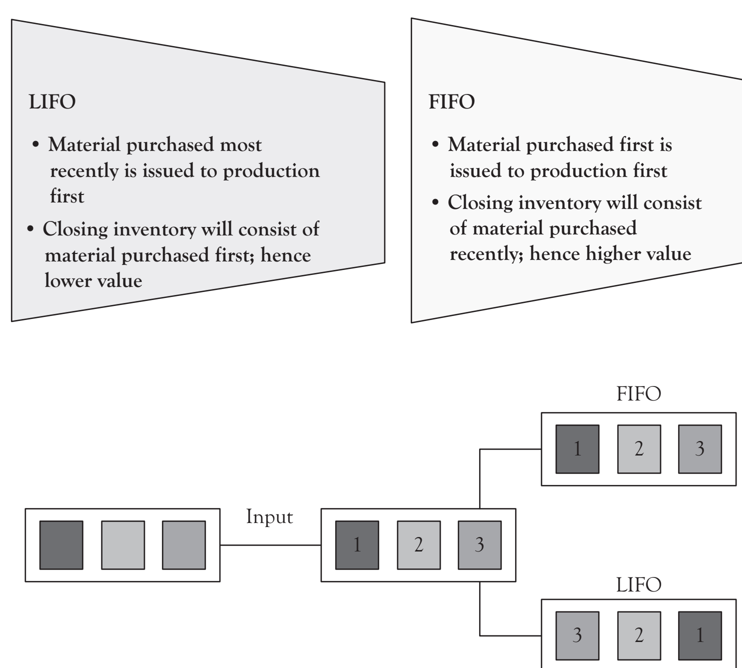
Inventory is valued at "lower" of:

i. Cost that is purchase cost
or
ii. Market price that is net realizable value

Though there are many methods of valuation of inventory by a company, the most important ones that are used practically are as follows:



Let us understand these methods while differentiating between the two.



The FIFO method is more acceptable and more widely used as compared to the LIFO method.

Example

Particulars	Units	Price per unit
Beginning inventory	100	5
Purchase	50	7
Purchase	200	9
Sale	300	12
Closing inventory	??	??

Let us calculate the value of closing inventory as per LIFO and FIFO methods.

LIFO	Units	Rate	Total value (Rs.)
Sale of 300 units	200 (since it is purchased last)	9	1,800
	50 (purchased before that)	7	350
	50 (from opening inventory)	5	250
Total cost of goods sold	**300**		**2,400**
Closing inventory	50 (from opening inventory)	5	**250**
FIFO			
Sale of 300 units	100 (from opening inventory)	5	**500**
	50 (from purchase made first)	7	**350**
	150 (from purchase made last)	9	**1,350**
Total cost of goods sold	**300**		**2,200**
Closing inventory	50 (from purchase made last)	9	**450**

We can see the value of closing inventory differs under both the methods. It is higher in the case of the FIFO method since the inventory left is that which was more recently purchased, and hence represents the current market price.

Glossary

Account—a record of financial transactions, usually refers to a specific category or type, such as travel expense account or purchase account.

Accountant—a person who is trained to prepare and maintain financial records.

Accounting—a system for keeping score in business.

Accounting period—the period of time over which profits are calculated. Normal accounting periods are months, quarters, and years (fiscal or calendar).

Accounts payable—amounts owed by the company for the goods or services it has purchased from outside suppliers.

Accounts receivable—amounts owed to the company by its customers.

Accrual basis, system, or method—an accounting system that records revenues and expenses at the time the transaction occurs, not at the time cash changes hands. If you buy a coat and charge it, the store records or accrues the sale when you walk out with the coat, not when you pay your bill. Cash basis accounting is used by individuals. Accrual basis accounting is used by most businesses.

Accrued expenses, accruals or an expense that has been incurred but not yet paid for. Salaries are a good example. Employees earn or accrue salaries each hour they work. The salaries continue to accrue until payday when the accrued expense of the salaries is eliminated.

Aging—a process where accounts receivable are sorted out by age (typically current, 30 to 60 days old, 60 to 120 days old, and so on.) Aging permits collection efforts to focus on accounts that are long overdue.

Amortize—to charge a regular portion of expenditure over a fixed period of time. For example, if something cost Rs.100 and is to be amortized over 10 years, the financial reports will show an expense of Rs.10 per year

for 10 years. If the cost was not amortized, the entire Rs. 100 would show up on the financial report as an expense in the year the expenditure was made. (See Expenditure and Expense.)

Appreciation—an increase in value. If a machine cost Rs. 1,000 last year and is now worth Rs. 1,200, it has appreciated in value by Rs. 200. (The opposite of depreciation.)

Assets—things of value owned by a business. An asset may be a physical property such as a building, or an object such as a stock certificate, or it may be a right, such as the right to use a patented process.

Current Assets—those assets that can be expected to turn into cash within a year or less. Current assets include cash, marketable securities, accounts receivable, and inventory.

Fixed Assets—cannot be quickly turned into cash without interfering with business operations. Fixed assets include land, buildings, machinery, equipment, furniture, and long-term investments.

Intangible Assets—items such as patents, copyrights, trademarks, licenses, franchises, and other kinds of rights or things of value to a company, which are not physical objects. These assets may be the most important ones a company owns. Often they do not appear on financial reports.

Audit—a careful review of financial records to verify their accuracy.

Bad debts—amounts owed to a company that are not going to be paid. An account receivable becomes a bad debt when it is recognized that it won't be paid. Sometimes, bad debts are written off when recognized. This is an expense. Sometimes, a reserve is set up to provide for possible bad debts. Creating or adding to a reserve is also an expense.

Balance sheet—a statement of the financial position of a company at a single specific time (often at the close of business on the last day of the month, quarter, or year.) The balance sheet normally lists all assets on the left side or top while liabilities and capital are listed on the right side or bottom. The total of all numbers on the left side or top must equal or balance the total of all numbers on the right side or bottom. A balance sheet balances according to this equation: Assets = Liabilities + Capital.

Bond—a written record of a debt payable more than a year in the future. The bond shows amount of the debt, due date, and interest rate.

Book value—total assets minus total liabilities. (See also Net worth.) Book value also means the value of an asset as recorded on the company's books or financial reports. Book value is often different than true value. It may be more or less.

Breakeven point—the amount of revenue from sales that exactly equals the amount of expense. Breakeven point is often expressed as the number of units that must be sold to produce revenues exactly equal to expenses. Sales above the breakeven point produce a profit; sales below the breakeven point produce a loss.

Capital—money invested in a business by its owners. (See Equity.) On the bottom or right side of a balance sheet. Capital also refers to buildings, machinery, and other fixed assets in a business. A capital investment is an investment in a fixed asset with a long-term use.

Capitalize—to capitalize means to record an expenditure on the balance sheet as an asset, to be amortized over the future. The opposite is to expense. For example, research expenditures can be capitalized or expensed. If expensed, they are charged against income when the expenditure occurs. If capitalized, the expenditure is charged against income over a period of time usually related to the life of the products or services created by the research.

Cash—Money available to spend now, usually in a checking account.

Cash flow—the amount of actual cash generated by business operations, which usually differs from profits shown.

Chart of accounts—a listing of all the accounts or categories into which business transactions will be classified and recorded. Each account usually has a number. Transactions are coded by this number for manipulation on computers.

Contingent liabilities—liabilities not recorded in a company's financial reports, but which might become due. If a company is being sued, it has a contingent liability that will become a real liability if the company loses the suit.

Cost of sales, cost of goods sold—the expense or cost of all items sold during an accounting period. Each unit sold has a cost of sales or cost of the goods sold. In businesses with a great many items flowing through, the cost of sales or cost of goods sold is often computed by this formula: Cost of Sales = Beginning Inventory + Purchases During the Period – Ending Inventory.

Credit—an accounting entry on the right or bottom of a balance sheet. Usually it is an increase in liabilities or capital, or a reduction in assets. The opposite of credit is debit. Each credit in a balance sheet has a balancing debit. Credit has other usages, as in "You have to pay cash; your credit is no good." Or "we will credit your account with the refund."

Debit—an accounting entry on the left or top of a balance sheet. Usually it is an increase in assets or a reduction in liabilities. Every debit has a balancing credit.

Deferred charges—see Prepaid expenses.

Deferred income—a liability that arises when a company is paid in advance for goods or services that will be provided for later. For example, when a magazine subscription is paid in advance, the magazine publisher is liable to provide magazines for the life of the subscription. The amount in deferred income is reduced as the magazines are delivered.

Depreciation—an expense that is supposed to reflect the loss in value of a fixed asset. For example, if a machine will completely wear out after ten year's use, the cost of the machine is charged as an expense over the ten-year life rather than all at once, when the machine is purchased. Straight line depreciation charges the same amount to expense each year. Accelerated depreciation charges more to expense in early years, less in later years. Depreciation is an accounting expense. In real life, the fixed asset may grow in value or it may become worthless long before the depreciation period ends.

Discounted cash flow—a system for evaluating investment opportunities that discounts or reduces the value of future cash flow. (See Present value.)

Dividend—a portion of the after-tax profits paid out to the owners of a business as a return on their investment.

Double entry—a system of accounting in which every transaction is recorded twice: as a debit and as a credit.

Earnings per share—a company's net profit after taxes for an accounting period, divided by the average number of shares of stock outstanding during the period.

80–20 rule—a general rule of thumb in business that says that 20 percent of the items produce 80 percent of the action; 20 percent of the product line produces 80 percent of the sales; 20 percent of the customers generate 80 percent of the complaints; and so on. In evaluating any business situation, look for the small group that produces the major portion of the transactions you are concerned with. This rule is not exactly accurate, but it reflects a general truth: nothing is evenly distributed.

Equity—the owners' share of a business.

Expenditure—expenditure occurs when something is acquired for a business—an asset is purchased, salaries are paid, and so on. Expenditure affects the balance sheet when it occurs. However, expenditure will not necessarily show up on the income statement or affect profits at the time the expenditure is made. All expenditures eventually show up as expenses, which do affect the income statement and profits. While most expenditure involves the exchange of cash for something, expenses need not involve cash. (See Expense below.)

Expense—expenditure that is chargeable against revenue during an accounting period. An expense results in the reduction of an asset. All expenditures are not expenses. For example, a company buys a truck. It trades one asset—cash—to acquire another asset. Expenditure has occurred but no expense is recorded. Only as the truck is depreciated will an expense be recorded. The concept of expense as being different from expenditure is one reason financial reports do not show numbers that represent cash that can be spent. The distinction between expenditure and an expense is important in understanding how accounting works and what financial reports mean. (To expense is a verb. It means to charge expenditure against income when the expenditure occurs. The opposite is to capitalize.)

Fiscal year—an accounting year than begins on a date other than January 1.

Fixed asset—see Asset.

Fixed cost—a cost that does not change as sales volume changes (in the short run.) Fixed costs normally include such items as rent, depreciation, interest, and any salaries unaffected by ups and downs in sales.

Goodwill—in accounting, the difference between what a company pays when it buys the assets of another company and the book value of those assets. Sometimes, real goodwill is involved—a company's good reputation, the loyalty of its customers, and so on. Sometimes, goodwill is an overpayment.

Income—see Profit.

Interest—a charge made for the use of money.

Inventory—the supply or stock of goods and products that a company has for sale. A manufacturer may have three kinds of inventory: raw materials waiting to be converted into goods, work in process, and finished goods ready for sale.

Inventory obsolescence—inventory no longer saleable. Perhaps there is too much on hand, perhaps it is out of fashion. The true value of the inventory is seldom exactly what is shown on the balance sheet. Often, there is unrecognized obsolescence.

Inventory shrinkage—a reduction in the amount of inventory that is not easily explainable. The most common cause of shrinkage is probably theft.

Inventory turnover—a ratio that indicates the amount of inventory a company uses to support a given level of sales. The formula is: Inventory Turnover = Cost of Sales ÷ Average Inventory. Different businesses have different general turnover levels. The ratio is significant in comparison with the ratio for previous periods or the ratio for similar businesses.

Invested capital—the total of a company's long-term debt and equity.

Journal—a chronological record of business transactions.

Ledger—a record of business transactions kept by type or account. Journal entries are usually transferred to ledgers.

Liabilities—amounts owed by a company to others. *Current liabilities* are those amounts due within one year or less and usually include accounts payable, accruals, loans due to be paid within a year, taxes due within a year, and so on. *Long-term liabilities* normally include the amounts of mortgages, bonds, and long-term loans that are due more than a year in the future.

Liquid—having lots of cash or assets easily convertible to cash.

Marginal cost, marginal revenue—marginal cost is the additional cost incurred by adding one more item. Marginal revenue is the revenue from selling one more item. Economic theory says that maximum profit comes at a point where marginal revenue exactly equals marginal cost.

Net worth—total assets minus total liabilities. Net worth is seldom the true value of a company.

Opportunity cost—a useful concept in evaluating alternate opportunities. If you choose alternative A, you cannot choose B, C, or D. What is the cost or loss of profit of not choosing B, C, or D? This cost or loss of profit is the opportunity cost of alternative A. In personal life you may buy a car instead of taking a European vacation. The opportunity cost of buying the car is the loss of the enjoyment of the vacation.

Overhead—a cost that does not vary with the level of production or sales, and usually a cost not directly involved with production or sales. The chief executive's salary and rent are typically overhead.

Post—to enter a business transaction into a journal or ledger or other financial record.

Prepaid expenses, deferred charges—assets already paid for, which are being used up or will expire. Insurance paid for in advance is a common example. The insurance protection is an asset. It is paid for in advance; it lasts for a period of time, and expires on a fixed date.

Present value—a concept that compares the value of money available in the future with the value of money in hand today. For example, Rs. 78.35

invested today in a 5 percent savings account will grow to Rs. 100 in five years. Thus the present value of Rs. 100 received in five years is Rs. 78.35. The concept of present value is used to analyze investment opportunities that have a future payoff.

Price earnings (P/E) ratio—the market price of a share of stock divided by the earnings (profit) per share. P/E ratios can vary from sky high to dismally low, but often do not reflect the true value of a company.

Profit—the amount left over when expenses are subtracted revenues. *Gross profit* is the profit left when cost of sales is subtracted from sales, before any operating expenses are subtracted. *Operating profit* is the profit from the primary operations of a business and is sales minus cost of sales minus operating expenses. *Net profit before taxes* is operating profit minus nonoperating expenses and plus nonoperating income. *Net profit after taxes* is the bottom line, after everything has been subtracted, and is also called income, net income, or earnings. It is not the same as cash flow and does not represent spendable dollars.

Retained earnings—profits not distributed to shareholders as dividends, the accumulation of a company's profits less any dividends paid out. Retained earnings are not spendable cash.

Return on investment (ROI)—a measure of the effectiveness and efficiency with which managers use the resources available to them, expressed as a percentage. *Return on equity* is usually net profit after taxes divided by the shareholders' equity. *Return on invested capital* is usually net profit after taxes plus interest paid on long-term debt divided by the equity plus the long-term debt. *Return on assets used* is usually the operating profit divided by the assets used to produce the profit. Typically used to evaluate divisions or subsidiaries. ROI is very useful but can only be used to compare consistent entities—similar companies in the same industry or the same company over a period of time. Different companies and different industries have different ROIs.

Revenue—the amounts received by or due a company for goods or services it provides to customers. Receipts are cash revenues. Revenues can also be represented by accounts receivable.

Risk—the possibility of loss; inherent in all business activities. High risk requires high return. All business decisions must consider the amount of risk involved.

Sales—amounts received or due for goods or services sold to customers. *Gross sales* are total sales before any returns or adjustments. *Net sales* are after accounting for returns and adjustments.

Stock—a certificate (or electronic or other record) that indicates ownership of a portion of a corporation; a share of stock. *Preferred stock* promises its owner a dividend that is usually fixed in amount or percent. Preferred shareholders get paid first out of any profits. They have preference. *Common stock* has no preference and no fixed rate of return. *Treasury stock* is originally issued to shareholders but that is subsequently acquired by the corporation. *Authorized by unissued stock* is stock that official corporate action has authorized but has not sold or issued. (Stock also means the stock of goods, the stock on hand, the inventory of a company.)

Sunk costs—money already spent and gone, which will not be recovered no matter what course of action is taken. Bad decisions are made when managers attempt to recoup sunk costs.

Trial balance—at the close of an accounting period, the transactions posted in the ledger are added up. A test or trial balance sheet is prepared with assets on one side and liabilities and capital on the other. The two sides should balance. If they don't, the accountants must search through the transactions to find out why. They keep making trial balances until the balance sheet balances.

Variable cost—a cost that changes as sales or production change. If a business is producing nothing and selling nothing, the variable cost should be zero. However, there will probably be fixed costs.

Working capital—current assets minus current liabilities. In most businesses the major components of working capital are cash, accounts receivable, and inventory minus accounts payable. As a business grows, it will have larger accounts receivable and more inventories. Thus the need for working capital will increase.

Write-down—the partial reduction in the value of an asset, recognizing obsolescence or other losses in value.

Write-offs—the total reduction in the value of an asset, recognizing that it no longer has any value. Write downs and write-offs are noncash expenses that affect profits.

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Accounting for People Who Think They Hate Accounting

Anurag Singal

Financial statements serve as a report card for a business through which managers and entrepreneurs can know their exact financial positions. These financial statements are prepared only through financial accounting. The main purpose of financial accounting is to help entrepreneurs exercise control over their business activities by controlling total costs incurred so that they are able to earn higher profits.

So, in order to understand where exactly the business stands financially, knowledge of financial accounting is imperative.

What is financial accounting?

Why do I need to understand it?

How will it help me in my business?

Why is it important to me? Or

Is it important to me?

These are some of the questions that surface in the minds of young and aspiring entrepreneurs when they start their business or are on the verge of starting one. This book aims to answer them in the most practical and comprehensible manner possible so that accounting is no longer a nightmare for them.

Anurag Singal is a chartered accountant and an MBA from IIM Ahmedabad. He secured All India Rank 22 and 25 in CA Final and CA PE-II respectively, having secured All India Highest in Mathematics in CA PE-I. He received the “CA Professional Achiever-Manufacturing Sector” at the 6th ICAI Awards in February 2013 for his professional contribution across his stints across leading corporate houses in India. He graduated from IIM Ahmedabad in the year 2015 after successfully completing his PGPX.

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