

## UNIT - V

### INTRODUCTION TO FINANCIAL ACCOUNTING CONCEPTS

#### Synopsis:

1. Introduction
2. Book-keeping and Accounting
3. Function of an Accountant
4. Users of Accounting
5. Advantages of Accounting
6. Limitations of Accounting
7. Basic Accounting concepts

#### 1. INTRODUCTON

As you are aware, every trader generally starts business for purpose of earning profit. While establishing business, he brings own capital, borrows money from relatives, friends, outsiders or financial institutions. Then he purchases machinery, plant , furniture, raw materials and other assets. He starts buying and selling of goods, paying for salaries, rent and other expenses, depositing and withdrawing cash from bank. Like this he undertakes innumerable transactions in business. Observe the following transactions of small trader for one week during the month of July, 1998.

1998		Rs.
July 24	Purchase of goods from Sree Ram	12,000
July 25	Goods sold for cash	5,000
July 25	Sold gods to Syam on credit	8,000
July 26	Advertising expenses	5,200
July 27	Stationary expenses	600
July 27	Withdrawal for personal use	2,500
July 28	Rent paid through cheque	1,000
July 31	Salaries paid	9,000
July 31	Received cash from Syam	5,000

The number of transactions in an organization depends upon the size of the organization. In small organizations, the transactions generally will be in thousand and in big organizations they may be in lakhs. As such it is humanly impossible to

remember all these transactions. Further, it may not be possible to find out the final result of the business without recording and analyzing these transactions.

Accounting came into practice as an aid to human memory by maintaining a systematic record of business transactions.

### **1.1 History of Accounting:**

Accounting is as old as civilization itself. From the ancient relics of Babylon, it can be well proved that accounting did exist as long as 2600 B.C. However, in modern form accounting based on the principles of Double Entry System came into existence in 17<sup>th</sup> Century. Fra Luca Paciolo, a Franciscan monk and mathematician published a book *De computis et scripturis* in 1494 at Venice in Italy. This book was translated into English in 1543. In this book he covered a brief section on 'book-keeping'.

### **1.2 Origin of Accounting in India:**

Accounting was practiced in India thousand years ago and there is a clear evidence for this. In his famous book *Arthashastra* Kautilya dealt with not only politics and economics but also the art of proper keeping of accounts. However, the accounting on modern lines was introduced in India after 1850 with the formation of joint stock companies in India.

Accounting in India is now a fast developing discipline. The two premier Accounting Institutes in India viz., Chartered Accountants of India and the Institute of Cost and Works Accountants of India are making continuous and substantial contributions. The International Accounts Standards Committee (IASC) was established as on 29<sup>th</sup> June. In India the 'Accounting Standards Board (ASB)' is formulating 'Accounting Standards' on the lines of standards framed by International Accounting Standards Committee.

## **2. BOOK-KEEPING AND ACCOUNTING**

According to G.A. Lee the accounting system has two stages.

1. The making of routine records in the prescribed form and according to set rules of all events which affect the financial state of the organization; and

2. The summarization from time to time of the information contained in the records, its presentation in a significant form to interested parties and its interpretation as an aid to decision making by these parties.

First stage is called Book-Keeping and the second one is Accounting.

**Book – Keeping:** Book – Keeping involves the chronological recording of financial transactions in a set of books in a systematic manner.

**Accounting:** Accounting is concerned with the maintenance of accounts giving stress to the design of the system of records, the preparation of reports based on the recorded date and the interpretation of the reports.

### **Distinction between Book – Keeping and Accountancy**

Thus, the terms, book-keeping and accounting are very closely related, through there is a subtle difference as mentioned below.

**1. Object :** The object of book-keeping is to prepare original books of Accounts. It is restricted to journal, subsidiary book and ledge accounts only. On the other hand, the main object of accounting is to record analyse and interpret the business transactions.

**2. Level of Work:** Book-keeping is restricted to level of work. Clerical work is mainly involved in it. Accountancy on the other hand, is concerned with all level of management.

**3. Principles of Accountancy:** In Book-keeping Accounting concepts and conventions will be followed by all without any difference. On the other hand, various firms follow various methods of reporting and interpretation in accounting.

**3. Final Result:** In Book-Keeping it is not possible to know the final result of business every year,

### **2.1 Meaning of Accounting**

Thus, book-keeping is an art of recording the business transactions in the books of original entry and the ledges. Accountancy begins where Book-keeping ends. Accountancy means the compilation of accounts in such a way that one is in a position to know the state of affairs of the business. The work of an accountant is to analyse, interpret and review the accounts and draw conclusion with a view to guide the management in chalking out the future policy of the business.

## 2.2 Definition of Accounting:

**Smith and Ashburne:** "Accounting is a means of measuring and reporting the results of economic activities."

**R.N. Anthony:** "Accounting system is a means of collecting summarizing, analyzing and reporting in monetary terms, the information about the business."

**American Institute of Certified Public Accountants (AICPA):** "The art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events, which are in part at least, of a financial character and interpreting the results thereof."

Thus, accounting is an art of identifying, recording, summarizing and interpreting business transactions of financial nature. Hence accounting is the **Language of Business.**

## 2.3 Branches of Accounting:

The important branches of accounting are:

- 1. Financial Accounting:** The purpose of Accounting is to ascertain the financial results i.e. profit or loss in the operations during a specific period. It is also aimed at knowing the financial position, i.e. assets, liabilities and equity position at the end of the period. It also provides other relevant information to the management as a basis for decision-making for planning and controlling the operations of the business.
- 2. Cost Accounting:** The purpose of this branch of accounting is to ascertain the cost of a product / operation / project and the costs incurred for carrying out various activities. It also assist the management in controlling the costs. The necessary data and information are gathered from financial and other sources.
- 3. Management Accounting :** Its aim to assist the management in taking correct policy decision and to evaluate the impact of its decisions and actions. The data required for this purpose are drawn from accounting and cost-accounting.
- 4. Inflation Accounting :** It is concerned with the adjustment in the values of assets and of profit in light of changes in the price level. In a way it is concerned with the overcoming of limitations that arise in financial statements on account of the cost assumption (i.e recording of the assets at their historical or original cost) and the assumption of stable monetary unit.

- 5. Human Resource Accounting :** It is a branch of accounting which seeks to report and emphasize the importance of human resources in a company's earning process and total assets. It is concerned with the process of identifying and measuring data about human resources and communicating this information to interested parties. In simple words, it is accounting for people as organizational resources.

### **3. FUNCTIONS OF AN ACCOUNTANT**

The job of an accountant involves the following types of accounting works :

- 1. Designing Work :** It includes the designing of the accounting system, basis for identification and classification of financial transactions and events, forms, methods, procedures, etc.
- 2. Recording Work :** The financial transactions are identified, classified and recorded in appropriate books of accounts according to principles. This is "Book Keeping". The recording of transactions tends to be mechanical and repetitive.
- 3. Summarizing Work :** The recorded transactions are summarized into significant form according to generally accepted accounting principles. The work includes the preparation of profit and loss account, balance sheet. This phase is called 'preparation of final accounts'
- 4. Analysis and Interpretation Work:** The financial statements are analysed by using ratio analysis, break-even analysis, funds flow and cash flow analysis.
- 5. Reporting Work:** The summarized statements along with analysis and interpretation are communicated to the interested parties or whoever has the right to receive them. For Ex. Share holders. In addition, the accounting departments has to prepare and send regular reports so as to assist the management in decision making. This is 'Reporting'.
- 6. Preparation of Budget :** The management must be able to reasonably estimate the future requirements and opportunities. As an aid to this process, the accountant has to prepare budgets, like cash budget, capital budget, purchase budget, sales budget etc. this is 'Budgeting'.
- 7. Taxation Work :** The accountant has to prepare various statements and returns pertaining to income-tax, sales-tax, excise or customs duties etc., and file the returns with the authorities concerned.

**8. Auditing :** It involves a critical review and verification of the books of accounts statements and reports with a view to verifying their accuracy. This is 'Auditing'

This is what the accountant or the accounting department does. A person may be placed in any part of Accounting Department or MIS (Management Information System) Department or in small organization, the same person may have to attend to all this work.

#### **4. USERS OF ACCOUNTING INFORMATION**

Different categories of users need different kinds of information for making decisions. The users of accounting can be divided in two board groups (1). Internal users and (2). External users.

##### **4.1 Internal Users:**

**Managers :** These are the persons who manage the business, i.e. management at the top, middle and lower levels. Their requirements of information are different because they make different types of decisions.

Accounting reports are important to managers for evaluating the results of their decisions. In additions to external financial statements, managers need detailed internal reports either branch division or department or product-wise. Accounting reports for managers are prepared much more frequently than external reports.

Accounting information also helps the managers in appraising the performance of subordinates. As such Accounting is termed as " the eyes and ears of management."

##### **4.2 External Users :**

**1. Investors :** Those who are interested in buying the shares of company are naturally interested in the financial statements to know how safe the investment already made is and how safe the proposed investments will be.

**2. Creditors :** Lenders are interested to know whether their load, principal and interest, will be paid when due. Suppliers and other creditors are also interested to know the ability of the firm to pay their dues in time.

**3. Workers :** In our country, workers are entitled to payment of bonus which depends on the size of profit earned. Hence, they would like to be satisfied that the bonus being paid to them is correct. This knowledge also helps them in conducting negotiations for wages.

**4. Customers :** They are also concerned with the stability and profitability of the enterprise. They may be interested in knowing the financial strength of the company to rent it for further decisions relating to purchase of goods.

**5. Government:** Governments all over the world are using financial statements for compiling statistics concerning business which, in turn, helps in compiling national accounts. The financial statements are useful for tax authorities for calculating taxes.

**6. Public :** The public at large interested in the functioning of the enterprises because it may make a substantial contribution to the local economy in many ways including the number of people employed and their patronage to local suppliers.

**7. Researchers:** The financial statements, being a mirror of business conditions, is of great interest to scholars undertaking research in accounting theory as well as business affairs and practices.

## 5. ADVANTAGES FROM ACCOUNTING

The role of accounting has changed from that of a mere record keeping during the 1<sup>st</sup> decade of 20<sup>th</sup> century of the present stage, which it is accepted as information system and decision making activity. The following are the advantages of accounting.

- 1. Provides for systematic records:** Since all the financial transactions are recorded in the books, one need not rely on memory. Any information required is readily available from these records.
- 2. Facilitates the preparation of financial statements:** Profit and loss account and balance sheet can be easily prepared with the help of the information in the records. This enables the trader to know the net result of business operations (i.e. profit / loss) during the accounting period and the financial position of the business at the end of the accounting period.
- 3. Provides control over assets:** Book-keeping provides information regarding cash in hand, cash at bank, stock of goods, accounts receivables from various parties and the amounts invested in various other assets. As the trader knows the values of the assets he will have control over them.
- 4. Provides the required information:** Interested parties such as owners, lenders, creditors etc., get necessary information at frequent intervals.
- 5. Comparative study:** One can compare the present performance of the organization with that of its past. This enables the managers to draw useful conclusion and make proper decisions.

- 6. Less Scope for fraud or theft:** It is difficult to conceal fraud or theft etc., because of the balancing of the books of accounts periodically. As the work is divided among many persons, there will be check and counter check.
- 7. Tax matters:** Properly maintained book-keeping records will help in the settlement of all tax matters with the tax authorities.
- 8. Ascertaining Value of Business:** The accounting records will help in ascertaining the correct value of the business. This helps in the event of sale or purchase of a business.
- 9. Documentary evidence:** Accounting records can also be used as an evidence in the court to substantiate the claim of the business. These records are based on documentary proof. Every entry is supported by authentic vouchers. As such, Courts accept these records as evidence.
- 10. Helpful to management:** Accounting is useful to the management in various ways. It enables the management to assess the achievement of its performance. The weakness of the business can be identified and corrective measures can be applied to remove them with the help of accounting.

## **6. LIMITATIONS OF ACCOUNTING**

The following are the limitations of accounting.

- 1. Does not record all events:** Only the transactions of a financial character will be recorded under book-keeping. So it does not reveal a complete picture about the quality of human resources, locational advantage, business contacts etc.
- 2. Does not reflect current values:** The data available under book-keeping is historical in nature. So they do not reflect current values. For instance, we record the value of stock at cost price or market price, whichever is less. In case of building, machinery etc., we adopt historical cost as the basis. In fact, the current values of buildings, plant and machinery may be much more than what is recorded in the balance sheet.
- 3. Estimates based on Personal Judgment:** The estimate used for determining the values of various items may not be correct. For example, debtors are estimated in terms of collectibility, inventories are based on marketability, and fixed assets are based on useful working life. These estimates are based on personal judgment and hence sometimes may not be correct.
- 4. Inadequate information on costs and Profits:** Book-keeping only provides information about the overall profitability of the business. No information is given about the cost and profitability of different activities of products or divisions.



## FINAL ACCOUNTS

**INTRODUCTION:** The main object of any Business is to make profit. Every trader generally starts business for the purpose of earning profit. While establishing Business, he brings his own capital, borrows money from relatives, friends, outsiders or financial institutions, then purchases machinery, plant, furniture, raw materials and other assets. He starts buying and selling of goods, paying for salaries, rent and other expenses, depositing and withdrawing cash from Bank. Like this he undertakes innumerable transactions in Business.

The number of Business transactions in an organization depends up on the size of the organization. In small organizations the transactions generally will be in thousands and in big organizations they may be in lacks. As such it is humanly impossible to remember all these transactions. Further it may not be possible to find out the final result of the Business with out recording and analyzing these transactions.

Accounting came in practice as an aid to human memory by maintaining a systematic record of Business transactions.

### **BOOK KEEPING AND ACCOUNTING:**

According to G.A.Lee the Accounting system has two stages. First stage is Book keeping and the second stage is accounting.

#### [A]. **BOOK KEEPING:**

Book keeping involves the chronological recording of financial transactions in a set of books in a systematic manner

“Book keeping is the system of recording Business transactions for the purpose of providing reliable information to the owners and managers about the state and prospect of the Business concepts”.

Thus Book keeping is an art of recording business transactions in the books of original entry and the ledges.

[B]. **ACCOUNTING:** Accounting begins where the Bookkeeping ends

1. **SMITH AND ASHBUNNE:** Accounting means “measuring and reporting the results of economic activities”.

2. **R.N ANTHONY:** Accounting is a system of “collecting, summarizing, Analyzing and reporting in monster terms, the information about the Business”.

3. **ICPA:** Recording, classifying and summarizing is a significant manner and in terms of money transactions and events, which are in part at least, of a financial character and interpreting the results there.

Thus accounting is an art of recording, classifying, summarizing and interpreting business transactions of financial nature. Hence accounting is the "Language of Business".

### **ADVANTAGE OF ACCOUNTING**

The following are the advantages of Accounting.....

1. **PROVIDES FOR SYSTEMATIC RECORDS:** Since all the financial transactions are recorded in the books, one need not rely on memory. Any information required is readily available from these records.
2. **FACILITATES THE PRPARATION OF FINANCIAL STATEMENTS:** Profit and Loss account and balance sheet can be easily prepared with the help of the information in the records. This enables the trader to know the net result of Business operations (i.e. profit/loss) during the accounting period and the financial position of the business at the end of the accounting period.
3. **PROVIDES CONTROL OVER ASSETS:** Book keeping provides information regarding cash in hand, cash at hand, stack of goods, accounts receivable from various parties and the amounts invested in various other assets. As the trader knows the values of the assets he will have control over them.
4. **PROVIES THE REQUIRED INFORMATION:** Interested parties such as owners, lenders, creditors etc, get necessary information at frequent intervals.
5. **COMPARITIVE STUDY:** One can compare present performance of the organization with that of its past. This enables the managers to draw useful conclusions and make proper decisions.
6. **LESS SCOPE FOR FRAUD OR THEFT:** It is difficult to conceal fraud or theft etc. because of the balancing of the books of accounts periodically. As the work is divided among many persons, there will be check and counter check.
7. **TAX MATLERS:** Properly maintained Book keeping records will help in the settlement of all tax matters with the tax authorities.
8. **ASCERTAINING VALUE OF BUSINESS:** The accounting records will help in ascertaining the correct value of the Business. This helps in the event of sale or purchase of a business.
9. **DOCUMENTARY EVIDENCE:** Accounting records can also be used as evidence in the court of substantial the claim of the Business. Thus records are based on

documentary proof. Authentic vouchers support every entry. As such, courts accept these records as evidence.

10. **HELPFUL TO MANAGEMENT:** Accounting is useful to the management in various ways. It enables the management to assess the achievement of its performance. The weaknesses of the business can be identified and corrective measures can be applied to remove them with the help of accounting.

### **LIMITATIONS OF ACCOUNTING**

The following are the limitations of accounting.....

1. **DOES NOT RECORD ALL EVENTS:** Only the transactions of a financial character will be recorded under book keeping. So it does not reveal a complete picture about the quality of human resources, locational advantages, business contacts etc.

2. **DOES NOT REFLECT CURRENT VLAUES:** The data available under book keeping is historical in nature. So they do not reflect current values. For instance we record the values of stock at cost price or market price, which ever is less. In case of building, machinery etc., we adapt historical case as the basis. Infact, the current values of Buildings, plant and machinery may be much more than what is recorded in the balance sheet.

3. **ESTIMATES BASED ON PERSONAL JUDGEMENT:** The estimates used for determining the values of various items may not be correct. For example, debtors are estimated in terms of collectibles, inventories are based on marketability and fixed assets are based on useful working life. These estimates are based on personal judgment and hence sometimes may not be correct.

4. **INADEQUATE INFORMATION ON COSTS AND PROFITS:** Book keeping only provides information about over all profitability of the business. No information is given about the cost and profitability of different activities of products or divisions.

### **BASIC ACCOUNTING CONCEPTS**

Accounting is a system evolved to achieve a set of objectives. In order to achieve the goals, we need a set of rules or guidelines. These guidelines are termed here as "BASIC ACCOUNTING ONCEPTS". The term concept means an idea or thought. Basic accounting concepts are the fundamental ideas or basic assumptions underlying the theory and profit of FINANCIAL ACCOUNTING. These concepts help in bringing about uniformity in the practice of accounting. In accountancy following concepts are quite popular.

1. **BUSINESS ENTITY CONCEPT:** In this concept "Business is treated as separate from the proprietor". All the Transactions recorded in the book of Business and not in the books of proprietor. The proprietor is also treated as a creditor for the Business.
  
2. **GOING CONCERN CONCEPT:** This concept relates with the long life of Business. The assumption is that business will continue to exist for unlimited period unless it is dissolved due to some reasons or the other.
  
3. **MONEY MEASUREMENT CONCEPT:** In this concept "Only those transactions are recorded in accounting which can be expressed in terms of money, those transactions which can not be expressed in terms of money are not recorded in the books of accounting".
  
4. **COST CONCEPT:** Accounting to this concept, an asset is recorded at its cost in the books of account. i.e., the price, which is paid at the time of acquiring it. In balance sheet, these assets appear not at cost price every year, but depreciation is deducted and they appear at the amount, which is cost, less classification.
  
5. **ACCOUNTING PERIOD CONCEPT:** every Businessman wants to know the result of his investment and efforts after a certain period. Usually one-year period is regarded as an ideal for this purpose. This period is called Accounting Period. It depends on the nature of the business and object of the proprietor of business.
  
6. **DUAL ASPECT CONCEPT:** According to this concept "Every business transactions has two aspects", one is the receiving benefit aspect another one is giving benefit aspect. The receiving benefit aspect is termed as "DEBIT", where as the giving benefit aspect is termed as "CREDIT". Therefore, for every debit, there will be corresponding credit.
  
7. **MATCHING COST CONCEPT:** According to this concept "The expenses incurred during an accounting period, e.g., if revenue is recognized on all goods sold during a period, cost of those goods sold should also Be charged to that period.
  
8. **REALISATION CONCEPT:** According to this concept revenue is recognized when a sale is made. Sale is Considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay.

### **ACCOUNTING CONVENTIONS**

Accounting is based on some customs or usages. Naturally accountants here to adopt that usage or custom.

They are termed as convert conventions in accounting. The following are some of the important accounting conventions.

1. **FULL DISCLOSURE:** According to this convention accounting reports should disclose fully and fairly the information. They purport to represent. They should be prepared honestly and sufficiently disclose information which is if material interest to proprietors, present and potential creditors and investors. The companies ACT, 1956 makes it compulsory to provide all the information in the prescribed form.

2. **MATERIALITY:** Under this convention the trader records important factor about the commercial activities. In the form of financial statements if any unimportant information is to be given for the sake of clarity it will be given as footnotes.

3. **CONSISTENCY:** It means that accounting method adopted should not be changed from year to year. It means that there should be consistent in the methods or principles followed. Or else the results of a year Cannot be conveniently compared with that of another.

4. **CONSERVATISM:** This convention warns the trader not to take unrealized income in to account. That is why the practice of valuing stock at cost or market price, which ever is lower is in vague. This is the policy of "playing safe"; it takes in to consideration all prospective losses but leaves all prospective profits.

### **KEY WORDS IN BOOK-KEEPING**

1. **TRANSACTIONS:** Any sale or purchase of goods of services is called the transaction.

Transactions are two types.

[a]. cash transaction: cash transaction is one where cash receipt or payment is involved in the exchange.

[b]. Credit transaction: Credit transaction will not have cash, either received or paid, for something given or received respectively.

2. **GOODS:** Fill those things which a firm purchases for resale are called goods.

3. **PURCHASES:** Purchases means purchase of goods, unless it is stated otherwise it also represents the

Goods purchased.

**4.SALES:** Sales means sale of goods, unless it is stated otherwise it also represents these goods sold.

**5.EXPENSES:** Payments for the purchase of goods as services are known as expenses.

**6.REVENUE:** Revenue is the amount realized or receivable from the sale of goods or services.

**7.ASSETS:** The valuable things owned by the business are known as assets. These are the properties  
Owned by the business.

**8.LIABILITIES:** Liabilities are the obligations or debts payable by the enterprise in future in the term  
Of money or goods.

**9. DEBTORS:** Debtors means a person who owes money to the trader.

10.**CREDITORS:** A creditor is a person to whom something is owned by the business.

**11.DRAWINGS:** cash or goods withdrawn by the proprietor from the Business for his personal or Household is termed to as "drawing".

**12.RESERVE:** An amount set aside out of profits or other surplus and designed to meet contingencies.

**13.ACCOUNT:** A summarized statements of transactions relating to a particular person, thing,  
Expense or income.

**14.DISCOUNT:** There are two types of discounts..  
a. cash discount: An allowable made to encourage frame payment or before the expiration of the period allowed for credit.  
b. Trade discount: A deduction from the gross or catalogue price allowed to traders who buys them for resale.

### **CLASSIFICATION OF BUSINESS TRANSACTIONS**

All business transactions are classified into three categories:

1. Those relating to persons
2. Those relating to property (Assets)
3. Those relating to income & expenses

Thus, three classes of accounts are maintained for recording all business transactions. They are:

1. Personal accounts
2. Real accounts
3. Nominal accounts

**1. Personal Accounts** :Accounts which are transactions with persons are called "Personal Accounts" .

A separate account is kept on the name of each person for recording the benefits received from ,or given to the person in the course of dealings with him.

E.g.: Krishna's A/C, Gopal's A/C, SBI A/C, Nagarjuna Finance Ltd.A/C, ObulReddy & Sons A/C , HMT Ltd. A/C, Capital A/C, Drawings A/C etc.

**2. Real Accounts**: The accounts relating to properties or assets are known as "Real Accounts" .Every business needs assets such as machinery , furniture etc, for running its activities .A separate account is maintained for each asset owned by the business .

E.g.: cash A/C, furniture A/C, building A/C, machinery A/C etc.

**3. Nominal Accounts**: Accounts relating to expenses, losses, incomes and gains are known as "Nominal Accounts". A separate account is maintained for each item of expenses, losses, income or gain.

E.g.: Salaries A/C, stationery A/C, wages A/C, postage A/C, commission A/C, interest A/C, purchases A/C, rent A/C, discount A/C, commission received A/C, interest received A/C, rent received A/C, discount received A/C.

Before recording a transaction, it is necessary to find out which of the accounts is to be debited and which is to be credited. The following three different rules have been laid down for the three classes of accounts....

## **ACCOUNTING RULES**

**1. Personal Accounts**: The account of the person receiving benefit (receiver) is to be debited and the account of the person giving the benefit (given) is to be credited.

**Rule**: "Debit----The Receiver  
Credit---The Giver"

**2. Real Accounts**: When an asset is coming into the business, account of that asset is to be debited .When an asset is going out of the business, the account of that asset is to be credited.

**Rule**: "Debit----What comes in  
Credit---What goes out"

**3. Nominal Accounts:** When an expense is incurred or loss encountered, the account representing the expense or loss is to be debited . When any income is earned or gain made, the account representing the income of gain is to be credited.

**Rule:** “Debit---All expenses and losses  
Credit---All incomes and gains”

### **JOURNAL**

The first step in accounting therefore is the record of all the transactions in the books of original entry viz., Journal and then posting into ledges.

**JOURNAL:** The word Journal is derived from the Latin word ‘journ’ which means a day. Therefore, journal means a ‘day Book’ in day-to-day business transactions are recorded in chronological order.

Journal is treated as the book of original entry or first entry or prime entry. All the business transactions are recorded in this book before they are posted in the ledges. The journal is a complete and chronological(in order of dates) record of business transactions. It is recorded in a systematic manner. The process of recording a transaction in the journal is called “JOURNALISING”. The entries made in the book are called “Journal Entries”.

The proforma of Journal is given below.

Date	Particulars	L.F. no	Debit RS.	Credit RS.
1998 Jan 1	Purchases account to cash account (being goods purchased for cash)		10,000/-	10,000/-



## LEDGER

All the transactions in a journal are recorded in a chronological order. After a certain period, if we want to know whether a particular account is showing a debit or credit balance it becomes very difficult. So, the ledger is designed to accommodate the various accounts maintained the trader. It contains the final or permanent record of all the transactions in duly classified form. "A ledger is a book which contains various accounts." The process of transferring entries from journal to ledger is called "POSTING".

Posting is the process of entering in the ledger the entries given in the journal. Posting into ledger is done periodically, may be weekly or fortnightly as per the convenience of the business. The following are the guidelines for posting transactions in the ledger.

1. After the completion of Journal entries only posting is to be made in the ledger.
2. For each item in the Journal a separate account is to be opened. Further, for each new item a new account is to be opened.
3. Depending upon the number of transactions space for each account is to be determined in the ledger.
4. For each account there must be a name. This should be written in the top of the table. At the end of the name, the word "Account" is to be added.
5. The debit side of the Journal entry is to be posted on the debit side of the account, by starting with "TO".
6. The credit side of the Journal entry is to be posted on the debit side of the account, by starting with "BY".

### ***Proforma for ledger: LEDGER BOOK***

#### Particulars account

Date	Particulars	Lfno	Amount	Date	Particulars	Lfno	amount

#### sales account

Date	Particulars	Lfno	Amount	Date	Particulars	Lfno	amount

cash account

Date	Particulars	Lfno	Amount	Date	Particulars	Lfno	amount

**TRAIL BALANCE**

The first step in the preparation of final accounts is the preparation of trail balance. In the double entry system of book keeping, there will be credit for every debit and there will not be any debit without credit. When this principle is followed in writing journal entries, the total amount of all debits is equal to the total amount all credits.

A trail balance is a statement of debit and credit balances. It is prepared on a particular date with the object of checking the accuracy of the books of accounts. It indicates that all the transactions for a particular period have been duly entered in the book, properly posted and balanced. The trail balance doesn't include stock in hand at the end of the period. All adjustments required to be done at the end of the period including closing stock are generally given under the trail balance.

**DEFINITIONS:**

**SPICER AND POGLAR :** A trail balance is a list of all the balances standing on the ledger accounts and cash book of a concern at any given date.

**J.R.BATLIBOI:**

A trail balance is a statement of debit and credit balances extracted from the ledger with a view to test the arithmetical accuracy of the books.

Thus a trail balance is a list of balances of the ledger accounts' and cash book of a business concern at any given date.

**PROFORMA FOR TRAIL BALANCE:**

Trail balance for MR..... as on .....

NO	NAME OF ACCOUNT (PARTICULARS)	DEBIT AMOUNT(RS.)	CREDIT AMOUNT(RS.)

## Trail Balance

### Specimen of trial balance

1	Capital	Credit	Loan
2	Opening stock	Debit	Asset
3	Purchases	Debit	Expense
4	Sales	Credit	Gain
5	Returns inwards	Debit	Loss
6	Returns outwards	Debit	Gain
7	Wages	Debit	Expense
8	Freight	Debit	Expense
9	Transport expenses	Debit	Expense
10	Royalties on production	Debit	Expense
11	Gas, fuel	Debit	Expense
12	Discount received	Credit	Revenue
13	Discount allowed	Debit	Loss
14	Bas debts	Debit	Loss
15	Dab debts reserve	Credit	Gain
16	Commission received	Credit	Revenue
17	Repairs	Debit	Expense
18	Rent	Debit	Expense
19	Salaries	Debit	Expense
20	Loan Taken	Credit	Loan
21	Interest received	Credit	Revenue
22	Interest paid	Debit	Expense
23	Insurance	Debit	Expense
24	Carriage outwards	Debit	Expense
25	Advertisements	Debit	Expense
26	Petty expenses	Debit	Expense
27	Trade expenses	Debit	Expense
28	Petty receipts	Credit	Revenue
29	Income tax	Debit	Drawings
30	Office expenses	Debit	Expense
31	Customs duty	Debit	Expense
32	Sales tax	Debit	Expense
33	Provision for discount on debtors	Debit	Liability
34	Provision for discount on creditors	Debit	Asset
35	Debtors	Debit	Asset
36	Creditors	Credit	Liability

37	Goodwill	Debit	Asset
38	Plant, machinery	Debit	Asset
39	Land, buildings	Debit	Asset
40	Furniture, fittings	Debit	Asset
41	Investments	Debit	Asset
42	Cash in hand	Debit	Asset
43	Cash at bank	Debit	Asset
44	Reserve fund	Credit	Liability
45	Loan advances	Debit	Asset
46	Horse, carts	Debit	Asset
47	Excise duty	Debit	Expense
48	General reserve	Credit	Liability
49	Provision for depreciation	Credit	Liability
50	Bills receivable	Debit	Asset
51	Bills payable	Credit	Liability
52	Depreciation	Debit	Loss
53	Bank overdraft	Credit	Liability
54	Outstanding salaries	Credit	Liability
55	Prepaid insurance	Debit	Asset
56	Bad debt reserve	Credit	Revenue
57	Patents & Trademarks	Debit	Asset
58	Motor vehicle	Debit	Asset
59	Outstanding rent	Credit	Revenue

## FINAL ACCOUNTS

In every business, the business man is interested in knowing whether the business has resulted in profit or loss and what the financial position of the business is at a given time. In brief, he wants to know (i) The profitability of the business and (ii) The soundness of the business.

The trader can ascertain this by preparing the final accounts. The final accounts are prepared from the trial balance. Hence the trial balance is said to be the link between the ledger accounts and the final accounts. The final accounts of a firm can be divided into two stages. The first stage is preparing the trading and profit and loss account and the second stage is preparing the balance sheet.

### TRADING ACCOUNT

The first step in the preparation of final account is the preparation of trading account. The main purpose of preparing the trading account is to ascertain gross profit or gross loss as a result of buying and selling the goods.

*Trading account of MR..... for the year ended .....*

Particulars	Amount	Particulars	Amount
To opening stock	Xxxx	By sales    xxxx	
To purchases   xxxx		Less: returns   xxx	Xxxx
Less: returns   xx	Xxxx	By closing stock	Xxxx
To carriage inwards	Xxxx		
To wages	Xxxx		
To freight	Xxxx		
To customs duty, octroi	Xxxx		
To gas, fuel, coal, Water	Xxxx		
To factory expenses			
To other man. Expenses	Xxxx		
To productive expenses	Xxxx		
To gross profit c/d			
	Xxxx		Xxxx
	Xxxx		
	Xxxx		

Finally, a ledger may be defined as a summary statement of all the transactions relating to a person , asset, expense or income which have taken place during a given period of time. The up-to-date state of any account can be easily known by referring to the ledger.

**PROFIT AND LOSS ACCOUNT**

The business man is always interested in knowing his net income or net profit. Net profit represents the excess of gross profit plus the other revenue incomes over administrative, sales, Financial and other expenses. The debit side of profit and loss account shows the expenses and the credit side the incomes. If the total of the credit side is more, it will be the net profit. And if the debit side is more, it will be net loss.

PROFIT AND LOSS A/C OF MR.....FOR THE YEAR ENDED.....

PARTICULARS	AMOUNT	PARTICULARS	AMOUNT
TO office salaries	Xxxxxx	By gross profit b/d	Xxxxx
TO rent,rates,taxes	Xxxxx	Interest received	Xxxxx
TO Printing and stationery	Xxxxx	Discount received	Xxxx
TO Legal charges		Commission received	Xxxxx
Audit fee	Xxxx	Income from	
TO Insurance	Xxxx	investments	
TO General expenses	Xxxx	Dividend on shares	Xxxx
TO Advertisements	Xxxxx	Miscellaneous	Xxxx
TO Bad debts	Xxxx	investments	
TO Carriage outwards	Xxxx	Rent received	xxxx
TO Repairs	Xxxx		
TO Depreciation	Xxxxx		
TO interest paid	Xxxxx		
TO Interest on capital	Xxxxx		
TO Interest on loans	Xxxx		
TO Discount allowed	Xxxxx		
TO Commission	Xxxxx		
TO Net profit-----→ (transferred to capital a/c)	Xxxxx		
	xxxxxx		Xxxxxx

**BALANCE SHEET**

The second point of final accounts is the preparation of balance sheet. It is prepared often in the trading and profit, loss accounts have been compiled and closed. A balance sheet may be considered as a statement of the financial position of the concern at a given date.

**DEFINITION:** A balance sheet is an item wise list of assets, liabilities and proprietorship of a business at a certain state.

**J.R.botliboi:** A balance sheet is a statement with a view to measure exact financial position of a business at a particular date.

Thus, Balance sheet is defined as a statement which sets out the assets and liabilities of a business firm and which serves to ascertain the financial position of the same on any particular date. On the left-hand side of this statement, the liabilities and the capital are shown. On the right-hand side all the assets are shown. Therefore, the two sides of the balance sheet should be equal. Otherwise, there is an error somewhere.

BALANCE SHEET OF ..... AS ON .....

Liabilities and capital	Amount	Assets	Amount
Creditors	Xxxx	Cash in hand	Xxxx
Bills payable	Xxxx	Cash at bank	Xxxx
Bank overdraft	Xxxx	Bills receivable	Xxxx
Loans	Xxxx	Debtors	Xxxx
Mortgage	Xxxx	Closing stock	Xxxx
Reserve fund	Xxxx	Investments	Xxxx
Capital xxxxxx		Furniture and fittings	Xxxx
<u>Add:</u>		Plats&machinery	
Net Profit xxxx		Land & buildings	Xxxx
-----		Patents, tm	Xxxx
xxxxxxx		,copyrights	Xxxx
-----		Goodwill	
<u>Less:</u>		Prepaid expenses	Xxxx
Drawings xxxx	Xxxx	Outstanding incomes	Xxxx
-----	XXXX		XXXX

**Advantages:** The following are the advantages of final balance .

1. It helps in checking the arithmetical accuracy of books of accounts.
2. It helps in the preparation of financial statements.
3. It helps in detecting errors.
4. It serves as an instrument for carrying out the job of rectification of entries.
5. It is possible to find out the balances of various accounts at one place.

## **FINAL ACCOUNTS -- ADJUSTMENTS**

We know that business is a going concern. It has to be carried on indefinitely. At the end of every accounting year. The trader prepares the trading and profit and loss account and balance sheet. While preparing these financial statements, sometimes the trader may come across certain problems. The expenses of the current year may be still payable or the expenses of the next year have been prepaid during the current year. In the same way, the income of the current year still receivable and the income of the next year have been received during the current year. Without these adjustments, the profit figures arrived at or the financial position of the concern may not be correct. As such these adjustments are to be made while preparing the final accounts.

The adjustments to be made to final accounts will be given under the Trial Balance. While making the adjustment in the final accounts, the student should remember that "every adjustment is to be made in the final accounts twice i.e. once in trading, profit and loss account and later in balance sheet generally". The following are some of the important adjustments to be made at the time of preparing of final accounts:-

### **1. CLOSING STOCK :-**

(i) **If closing stock is given in Trail Balance:** It should be shown only in the balance sheet "Assets Side".

(ii) **If closing stock is given as adjustment :**

1. First, it should be posted at the credit side of "Trading Account".
2. Next, shown at the asset side of the "Balance Sheet".

### **2. OUTSTANDING EXPENSES :-**

(i) **If outstanding expenses given in Trail Balance:** It should be only on the liability side of Balance Sheet.

(ii) **If outstanding expenses given as adjustment :**

1. First, it should be added to the concerned expense at the debit side of profit and loss account or Trading Account.
2. Next, it should be added at the liabilities side of the Balance Sheet.

### **3. PREPAID EXPENSES :-**

(i) **If prepaid expenses given in Trial Balance:** It should be shown only in assets side of the Balance Sheet.



**(ii) If prepaid expense given as adjustment :**

1. First, it should be deducted from the concerned expenses at the debit side of profit and loss account or Trading Account.
2. Next, it should be shown at the assets side of the Balance Sheet.

**4. INCOME EARNED BUT NOT RECEIVED [OR] OUTSTANDING INCOME [OR] ACCURED INCOME :-**

(i) **If incomes given in Trial Balance:** It should be shown only on the assets side of the Balance Sheet.

**(ii) If incomes outstanding given as adjustment:**

1. First, it should be added to the concerned income at the credit side of profit and loss account.
2. Next, it should be shown at the assets side of the Balance sheet.

**5. INCOME RECEIVED IN ADVANCE: UNEARNED INCOME:-**

(i) **If unearned incomes given in Trail Balance :** It should be shown only on the liabilities side of the Balance Sheet.

**(ii) If unearned income given as adjustment :**

1. First, it should be deducted from the concerned income in the credit side of the profit and loss account.
2. Secondly, it should be shown in the liabilities side of the Balance Sheet.

**6. DEPRECIATION:-**

(i) **If Depreciation given in Trail Balance:** It should be shown only on the debit side of the profit and loss account.

**(ii) If Depreciation given as adjustment**

1. First, it should be shown on the debit side of the profit and loss account.
2. Secondly, it should be deducted from the concerned asset in the Balance sheet assets side.

**7. INTEREST ON LOAN [OR] CAPITAL :-**

(i) **If interest on loan (or) capital given in Trail balance** : It should be shown only on debit side of the profit and loss account.

**(ii) If interest on loan (or) capital given as adjustment :**

1. First, it should be shown on debit side of the profit and loss account.
2. Secondly, it should be added to the loan or capital in the liabilities side of the Balance Sheet.

**8. BAD DEBTS:-**

(i) **If bad debts given in Trail balance** : It should be shown on the debit side of the profit and loss account.

(ii) **If bad debts given as adjustment:**

1. First, it should be shown on the debit side of the profit and loss account.
2. Secondly, it should be deducted from debtors in the assets side of the Balance Sheet.

**9. INTEREST ON DRAWINGS :-**

(i) **If interest on drawings given in Trail balance:** It should be shown on the credit side of the profit and loss account.

(ii) **If interest on drawings given as adjustments :**

1. First, it should be shown on the credit side of the profit and loss account.
2. Secondly, it should be deducted from capital on liabilities side of the Balance Sheet.

**10. INTEREST ON INVESTMENTS :-**

(i) **If interest on the investments given in Trail balance :** It should be shown on the credit side of the profit and loss account.

(ii) **If interest on investments given as adjustments :**

1. First, it should be shown on the credit side of the profit and loss account.
2. Secondly, it should be added to the investments on assets side of the Balance Sheet.

**Note: Problems to be solved on final accounts**

**SUBSIDIARY BOOKS**

In a small business concern, the numbers of transactions are limited. These transactions are first recorded in the journal as and when they take place. Subsequently, these

transactions are posted in the appropriate accounts of the ledger. Therefore, the journal is known as "Book Of Original Entry" or "Book of Prime Entry" while the ledger is known as main book of accounts.

On the other hand, the transactions in big concern are numerous and sometimes even run into thousands and lakhs. It is inconvenient and time wasting process if all the transactions are going to be managed with a journal.

Therefore, a convenient device is made. Smaller account books known as subsidiary books or subsidiary journals are distributed to various sections of the business house. As and when transactions take place, they are recorded in these subsidiary books simultaneously without delay. The original journal (which is known as Journal Proper) is used only occasionally to record those transactions which cannot be recorded in any of the subsidiary books.

TYPES OF SUBSIDIARY BOOKS:-- Subsidiary books are divided into eight types. They are,

1. Purchases Book
2. Sales Book
3. Purchase Returns Book
4. Sales Returns Book
5. Cash Book
6. Bills Receivable Book
7. Bills Payable Book
8. Journal Proper

1. **PURCHASES BOOK** :- This book records all credit purchases only. Purchase of goods for cash and purchase of assets for cash. Credit will not be recorded in this book. Purchases book is otherwise called Purchases Day Book, Purchases Journal or Purchases Register.

2. **SALES BOOK** :-This book is used to record credit sales only. Goods are sold for cash and sale of assets for cash or credit will not be recorded in this book. This book is otherwise called Sales Day Book, Sales Journal or Sales Register.

3. **PURCHASE RETURNS BOOK** :- This book is used to record the particulars of goods returned to the suppliers .This book is otherwise called Returns Outward Book.

4. **SALES RETURNS BOOK** :- This book is used to record the particulars of goods returned by the customers. This book is otherwise called Returns Inward Book.

5. **CASH BOOK** :- All cash transactions , receipts and payments are recorded in this book. Cash includes cheques, money orders etc.

**6. BILLS RECEIVABLE BOOK** :- This book is used to record all the bills and promissory notes are received from the customers.

**7. BILLS PAYABLE BOOK** :- This book is used to record all the bills or promissory notes accepted to the suppliers.

**8. JOURNAL PROPER** :- This is used to record all the transactions that cannot be recorded in any of the above mentioned subsidiary books.

**FORMAT FOR PURCHASE BOOK**

Date	Name of supplier	Invoice No	Lf no	Details	Amount(Rs.)

**FORMAT FOR SALES BOOK**

Date	Name of customer	Invoice No	Lf no	Details	Amount(Rs.)

**FORMAT FOR PURCHASE RETURNS BOOK**

Date	Name of supplier	Debit note No	Lf no	Details	Amount(Rs.)

**FORMAT FOR SALES RETURNS BOOK**

Date	Name of supplier	Credit note No	Lf no	Details	Amount(Rs.)

# FINANCIAL ANALYSIS THROUGH RATIOS

## Ratio Analysis

Absolute figures are valuable but they standing alone convey no meaning unless compared with another. Accounting ratio show inter-relationships which exist among various accounting data. When relationships among various accounting data supplied by financial statements are worked out, they are known as accounting ratios.

### Accounting ratios can be expressed in various ways such as:

1. a pure ratio says ratio of current assets to current liabilities is 2:1 or
2. a rate say current assets are two times of current liabilities or
3. a percentage say current assets are 200% of current liabilities.

Each method of expression has a distinct advantage over the other the analyst will selected that mode which will best suit his convenience and purpose.

### Uses or Advantages or Importance of Ratio Analysis

Ratio Analysis stands for the process of determining and presenting the relationship of items and groups of items in the financial statements. It is an important technique of financial analysis. It is a way by which financial stability and health of a concern can be judged. The following are the main uses of Ratio analysis:

(a) **Useful in financial position analysis:** Accounting reveals the financial position of the concern. This helps banks, insurance companies and other financial institution in lending and making investment decisions.

(ii) **Useful in simplifying accounting figures:** Accounting ratios simplify, summaries and systematic the accounting figures in order to make them more understandable and in lucid form.

(iii) **Useful in assessing the operational efficiency:** Accounting ratios helps to have an idea of the working of a concern. The efficiency of the firm becomes evident when analysis is based on accounting ratio. This helps the management to assess financial requirements and the capabilities of various business units.

(iv) **Useful in forecasting purposes:** If accounting ratios are calculated for number of years, then a trend is established. This trend helps in setting up future plans and forecasting.

(v) **Useful in locating the weak spots of the business:** Accounting ratios are of great assistance in locating the weak spots in the business even through the overall performance may be efficient.

**(vi) Useful in comparison of performance:** Managers are usually interested to know which department performance is good and for that he compare one department with the another department of the same firm. Ratios also help him to make any change in the organisation structure.

**Limitations of Ratio Analysis:** These limitations should be kept in mind while making use of ratio analyses for interpreting the financial statements. The following are the main limitations of ratio analysis.

1. **False results if based on incorrect accounting data:** Accounting ratios can be correct only if the data (on which they are based) is correct. Sometimes, the information given in the financial statements is affected by window dressing, i. e. showing position better than what actually is.
2. **No idea of probable happenings in future:** Ratios are an attempt to make an analysis of the past financial statements; so they are historical documents. Now-a-days keeping in view the complexities of the business, it is important to have an idea of the probable happenings in future.
3. **Variation in accounting methods:** The two firms' results are comparable with the help of accounting ratios only if they follow the some accounting methods or bases. Comparison will become difficult if the two concerns follow the different methods of providing depreciation or valuing stock.
4. **Price level change:** Change in price levels make comparison for various years difficult.
5. **Only one method of analysis:** Ratio analysis is only a beginning and gives just a fraction of information needed for decision-making so, to have a comprehensive analysis of financial statements, ratios should be used along with other methods of analysis.
6. **No common standards:** It is very difficult to by down a common standard for comparison because circumstances differ from concern to concern and the nature of each industry is different.
7. **Different meanings assigned to the some term:** Different firms, in order to calculate ratio may assign different meanings. This may affect the calculation of ratio in different firms and such ratio when used for comparison may lead to wrong conclusions.
8. **Ignores qualitative factors:** Accounting ratios are tools of quantitative analysis only. But sometimes qualitative factors may surmount the quantitative aspects. The calculations derived from the ratio analysis under such circumstances may get distorted.
9. **No use if ratios are worked out for insignificant and unrelated figure:** Accounting ratios should be calculated on the basis of cause and effect relationship. One should be clear as to what cause is and what effect is before calculating a ratio between two figures.

## RATIO ANALYSIS

Ratio is an expression of one number in relation to another. It is one of the methods of analyzing financial statements. Ratio analysis facilitates the presentation of the information of the financial statements in simplified and summarized form. Ratio is a measuring of two numerical positions. It expresses the relation between two numeric figures. It can be found by dividing one figure by another. Ratios are expressed in three ways.

1. Jones method
2. Ratio Method
3. Percentage Method

### CLASSIFICATION OF RATIOS

All the ratios are broadly classified into four types due to the interest of different parties for different purposes. They are:

- I. Profitability ratios
- II. Activity ratios or Turn over ratios
- III. Liquidity or Financial ratios
- IV. Leverage ratios

1. **Profitability ratios:** These ratios are calculated to understand the profit positions of the business. These ratios measure the profit earning capacity of an enterprise. These ratios can be related to sales or capital to a certain margin on sales or profitability of capital employed. These ratios are of interest to management. Who are responsible for success and growth of enterprise? Owners as well as financiers are interested in profitability ratios as these reflect the ability of enterprises to generate return on capital employed. Important profitability ratios are:

Profitability ratios in relation to sales: Profitability ratios are almost the most important of concern. These ratios are calculated to focus the end results of the business activities which are the sole criterion of overall efficiency of organization.

1. **Gross profit ratio:**  $\frac{\text{gross profit}}{\text{Net sales}} \times 100$

Note: Higher the ratio the better it is

2. **Net profit ratio:**  $\frac{\text{Net profit after interest \& Tax}}{\text{Net sales}} \times 100$

Note: Higher the ratio the better it is

3. Operating ratio (Operating expenses ratio)

$$\frac{\text{Cost of goods sold} + \text{operating expenses}}{\text{Net sales}} \times 100$$

Net: Lower the ratio the better it is

4. Operating profit ratio:  $\frac{\text{Operating profit}}{\text{Net sales}} \times 100 = 100$  operating ratio

Note: Higher the ratio the better it is cost of goods sold = opening stock + purchase + wages + other direct expenses - closing stock (or) sales - gross profit.

Operating expenses:

= administration expenses + selling, distribution expenses operating profit = gross profit - operating expense.

$$\text{Expenses ratio} = \frac{\text{concern expense}}{\text{Net sales}} \times 100$$

Note: Lower the ratio the better it is

### **Profitability ratios in relation to investments:**

1. Return on investments:  $\frac{\text{Net profit after tax \& latest depreciation}}{\text{share holders funds}} \times 100$

Share holders funds = equity share capital + preference share capital + reserves & surpluses + undistributed profits.

Note: Higher the ratio the better it is

2. Return on equity capital:  $\frac{\text{Net Profit after tax \& interest} - \text{preference dividend}}{\text{equity share capital}} \times 100$

Note: Higher the ratio the better it is

3. Earnings per share =  $\frac{\text{Net profit after tax} - \text{preference dividend}}{\text{No. of equity shares}}$

4. Return on capital employed =  $\frac{\text{operating profit}}{\text{capital employed}} \times 100$

5. Return on total assets =  $\frac{\text{N. P. after tax and interest}}{\text{Total Assets}}$

Here, capital employed = equity share capital + preference share capital + reserves & surpluses + undistributed profits + debentures + public deposit + securities + long term loan + other long term liability - fictitious assets (preliminary expressed & profit & loss account debt balance)

## **II. Turn over ratios or activity ratios:**



These ratios measure how efficiency the enterprise employees the resources of assets at its command. They indicate the performance of the business. The performance if an enterprise is judged with its save. It means ratios are also laced efficiency ratios.

These ratios are used to know the turn over position of various things in the \_\_\_\_\_. The turnover ratios are measured to help the management in taking the decisions regarding the levels maintained in the assets, and raw materials and in the funds. These ratio s are measured in ratio method.

$$1. \text{ Stock turnover ratio} = \frac{\text{cost of goods sold}}{\text{average stock}}$$

Here,

$$\text{Average stock} = \frac{\text{opening stock} + \text{closing stock}}{2}$$

Note: Higher the ratio, the better it is

$$2. \text{ Working capital turnover ratio} = \frac{\text{sales}}{\text{working capital}}$$

Note: Higher the ratio the better it is working capital = current assets – essential liabilities.

$$3. \text{ Fixed assets turnover ratio} = \frac{\text{sales}}{\text{fixed assets}}$$

Note: Higher the ratio the better it is.

$$3 (i) \text{ Total assets turnover ratio is : } \frac{\text{sales}}{\text{total assets}}$$

Note: Higher the ratio the better it is.

$$4. \text{ Capital turnover ratio} = \frac{\text{Sales}}{\text{Capital employed}}$$

Note: Higher the ratio the better it is

$$5. \text{ Debtors turnover ratio} = \frac{\text{credits sales or sales}}{\text{average debtors}}$$

$$5(i) = \text{Debtors collection period} = \frac{365 \text{ (or) } 12}{\text{Turnove ratio}}$$

Here,

$$\text{Average debtors} = \frac{\text{opening debtors} + \text{closing bebtors}}{2}$$

Debtors = debtors + bills receivable

Note: Higher the ratio the better it is.

$$6. \text{ Creditors turnover ratio} = \frac{\text{credit purchasers or purchases}}{\text{average creditors}}$$

$$6 \text{ (i) creditors collection period} = \frac{365 \text{ (or) } 12}{\text{Creditor turnover ratio}}$$

Here,

$$\text{Average creditor} = \frac{\text{opening} + \text{closing creditors}}{2}$$

Creditors = creditors + bills payable.

Note: lower the ratio the better it is.

### **III. Financial ratios or liquidity ratios:**

Liquidity refers to ability of organisation to meet its current obligation. These ratios are used to measure the financial status of an organisation. These ratios help to the management to make the decisions about the maintained level of current assets & current liabilities of the business. The main purpose to calculate these ratios is to know the short terms solvency of the concern. These ratios are useful to various parties having interest in the enterprise over a short period – such parties include banks. Lenders, suppliers, employees and other.

The liquidity ratios assess the capacity of the company to repay its short term liabilities. These ratios are calculated in ratio method.

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

Note: The ideal ratio is 2:1

i. e., current assets should be twice. The current liabilities.

$$\text{Quick ratio or liquid ratio or acid test ratio: } \frac{\text{quick assets}}{\text{current liabilities}}$$

Quick assets = cash in hand + cash at bank + short term investments + debtors + bills receivables short term investments are also known as marketable securities.

Here the ideal ratio is 1:1 is, quick assets should be equal to the current liabilities.

$$\text{Absolute liquid ratio} = \frac{\text{absolute liquid assets}}{\text{current liabilities}}$$

Here,

Absolute liquid assets=cash in hand + cash at bank + short term investments + marketable securities.

Here, the ideal ratio is 0,0:1 or 1:2 it, absolute liquid assets must be half of current liabilities.

**IV. Leverage ratio of solvency ratios:** Solvency refers to the ability of a business to honour long term obligations like interest and installments associated with long term debts. Solvency ratios indicate long term stability of an enterprise. These ratios are used to understand the yield rate if the organisation.

Lenders like financial institutions, debenture, holders, banks are interested in ascertaining solvency of the enterprise. The important solvency ratios are:

$$1. \text{ Debt - equity ratio} = \frac{\text{outsiders funds}}{\text{share holders funds}} = \frac{\text{Debt}}{\text{Equity}}$$

Here,

Outsiders funds = Debentures, public deposits, securities, long term bank loans + other long term liabilities.

Share holders funds = equity share capital + preference share capital + reserves & surpluses + undistributed projects.

The ideal ratio is 2:1

$$2. \text{ Preprimary ratio or equity ratio} = \frac{\text{share holder funds}}{\text{total assets}}$$

The ideal ratio is 1:3 or 0.33:1

3. Capital – greasing ratio:

$$= \frac{(\text{equity share capital} + \text{reserves \& surpluses} + \text{undistributed projects})}{(\text{Outsiders funds} + \text{preference share capital})}$$

Here,

higher gearing ratio is not good for a new company or the company in which future earnings are uncertain.

$$11. \text{ Debt to total fund ratio} = \frac{\text{outsiders funds}}{\text{capital employed}}$$

Capital employed= outsiders funds + share holders funds = debt + equity.

The ideal ratio is 0.6.7 :1 or 2:3

## QUIZ

1. A company's 'return on investment' indicates its \_\_\_\_\_. ( )  
(a) Solvency (b) Stock turnover  
(c) Profitability (d) Debtors collection
2. Which would a business be most likely to use its 'solvency' ( )  
(a) Gross profit ratio (b) Debtors collection period  
(c) Debt – Equity ratio (d) Current ratio
3. Higher 'Assets turnover ratio' explains \_\_\_\_\_. ( )  
(a) More profitability (b) Higher sales turnover  
(c) Better utilization of assets (d) large liability base
4. Which of the following measures company's liquidity position ( )  
(a) Stock Turnover ratio (b) Debtor's collection period  
(c) Current ratio (d) Net profit ratio
5. The difference between current assets and current liabilities is called \_\_\_\_\_. ( )  
(a) Cost of goods sold (b) Outsiders funds  
(c) Working capital (d) Shareholders funds
6. Debtor's is a current asset, where as creditor's is \_\_\_\_\_. ( )  
(a) Fixed Asset (b) Fixed Liability  
(c) Current Liability (d) Long-term Liability
7. What is the Desirable current Ratio \_\_\_\_\_? ( )  
(a) 1:2 (b) 3:2 (c) 2:1 (d) 1:1
8. Long-term stability of an enterprise indicates by \_\_\_\_\_ ratios. ( )  
(a) Liquidity (b) Profitability  
(c) Solvency (d) Turnover
9. The Liquidity ratios assess the capacity of the company to repay  
Its \_\_\_\_\_ Liability. ( )  
(a) Long-term (b) Profitability  
(c) Solvency (d) Turnover
10. In which Book-keeping system, business transactions are recorded as  
two separate accounts at the same time? ( )  
(a) Single entry (b) Triple entry  
(c) Double entry (d) None
11. In which Concept "Business is treated separate from the Proprietor? ( )  
(a) Cost concept (b) Dual aspect concept  
(c) Business entity concept (d) Matching concept
12. When a deduction allowed from the gross or catalogue price to traders;  
then it is called as \_\_\_\_\_. ( )  
(a) Cash discount (b) Credit discount  
(c) Trade discount (d) None

13. "Out standing wages" is treated as \_\_\_\_\_. ( )  
 (a) Asset (b) Expense  
 (c) Liability (d) Income
14. How many types of accounts are maintained to record all types of business transactions? ( )  
 (a) Five (b) four  
 (c) Three (d) Two
15. Which connects the link between Journal and Trial Balance? ( )  
 (a) Trading Account (b) Profit & Loss account  
 (c) Ledger (d) Balance sheet
16. Which assets can be converted into cash in short period? ( )  
 (a) Fixed Assets (b) Intangible Assets  
 (c) Current Assets (d) Fictious Assets
17. "Bank over draft" is a \_\_\_\_\_. ( )  
 (a) Asset (b) Expense  
 (c) Liability (d) Income
18. Profit and Loss account is prepared to find out the business \_\_\_\_\_. ( )  
 (a) Gross result (b) Financial position  
 (c) Net result (d) Liquidity position
19. The statement of "Debit and credit balances of Ledger accounts" is called as \_\_\_\_\_. ( )  
 (a) Journal (b) Ledger  
 (c) Trial balance (d) Balance sheet
20. \_\_\_\_\_ is a person who owes money to the firm. ( )  
 (a) Creditor (b) Owner  
 (c) Debtor (d) Share holder
21. The statement reveals the financial positions of a business at any given date is called \_\_\_\_\_. ( )  
 (a) Trading account (b) Profit and loss account  
 (c) Balance sheet (d) Trial balance
22. \_\_\_\_\_ is called as 'Book of Original Entry'. ( )  
 (a) Ledger (b) Trial Balance  
 (c) Journal (d) Trading account
23. Debit what comes in; Credit what goes out is \_\_\_\_\_ account principle? ( )  
 (a) Nominal (b) Personal  
 (c) Real (d) None
24. The process of entering transactions in to Ledge accounts known as \_\_\_\_\_. ( )  
 (a) Journal entry (b) First entry  
 (c) Posting (d) None

25. Debit Expenses and Losses; Credit Incomes and Gains is \_\_\_\_ account Principle ( )  
 (a) Personal (b) Real  
 (c) Nominal (d) None
26. "Prepaid Insurance Premium" is treated as \_\_\_\_\_. ( )  
 (a) Gain (b) Income  
 (c) Asset (d) Liability
27. Acid Test Ratio is also called as \_\_\_\_\_. ( )  
 (a) Current Ratio (b) Absolute Liquid Ratio  
 (c) Quick Ratio (d) Debt-Equity Ratio
28. The relationship between two numerical values is called as \_\_\_\_\_. ( )  
 (a) Account (b) Ledger  
 (c) Ratio (d) Discount
29. "Gross Profit" can be found out by preparing \_\_\_\_\_. ( )  
 (a) Profit and Loss account (b) Balance sheet  
 (c) Trading account (d) Trial balance
30. "Net Profit" can be found out by preparing \_\_\_\_\_. ( )  
 (a) Trading account (b) Trial balance  
 (c) Profit and Loss account (d) Balance sheet

**Note: Answer is "C" for all the above questions.**