

Biyani's Think Tank

**Concept based notes**

# **Accountancy**

*(Class-XII)*

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## **Preface**

I am glad to present this book, especially designed to serve the needs of the students. The book has been written keeping in mind the general weakness in understanding the fundamental concepts of the topics. The book is self-explanatory and adopts the “Teach Yourself” style. It is based on question-answer pattern. The language of book is quite easy and understandable based on scientific approach.

Any further improvement in the contents of the book by making corrections, omission and inclusion is keen to be achieved based on suggestions from the readers for which the author shall be obliged.

I acknowledge special thanks to Mr. Rajeev Biyani, *Chairman* & Dr. Sanjay Biyani, *Director (Acad.)* Biyani Group of Colleges, who are the backbones and main concept provider and also have been constant source of motivation throughout this Endeavour. They played an active role in coordinating the various stages of this Endeavour and spearheaded the publishing work.

I look forward to receiving valuable suggestions from professors of various educational institutions, other faculty members and students for improvement of the quality of the book. The reader may feel free to send in their comments and suggestions to the under mentioned address.

**Author**

## **Theoretical Question**

### **Financial Statements of Not-For-Profit Organisations**

**Not-for-Profit organizations** refer to those organizations which:

- a) are formed for the purpose of promoting commerce, art, science, religion, charity or any other useful object.
- b) intend to spend their income in promoting their objectives, and
- c) prohibit the payment of any dividend to their members.

**Examples of Not for Profit Organisation.**

- 1. Sports Clubs                      2. charitable Hospitals                      3. Social Clubs
- 4. Charitable Schools              5. Charitable Schools/ Colleges
- 6. Temples/ Churches/ Gurudwaras/ Masjids

**Difference between a Profit seeking organisation and a Not-for-profit Organisation**

<b>Basis of Distinction</b>	<b>Profit Seeking Organisation</b>	<b>Not-for-Profit Organisation</b>
<b>1. Primary Motive</b>	The primary motive of such an entity is to earn profit	The Primary motive of such an entity is to provide services
<b>2.Owner's Fund Vs. Capital Fund</b>	Interest of owners is known as owner's fund which represents the owner's investments plus accumulated reserves and surplus	Interest of members is known as capital fund which represents the accumulated surplus of subscriptions, donations and net profits from activities carried on by such an entity.
<b>3. Net result of activities</b>	The net result of the activities of such an entity is known as the profit/loss.	The net result of the activities of such an entity is known as the surplus/deficit.
<b>4. Accounting Statements</b>	The accounting statements of such type of entity include <ul style="list-style-type: none"> <li>a) a Manufacturing A/C</li> <li>b) a Trading A/c</li> <li>c) a Profit and Loss A/.c</li> <li>d) a Balance Sheet</li> </ul>	The accounting statements of such an entity include: <ul style="list-style-type: none"> <li>a) a Receipts and Payments A/c</li> <li>b) a Trading A/c</li> <li>c) an Income and Expenditure A/c</li> <li>d) a Balance Sheet</li> </ul>

### **Fund based Accounting**

Fund based accounting essentially involves preparation of financial statements fund wise and consolidation of those statements to represent the financial results/ position of the organisation as a whole.

### **What is meant by Revenue Fund in a Not-for – Profit Organisation ?**

Revenue funds essentially record normal revenue transactions. In other words, revenue funds are received to meet operating expenses. The accrual basis of accounting is used to recognize revenue and expense in the revenue fund for Operating Funds). However, the use of revenue fund may be restricted or unrestricted.

### **What is meant by Special Funds in a Not-for-Profit Organisation?**

Special funds essentially record transactions of capital nature. These funds account for those resources which may not be currently expended.

### **What is meant by Receipts & Payments Account ?**

The 'Receipts & Payment Account' is an asset account ( or Real Account) which shows all receipts and payments ( whether Capital or Revenue or relating to Previous or Current or following accounting year) along with the Cash & Bank balances in the beginning and at the end of an accounting period.

### **What is meant by Income & Expenditure Account ?**

An Income and Expenditure Account is a final account like Profit & Loss Account, which shows the classified summary of revenue incomes, revenue expenses and losses for current accounting period along with surplus ( i.e. the excess of income over expenditure) or deficit ( i.e. excess of expenditure over income) which is transferred to the Capital Fund.

### **Differences between Receipts & Payments Account and Income & Expenditure Account**

<b>Basis of Distinction</b>	<b>Receipts &amp; Payments Account</b>	<b>Income &amp; Expenditure Account</b>
<b>1. Nature of Account</b>	It is a real account	It is a nominal account
<b>2. Basic Structure</b>	It is basically a summarised Cash Book.	It is like a Profit & Loss Account.
<b>3. Object</b>	It is prepared to present a summary of cash transactions during an accounting period	It is prepared to ascertain the net results of all the transactions during an accounting period.
<b>4. Opening Balance</b>	Opening balance represents cash or bank balances ( or Bank Overdraft) in the beginning of the accounting period.	It has no opening balance
<b>5. Items of Debit side</b>	It is debited with all the sums received.	It is debited with the expenses and losses .
<b>6. Items of Credit side</b>	It is credited with all the sums paid out.	It is credited with the incomes.

<b>7. Closing Balance</b>	Closing balance represents cash or bank balance {or bank overdraft} at the end of the accounting period.	Its closing balance Represents either net Surplus or net deficit.
<b>8. Treatment of Closing balance</b>	Its closing balance is Carried forward in the same Account of the next period.	Its closing balance is transferred to the capital fund in the balance sheet.
<b>9. Non-cash Items</b>	Non-cash items are not Shown in this account.	Non-cash items such as depreciation, bad debts, Etc., are shown.
<b>10. Period to which Items relate</b>	It records the receipts and payments whether they relate to previous, current or following accounting period.	It records only those incomes, expenses and losses which relate to current accounting period.
<b>11. nature of items Recorded-revenue Vs. capital</b>	It records the receipts and payments whether of capital or revenue nature.	It records the incomes, expenditures and losses of revenue nature.

#### **Differences between Profit and Loss Account and Income & Expenditure Account.**

<b>Basic of Distinction</b>	<b>Income &amp; Expenditure Account</b>	<b>Profit &amp; Loss Account</b>
<b>1. Object</b>	The main object of Income and Expenditure Account is to ascertain excess of income over expenditure or excess of expenditure over income.	The main object of Profit and Loss Account is to ascertain net profit or net loss
<b>2. Who Prepares ?</b>	This account is prepared by non-profit organisations	This account is prepared by trading institutions.
<b>3. Basis of Preparation</b>	This account is prepared on the basis of Receipts and Payments Account and other information	This account is prepared on the basis of trial balance.
<b>4. Balance</b>	The balance of this account represents surplus or deficit.	The balance of this account represents net profit or net loss.

#### **Method of calculating the current year's income by way of subscription**

Statement showing Computation of Subscriptions Income for the Current Year

Particulars

A.	Subscriptions received during the current year	Rs.
B.	Add :	xx
	(i) Outstanding Subscriptions at the end of current year	xx

	(ii) Advance subscriptions in the beginning of current year	xx	xx
C.	Less :		
	(i) Outstanding subscriptions in the beginning of current year	xx	
	(ii) Advance subscriptions at the end of current year	xx	xx
D.	Subscription Income to be credited to Income & Expenditure Account ( A+B-C)		xx

### How will you account for Life Membership Fees ?

Life Membership may be treated in any one of the following ways : -

(a) These subscriptions may be treated as a capital receipt and thus be transferred to a " Life membership Fund Account" which shall be shown in the Balance Sheet till the membership ceases when the same may be transferred to the Capital Fund Account.

(b) These subscriptions may be treated as deferred revenue receipts and thus be transferred to Life Membership Fund Account. In such a case, an amount representing the normal annual subscription is treated as a revenue receipt and thus transferred out of Life Membership Fund Account to Income & Expenditure Account and the balance appears in the Balance Sheet till the amount is exhausted or till the memberships ceases, whichever is earlier.

### How will you account for Entrance Fee/ Admission Fee ?

The entrance fees may be accounted for in any of the following three ways:

1. It may be treated exclusively as a revenue receipt and thus, be transferred to the credit of Income & Expenditure Account.
2. It may be treated exclusively as a capital receipt and thus, be added to the Capital Fund on the liabilities side of the Balance Sheet.
3. Some portion of Entrance Fee ( say 40% ) may be treated as a revenue receipt and thus, be transferred to the credit of Income & Expenditure Account and remaining portion ( say 60% ) may be treated as a capital receipt and thus, be added to the Capital Fund on the liabilities side of the Balance Sheet.

### How will you account for Donation & Legacies ?

Types of Donations and Legacies	Accounting Treatment
(a) General Donations and Legacies	(a) These donations & legacies are treated as revenue receipts and thus, are transferred to the credit of Income & Expenditure Account.
(b) Specific Donations	(b) These donations & legacies are treated as capital receipts and thus, are transferred to a ' Special Fund Account' (e.g., expenditure on the construction of building out of Building Fund) should be shown on the assets side of the Balance Sheet and an equal amount should be transferred from that Special Fund to the Capital Fund.

### Accounting Treatment in the absence of express provision in Partnership Deed



(a) Sharing of Profits & Losses	- Profits & Losses are to be shared equally ( Sec 13 (b)
(b) Interest on Capital	- No interest is to be allowed on Capital ( Sec 13 (c)
(c) Interest on Drawings	- No interest is to be charged on Drawings
(d) Interest on Advances/ Loans by a partner	- Interest @ 6 % p.a. is to be allowed on Advances/ Loans. (Sec. 13 (d)
(e) Salary to a partner	- No remuneration for taking part in the conduct of business is to be allowed to any partner. ( sec 13 (a)

**Give any three points of differences between Fixed Capital Method & Fluctuating Capital Method**

Basis of Distinction	Fixed Capital Method	Fluctuating Capital Method
<b>1. Change in Capital</b>	The capital normally remains unchanged except under special circumstances	The capital fluctuates quite frequently from period to period.
<b>2. No. of Accounts maintained</b>	In case of Fixed Capital Method, two accounts are maintained for each partner viz. (a) Fixed Capital Account. (b) Current Account.	In case of Fluctuating capital method only one account viz. Capital Account) is maintained for each partner.
<b>3. Adjustment for</b>	All adjustments for drawings	All adjustments for drawing, interest on capital salary share of profit/ lose are made in Capital Account.
<b>4. Can Capital Account show a negative balance?</b>	Fixed Capital Account can never show a negative balance.	Fluctuating Capital Account can show a negative balance.

**Give any two points of differences between Drawings Against Profits and Drawings Against Capital.**

Basis of Distinction	Drawings Against Profits	Drawings Against Capital
<b>1. Part of</b>	It is part of expected profits	It is part of Capital
<b>2. Whether Considered for calculation of Interest on Capital</b>	It is not considered to calculate interest on capital	It is considered to calculate interest on capital
<b>3. Where debited ?</b>	It is debited in Drawings Account	It is debited in Capital Account
<b>4. Whether reduces fixed capital</b>	It does not reduce fixed capital	It reduces fixed Capital.

**What is the objective of preparing Profit & Loss Appropriation Account ?**

- *Objective of Profit & Loss Appropriation Account*

After ascertaining the Net Profit as per Profit & Loss Account, usually the Profit & Loss Appropriation Account is prepared to show how Net Profit has been distributed among the partners. The balance in Profit & Loss Appropriation Account may be used :

1. To provide for interest on Capital of Partners ( if Partnership Deed so provides)
2. To provide for Salary or Commission to partners ( if Partnership Deed so provides)
3. To transfer the profits to General Reserve or Specific Reserve.
4. To distribute the profits among the partners in their profit sharing ration.

This account is merely an extension of the Profit & Loss Account and is credited with Net Profits and interest on drawings and debited with Interest on Capitals, salary or commission to partners if provided under the terms of partnership agreement and its balance is transferred to the partners Capital ( or Current) Accounts in their agreed profit sharing ratio.

### **What is the purpose of Profit & Loss Adjustment Account ?**

Profit & Loss-Adjustment Account is prepared to show the effect of revaluation of assets and liabilities at the time of reconstitution of partnership. (i.e. Change in Profit Sharing Ratio, Admission, Retirement and Death of a partner).

### **Define Goodwill. What is the nature of goodwill ?**

#### *- Meaning of Goodwill*

Goodwill is the value of reputation of a firm in respect of the profit expected in future over and above the normal profits earned by other similar firms belonging to the same industry. Such excess of future profits over the normal profits is known as super profits. Thus, goodwill exists only when the firm earns super profits. Any firm that earns only normal profits or is incurring losses has no goodwill. If time value of money is considered, goodwill can be defined as the present value of anticipated super profits.

#### *Nature of Goodwill*

Goodwill is regarded as an intangible asset and not a fictitious asset. Goodwill is a valuable asset if the firms is earning profits and is a valueless asset if the firm is incurring losses. However, in the periods of temporary recession, the goodwill of the firm which is incurring least losses as compared to other similar firms, may be a valuable asset.

### **List any four factors affecting goodwill.**

- (a) Technical know-how
- (b) Favourable Location,
- (c) Efficiency of Management,
- (d) Market Situation
- (e) Special Advantages (if any) enjoyed by the firm, like import license, patent, trade marks etc.
- (f) Quality of Products
- (g) After Sales Service
- (h) Producing' providing customers satisfying products
- (i) Management's attitude towards fulfillment of commitments (e.g. Timely delivery of goods to customers, timely payment to creditors, delivery of goods to customers at committed prices inspite of increase in market prices)

**Mention any four circumstances when goodwill of a partnership firm may have to be valued.**

- (a) When there is a change in profit- sharing ratio amongst the existing partners
- (b) When a new partner is admitted
- (c) When a partner retires or dies :
- (d) When the firm is sold
- (d) When the firm is amalgamated with another firm.

**List the methods of Valuation of Goodwill,.**

- (1) Average Profits Method.
- (2) Super Profits Method, and
- (3) Capitalisation Method.

**Give any two points of differences between Average Profits & Super Profits**

Particulars	Average Profit	Super Profit
<b>1. Meaning</b>	Average Profit is the average of the profits of past few years	Super Profit is the excess of Average profits over normal profits.
<b>2. Whether Average Capital Employed considered for calculation ?</b>	Average Capital Employed is not considered while calculating Average Profits.	Average Capital Employed is considered while calculating Super profits.
<b>3. Whether Normal Rate of Return considered for calculation ?</b>	Normal Rate of Return is not considered while calculating Average Profits.	Normal Rate of Return is considered while calculating Average profits.
<b>4. Relevance while valuing Super Goodwill</b>	Average profit is relevant for Average Profits Method. Super Profits Method and Capitalization Methods of valuation of Goodwill.	Super Profit is relevant for Profit Method and Capitalization of Super Profit Method of valuation of Goodwill.

**What is a Joint Life Policy ? What is the objective of taking a joint life policy by the partners ? -Meaning** – Joint Life Policy is an assurance policy covering the lives of the partner jointly.

**Objective** – The main objective behind taking out a joint life policy is to make provision for payment of the amount due to the executors of a deceased partner so that the working capital of the firm may not be adversely affected to that extent.

## **RECONSTITUTION OF PARTNERSHIP - CHANGE IN PROFIT**

### **The need for change in profit sharing ratio**

The Need for Change in Profit Sharing Ratio arises –

1. When the partners so decide
2. When a new partner is admitted.
3. When a partner retires.
4. When a partner dies.

### **Why are assets and liabilities revalued at the time of change in profit sharing ratio ?**

Assets and liabilities are revalued at the time of change in profit sharing ratio so that the profit/ loss on account of such revaluation up to the date of change in profit sharing ratio may be ascertained and adjusted in the partners' capital accounts in their old profit sharing ratio.

### **Why is it necessary to distribute accumulated Reserves, Profits & Losses at the time of change in profit sharing ratio ?**

It is necessary to distribute accumulated reserves, profits & losses at the time of change in profit sharing ratio so that such profits/ losses up to the date of change in profit sharing ratio may be ascertained and adjusted in the partners' capital accounts in their old profit sharing ratio.

## **RECONSTITUTION OF PARTNERSHIP- ADMISSION OF A PARTNER**

### **State the two main rights acquired by a new partner.**

- (a) Right to share the assets of the firm
- (b) Right to share the future profits of the firm

### **Give two circumstances in which sacrificing ratio may be applied.**

- (a) When there is change in profit sharing ratio.
- (b) When a new partner is admitted.

### **Why do you determine new profit sharing ratio even for old partners when a new partner is admitted**

When a new partner is admitted, he acquires his share in profits from the old partners. This reduces the old partners' shares in profits hence, profit sharing ratio for old partners have to be calculated.

### **Enumerate the Adjustments required on admission of a partner.**

1. Adjustment in Profit Sharing Ratio.
2. Adjustment of Goodwill
3. Adjustment of Profit/ Loss arising from the Revaluation of Assets and Liabilities.
4. Adjustment of Accumulated Profits, Reserves and Losses
5. Adjustment of Capitals ( if agreed)

**How is the amount of hidden Goodwill calculated ?**

When the value of the goodwill of the firm is not specifically given, the value of goodwill has to be interred on the basis of the net worth of the firm as follows:

A.	Net worth (including goodwill) on the basis of capital brought in by incoming partner (Incoming partner's capital x Reciprocal of share of incoming partner)	Rs. xx
B.	Less: Net worth (excluding goodwill) of the reconstituted firm (i.e. after taking into consideration the capital brought in by incoming partner)	xx
C.	Value of Goodwill (A-B)	xx

Note: Net worth = Sundry Assets – Outsiders' Liabilities  
or = Capitals of partners + Net Accumulated Profits & Reserves ( if any)

**Why is it necessary to revalue Assets & Liabilities at the time of admission of a partner ?**

- At the time of admission of a partner, the assets and liabilities are revalued so that the profit or loss arising on account of such revaluation upto the date of admission of new partner may not be affected by such profit or loss.

**Why is it necessary to distribute Accumulated Reserves, Profits & Losses at the time of admission of a partner ?**

- At the time of admission of a partner, any reserves, accumulated profits/losses upto the date of admission of a partner are transferred to old partners' Capital Accounts ( if capitals are fluctuating) or Current Accounts ( if capitals are fixed) in their old profit sharing ratio since the reserves, accumulated profits / losses upto the date of admission of a new partner belong to the old partners and not to the new partner.

## **RECONSTITUTION OF PARTNERSHIP- RETIREMENT/ DEATH OF A PARTNER**

**Give the two circumstances in which gaining ratio may be applied.**

- (a) When there is change in profit sharing ratio.
- (b) When a partner retires/dies.

**Give any two points of differences between Sacrificing Ratio and Gaining Ratio**

Basis of Distinction	Sacrificing Ratio	Gaining Ratio
<b>1. Meaning</b>	It is the ratio in which the old partners have agreed to sacrifice their shares in profit in favour of new partner.	It is the ratio in which the continuing partners acquire the outgoing (retired or deceased) partner's share.
<b>2. Purpose</b>	It is calculated to determine the	It is calculated to determine the

	amount of compensation to be paid by the incoming partner to the sacrificing partners.	amount of compensation to be paid by each of the continuing partners to the outgoing partner.
<b>3. How to calculate</b>	It is calculated by taking out the difference between old shares and new shares	It is calculated by taking out the difference between new shares and old shares
<b>4. When to calculate</b>	It is calculated at the time of admission of ---- partner and change in profit sharing ratio.	It is calculated at the time of retirement or death of a partner and change in profit sharing ratio.

**Why is it necessary to revalue Assets & Liabilities at the time of retirement of a partner ?**

- At the time of retirement of a partner, the assets and liabilities are revalued so that the profit/ loss arising on account of such revaluation up to the date of retirement/death of a partner may be ascertained and adjusted in all partner's capital accounts in their old profit sharing ratio.

**Why is it necessary to distribute Accumulated Reserves, Profits & Losses at the time of retirement of a partner ?**

- At the time of retirement of a partner, any reserve, accumulated profits or losses up to the date of retirement/ death of a partner are transferred to the Capital Accounts in case of fluctuating capitals ( or Current Accounts in case of fixed capitals) of all the partners ( including outgoing partner) in their old profit sharing ratio so that the due share of an outgoing partner in the reserves, accumulated profits/ losses gets adjusted in his Capital Account ( or Current Account)

**Give two basis for Determination of Profits from the date of last Balance Sheet to the date of death/ retirement**

1. On Time Basis
2. On Sales Basis

**Can an outgoing Partner or Legal Representative of a Deceased Partner share in the subsequent profits?**

The amount due to the retiring partner is settled in the manner prescribed in the partnership deed. The amount due is either paid off immediately or is paid in installments with or without interest as per agreement. In the absence of an agreement in this regard, the outgoing partner at his option is entitled to receive either interest @ 6% p.a. till the amount is paid off or a share of the profit which has been earned by using the amount due to him (Section 37)

## **ACCOUNTING FOR SHARE CAPITAL**

**Define Share and Share Capital. Give two kinds of shares.**

*Meaning of Share*

Share is a fractional part of the capital and forms the basis of ownership in a company. The persons who contribute money through shares are called Shareholder A share is not a sum of money but is an interest measured by a sum of money. Share is a bundle of rights and obligations contained in the contract (i.e., Articles of Association).

The amount of authorized capital, together with the number of shares in which it is divided, is stated in the Memorandum of Association but the classes of shares in which the company's capital is to be divided, along with their respective rights and obligations, are determined by the Articles of Association of the company.

Under the existing provisions of Sec. 86 of the Companies Act, now only two kinds of shares may be issued, viz, Preference shares and Equity shares.

*- Meaning of Share Capital.*

Share Capital means the capital raised by the issue of shares. The amounts invested by the shareholders towards the face value of shares are collectively known as 'Share Capital' which is quite distinct from the capital put in by individual share holders.

The share capital is divided under the following three heads:

- (a) Authorised Capital              (b) Issued Capital              (c) Subscribed Capital

**Give any three points of differences between Authorised Capital and Issued Capital.**

<b>Basis of Distinction</b>	<b>Authorised Capital</b>	<b>Issued Capital</b>
<b>1. Meaning</b>	It refers to that amount which is stated in the Memorandum of Association as the share capital of the company	It refers to the nominal value of that part of authorised capital which has been (i) subscribed for by the signatories to the Memorandum of Association and (ii) allotted for cash or consideration other than cash.
<b>2. Determination</b>	Its amount is determined after considering present and future requirements	Its amount is determined after considering the present requirements.
<b>3. Disclosure in Memorandum of</b>	Its amount is required to be disclosed in Memorandum of	Its amount is not required to be disclosed in the
<b>4. Basis of Stamp Duty</b>	It is the basis for the payment of Stamp Duty	It is not the basis for the payment of Stamp Duty.
<b>5. Basis of Company registration fees</b>	It is the basis for the payment of Company registration fee.	It is not the basis for the payment of company registration fees.
<b>6. Whether change in its amount treated as Alteration of Memorandum</b>	Any change in the amount of authorised capital is treated an alternation of Memorandum of Association	Any change in the amount of issued capital is not treated as an alteration of Memorandum of Association
<b>7. Whether one can exceed other</b>	It can exceed issued capital.	It cannot exceed authorised capital.

**Give any three points of differences between Reserve Capital and Capital Reserve**

<b>Basis of Distinction</b>	<b>Reserve Capital</b>	<b>Capital Reserve</b>
<b>1. Meaning</b>	It refers to those portion of uncalled share capital which shall not be capable of being called up except in the event and for the purpose of the any being would up ----	It refers to those amounts which are not regarded as free for distribution by way of divided through profit and Loss Account
<b>2. Creation- Optional Mandatory</b>	It is not mandatory to create Reserve Capital.	It is mandatory to create Capital Reserve in case of profit on forfeited shares.
<b>3. Treatment in B/S</b>	It is not disclosed in the company's Balance Sheet.	It is required to be disclosed as the 1st item under the head Reserves and Surplus on the liabilities side of the Balance Sheet.
<b>4. Time when it can be used</b>	It can be used only at the time of winding up	It can be used during the life of the company
<b>5. Realized vs. Unrealized</b>	It refers to the amount which has neither been called up nor been received	It ( excluding) items like revaluation profit) refers to that amount which has already been realized.
<b>6. Can be used to write off capital losses ?</b>	It cannot be used to write off capital losses.	It can be used to write off capital losses.
<b>7. Can be used to declare share bonus ?</b>	It cannot be used to declare a share bonus.	It ( excluding items like revaluation profit) can be used to declare a share bonus.

**Give any three points of differences between Authorised (or Nominal) Capital and Paid up Capital**

<b>Basis of Distinction</b>	<b>Authorised Capital (or Nominal Capital)</b>	<b>Paid up Capital</b>
<b>1. Meaning</b>	It refers to that amount which is stated in the Memorandum of Association as the share capital of the company.	It refers to the paid up value of the called up capital.
<b>2. Determination</b>	Its amount is determined after considering present and future requirements	Its amount is determined after considering the present requirements
<b>3. Disclosure in Memorandum of Association</b>	Its amount is required to be disclosed in Memorandum of Association.	Its amount is not required to be disclosed in the Memorandum of Association.
<b>4. Basis of Stamp Duty</b>	It is the basis for the payment of Stamp duty	It is not the basis for the payment of Stamp Duty
<b>5. Basis of company</b>	It is the basis for the payment of	It is not the basis for the payment



<b>registration fees</b>	Company registration fee	of company registration fees.
<b>6. Whether change in its amount treated as Alteration of Memorandum</b>	Any change in the amount of authorised capital is treated as an alternation of Memorandum of Association	Any change in the amount of issued capital is not treated as an alteration of Memorandum of Association
<b>7. Whether and can exceed other</b>	It can exceed paid up capital.	It cannot exceed authorised capital.

**Give any three points of differences between An Equity Share and A Preference Share**

<b>----- Distinction</b>	<b>An Equity Share</b>	<b>A preference share</b>
<b>1. Preferential right as to the payment of dividend</b>	Payment of equity dividend is made after the payment of preference dividend.	Payment of preference dividend is made before the payment of equity dividend
<b>2. Preferential right as to the repayment of capital</b>	Repayment of Equity share capital is made after the repayment of preference share capital.	Repayment of preference share capital is made before the repayment of equity share capital
<b>3. Fluctuations in the rate of dividend</b>	The rate of equity dividend may vary from year to year depending upon the decision of directors and members.	The rate of preference dividend is fixed
<b>4. Arrears of dividend</b>	In case of an equity share, arrears of dividend cannot accumulate in any case.	In case of a preference share arrears of dividend may accumulate.
<b>5. Convertibility</b>	It cannot be convertible.	It may be convertible
<b>6. Voting Rights</b>	Equity shareholders generally enjoy voting rights.	Preference shareholders do not have any voting rights except at their class meeting.
<b>7. Redeem ability</b>	It is not redeemable during the life time of the company unless the company decided to buyback the shares.	It is redeemable during the life time of the company.

**Give any three points of differences between over-subscription and under subscription.**

<b>Basis of Distinction</b>	<b>Over subscription of shares</b>	<b>Under subscription of shares</b>
<b>1. No. of shares applied as compared to No. of shares offered.</b>	In case of over subscription, number of shares applied for is more than the number of shares offered by the company	In case of under subscription number of shares applied for is less than the number of shares offered by the company
<b>2. Acceptance of all application</b>	All applications are not accepted in full	All applications are accepted in full.
<b>3. Problem of minimum subscription when shares are issued for</b>	This problem does not arise at all.	If the minimum subscription has not been subscribed all application money may be required to be returned

<b>the first time.</b>		
<b>4. Return of money if minimum subscription has been received</b>	The company returns the money to the applicants whose applications have either been rejected or have been accepted partially.	The question of returning the money does not arise at all.

#### **State the meaning of Minimum Subscription**

The minimum subscription refers to the amount which, in the opinion of directors, must be raised by issue of shares in order to provide for the following:

- (i) the purchase price of any property purchased or to be purchased which is to be met out of the proceeds of the issue of shares;
- (ii) any preliminary expenses payable by the company and any commission payable in connection with the issue of shares
- (iii) the repayment of any money borrowed by the company in respect of any of the above two matters;
- (iv) working capital; and
- (v) any other expenditure stating the nature and purposes thereof and the estimated amount in each case.

#### **Sate the purposes for which Securities Premium can be used**

- According to Sec. 78 of the Companies Act 1956, the securities premium may be applied only for the following purposes:
  1. To issue fully paid bonus shares to the members.
  2. To write off preliminary expenses of the company.
  3. To write off the expenses of or the commission paid or discount allowed on any issue of shares or debentures of the company.
  4. To provide for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

#### **State conditions for the Issue of Shares at discount**

According to Sec. 79 of the Companies Act 1956, a company may issue the shares at a discount only if the following conditions are fulfilled:

1. The share must belong to a class already issued:
2. The issue must be authorised by an ordinary resolution of the company
3. The sanction of the Company Law Tribunal must be obtained
4. The resolution must specify the maximum rate of discount at which the shares are to be issued. no resolution shall be sanctioned by the Company Law Board if the maximum rate of discount specified in the resolution exceeds 10% unless it is of opinion that a higher percentage of discount may be allowed in the special circumstances of the case;
5. At least one year must have elapsed since the date on which the company was entitled to commence business

6. The issue must be made within two months from the date of receiving the sanction of the Company Law Board or within such extended time as the Company Law Board may allow.

**State the conditions for the issue of sweat shares.**

-Meaning – Sweat equity shares means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

**Give any two differences between Calls-in-arrears and Calls-in-advance**

Basis of Distinction	Calls-in-arrears	Calls-in-advance
<b>1. Meaning</b>	It refers to the amount called up by the company which has not yet been paid by the shareholders till the last day fixed for payment thereof	It refers to the amount paid by the shareholders in excess of the amount due from them.
<b>2. Is Authority under Articles required?</b>	There is no question of any authority under Articles	A company may accept calls-in-advance only if Articles authorised to do so.
<b>3. Interest charged or allowed</b>	Interest is charged on calls-in-arrears.	Interest is allowed on calls-in-advance.
<b>4. Maximum Rate of Interest</b>	The maximum rate of interest as per Table A is 5 % p.a.	The maximum rate of interest as per Table A is 6% p.a.
<b>5. Disclosure in Balance Sheet</b>	The amount of calls-in-arrears is shown by way of deduction from the called-up capital in the Balance Sheet.	The amount of calls-in-advance is shown as a separate item under the head Share Capital (but is not added to the amount of paid up capital) or Current Liabilities.

**What is meant by a Prorate allotment ? When does the need for a prorata allotment arise ?**

- *Meaning of Prorate Allotment*

Prorate Allotment means making allotment of shares to the applicants in the ratio of total number of shares offered to the total number of shares applied.

*For example – Total no. of shares offered = 2,000*

*Total no. of shares applied = 2,400*

*No. of shares applied by Mr X = 48*

*No. of shares to be allotted to Mr x =  $2,000/2,400 \times 48 = 40$*

*The need for a prorata allotment arise in case of over subscription of shares ( i.e. when the total number of shares applied exceeds the total number of shares offered)*

**How would you treat the balance in the Forfeited Shares Account if**

- All the forfeited shares have been reissued**
- Some of the forfeited shares have been reissued ?**

- |  |   |                      |     |                        |  |
|--|---|----------------------|-----|------------------------|--|
| <b>(a) If all the forfeited shares have been re-issued.</b>    | <p>The credit balance left on the Forfeited Shares Account is transferred to Capital Reserve Account by passing the following entry:</p> <table border="0" style="width: 100%;"> <tr> <td style="width: 60%;">Forfeited Shares A/c</td> <td style="width: 40%; text-align: right;">Dr.</td> </tr> <tr> <td style="padding-left: 40px;">To Capital Reserve A/c</td> <td></td> </tr> </table> | Forfeited Shares A/c | Dr. | To Capital Reserve A/c |  |
| Forfeited Shares A/c   | Dr.   |                      |     |                        |  |
| To Capital Reserve A/c   |   |                      |     |                        |  |
| <b>(b) If some of the forfeited shares have been re-issued</b> | <p>The profit on re-issue of shares is transferred to Capital Reserve Account and the balance on the Forfeited Shares Account relating to shares not yet re-issued is carried forward and is shown by way of addition to paid up Capital in the Balance Sheet.</p>  |                      |     |                        |  |

The maximum amount of discount which may be allowed on re-issue is explained as follows:

Case	Maximum Permissible Discount on Re-issue
(a) When the shares were originally issued at par or at a premium	The amount credited to Forfeited share account
(b) When the shares were originally plus issued at a discount	The amount credited to forfeited Share Account the amount of original discount.

- According to Section 81 (1A) private placement of shares implies issue and allotment of shares to a selected group of persons. In other words, an issue, which is not a public issue but offered to a select group of persons, is called 'Private Placement of Shares.' All SEBI Guidelines concerning preferential issue are applicable to private placement of shares as well

- Securities Premium once received cannot be utilized for purposes other than those mentioned u/s 78.

- Sec. 81 gives pre-emptive right to existing equity shareholders in case of further issue of shares. Pre-emptive rights mean that further shares must be offered to the existing shareholders in proportion as nearly as the circumstances admit to the capital paid up on those shares at that date. Such shares are called 'Rights Shares.'

- A preferential allotment is one that is made at a pre-determined price to the pre-identified people who wish to take a strategic stake in the company such as promoters, venture capitalists, financial institutions, buyers of companies' products or its suppliers..

## ISSUE OF DEBENTURES

### **- Meaning of Debenture**

Debenture is a written instrument acknowledging a debt and containing provisions as regards the repayment of principal and the payment of interest at a fixed rate. According to Sec. 2 (12) of the Companies Act, 1956, debenture includes debentures, stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not. Debenture represents a debt.

### **Types of Debentures**

1. From the point of view of Security	1. Unsecured Debentures 2. Fully Secured Debentures 3. Partly Secured Debentures
2. From the point of view of Tenure	1. Redeemable Debentures 2. Irredeemable Debentures
3. From the point view of Mode on Redemption	1. Convertible Debentures (i) Fully Convertible Debentures (FCD) (ii) Partly Convertible Debenture (PCD) 2. Non- convertible Debentures
4. From the point of view of Coupon Rate	1. Debentures carrying Fixed Rate of Interest 2. Debentures carrying Floating Rate of interest
5. From the point of view of Registration	1. Registered Debentures 2. Bearer.

### **What is meant by a ' Convertible Debenture' ? Give two types of such debentures.**

- *Meaning of Convertible Debentures 9CD)*

Convertible Debentures are those debentures which are convertible into equity shares or other securities either at the option of debenture holders or at the option of the company as the case may be. Convertible debentures are of two types.

- (i) *Fully Convertible Debenture (FCD)* – These are the debentures where the full amount is convertible into shares or other securities at agreed terms and conditions. Where the conversion is to be made at or after 18 months from the date of allotment but before 36 months, the conversion is optional on the part of debenture holders as per SEBI Guidelines.
- (ii) *Partly Convertible Debenture (PCD)* – These are the debentures where only a portion of the amount of debenture is convertible into shares or other securities at a specified time and remaining part of debenture is redeemable on agreed terms. The portion of debenture which is fully convertible into shares is termed as FCD (i.e., Fully Convertible Debenture) portion and the remaining portion which is not convertible into shares is termed as NCD ( i.e., Non-convertible Debenture

**Give any three points of difference between A Share and A Debenture.**

<b>Basis of Distinction</b>	<b>A Share</b>	<b>A Debenture</b>
<b>1. Capital Vs. Loan</b>	Share is a part of owned capital.	Debenture constitutes a loan
<b>2. Reward for investment</b>	Reward is the payment of dividend.	Reward is the payment of interest
<b>3. Fluctuations in the rate of Interest and dividend</b>	The rate of dividend may vary from year to year depending upon the profit decisions of directors and members.	The rate of interest is fixed.
<b>4. Charge vs. Appropriation</b>	Payment of dividend is an appropriation out of profit and this cannot be made if there is no profit.	Payment of interest is charge against profits and is to be made even if there is no profit.
<b>5. Priority as to payment</b>	Payment of dividend gets no priority over the payment of interest.	Payment of interest gets priority over the payment of dividend.
<b>6. Priority as to repayment of principal during winding u./</b>	Payment of share capital is made after the repayment of debentures.	Payment of debentures is made before the payment of share capital.
<b>7. Secured by charge</b>	Shares are not secured by any charge.	Non-convertible Debentures redeemable on or after 18 months are secured by a charge.
<b>8. Restriction on issue discount</b>	Sec. 79 imposes certain restrictions on issue of shares at discount.	No restriction is imposed on the issue of debentures at discount.
<b>9. Voting rights</b>	Shareholders generally enjoy voting rights.	Debenture- holders do not have any voting rights ( except at their class-meetings).
<b>10. Convertibility</b>	Equity shares can never be convertible	Debentures can be convertible.
<b>11. Trust Deed</b>	Share Trust Deed is not required to be executed	Debenture Trust Deed is required to be executed.

**Explain the meaning of debentures issued as collateral security.**

- Meaning – The issue of debentures as a collateral security means the issue of debentures as an additional security against the loan in addition to any other security that may be offered.

Such liability may arise only when the lender invokes his right vested in the collateral Security. The following Journal entry will be passed to record the conversion of collateral securities into actual debenture liability:

## **REDEMPTION OF DEBENTURES**

### **What is meant by Redemption of Debentures ?**

#### *- Meaning of Redemption of Debentures*

Redemption of debentures means discharge of an obligation arising out of the contractual obligations created through the Debentures Trust Deed.

### **Enumerate the various sources out of which the debentures may be redeemed and various methods of redemption of debentures**

#### *- Three Methods of Redemption of Debentures*

1. By Payment in Lump sum at the end of stipulated period
2. By Draw of Lot ( Payment in Installments)
3. By Purchase in the Open Market

#### *- Three Sources of Redemption of Debentures*

1. Out of Accumulated Profits and Sinking Fund
2. Out of proceeds of fresh issue of share capital and debentures
3. By Conversion into New Shares/ Debentures

### **List the cases when Debenture Redemption Reserve is not required to be created.**

- Cases where the creation of Debenture Redemption Reserve is not mandatory as per SEBI Guidelines.
  1. Infrastructure company (a company wholly engaged in the business of developing, maintaining and operating infrastructure facilities)
  2. A' Company issuing debentures with a maturity period of not more than 18 months.

### **What is meant by ' Redemption by purchase in the open market? How would you treat the profit on cancellation of such debentures? Give any three advantages of the redemption by purchase in the open market method.**

#### *- Meaning of Redemption by Purchases in the Open Market*

When a company purchases its own debentures in the open market for the purposes of cancellation, such an act of purchasing and canceling the debentures constitutes redemption by purchase in the open market.

#### *- Advantages of Redemption by Purchase in the Open Market*

1. Saving equal to the amounted discount
2. Reduction in interest burden
3. Saving equal to premium payable on redemption

### **How would you deal with the conversion of debentures which were originally issued at a discount into shares?**

In case of conversion of debentures which were originally issued at a discount into shares, the following points are worth noting:

- (a) *Conversion Before Maturity*- In case of conversion before the maturity of debentures, either the lesser fully paid up shares equivalent to the net amount actually received (i.e. net of

discount) at the time of issue of debentures or greater partly paid-up shares having paid up value in proportion to the net cash originally received at the time of issue of debentures, may be issued, otherwise it would amount to an issue of shares at a discount without complying with the provisions of Section 79 of The Companies Act, 1956.

- (b) *Conversion at Maturity*- In case of conversion at maturity the debentures may be converted into the shares on the basis of the nominal value of the debentures and the provisions of Section 79 cannot be regarded as being violated.

**Explain the meaning of Cum-Interest Price and Ex-Interest Price.**

- (a) *Cum Interest Price* – If the interest accrued from the last due date of interest to the date of transaction is included in the price quoted, it is called Cum-Interest price which is the total amount paid for the purchase of debentures. Thus, Cum-Interest Price = Payment towards Capital Portion + Payment towards interest accrued from the last due date of interest to the date of transaction.
- (c) *Ex-Interest Price*- If the interest accrued from the last due date of interest to the date of transaction is not included in the price quoted, it is called Ex-interest price or Real Price. Thus, Ex-Interest Price = Payment towards Capital Portion

## Part-II

### Financial Statements Of A Company

**What are the final accounts of a company ?**

**Or**

**Briefly explain the meaning of Financial Statements.**

Final accounts or Financial statements are final documents of accounting work done during the accounting period which provide financial information about the profitability and the financial position of a business firm.

According to Section 210 of the Companies Act, final accounts or financial statements of a company includes:

- (i) Profit and Loss account or Income statement which discloses the net profit earned or losses suffered.
- (ii) Balance Sheet or position statement which discloses the company's financial position assets, capital, reserves and borrowed funds etc.

According to Securities Exchange Board of India (SEBI), a Company should also prepare a Cash Flow Statements in addition to above two financial statements, if a company is listed on a stock exchange or the sales of company is more than Rs. 50 crores

**What is income statement or profit and loss account ?**



The Profit & Loss A/c is also known as an income statement. It includes Trading A/c as well. It is the accounting report which shows the revenues, expenses and difference between them represents either net profit or net loss for a particular accounting period.

**What is position statement or balance sheet ?**

The statement which show total of assets and liabilities, is known as balance sheet. The purpose of balance sheet is to show its resources and obligations for acquiring these resources. i.e., assets and liabilities. It is also termed as position statement.

**State the features' characteristics or nature of financial statements.**

Following are the features / nature of financial statements:

- (i) *Recorded facts* : Financial statements are prepared on the basis of facts recorded in the accounting books.
- (ii) *Follows accounting conventions*: Accounting conventions are followed while preparing financial statements, e.g. valuing of closing stock at cost or market price whichever is less is an accounting convention followed by a company.
- (iii) *Accounting assumptions* : Financial statements are prepared on certain basic accounting assumptions such as Going Concern Assumption, Money Measurement Assumption etc.
- (iv) *Based on personal opinion judgments* and estimates such as creating provision for doubtful debts, valuing closing stock at cost or market price whichever is less etc.

**State any five objective (uses) of final accounts.**

- (i) Helpful in estimating the earning capacity of the business.
- (ii) Helpful in taking investment decision by the prospective investors.
- (iii) Helpful in providing information about flow of cash within a company.
- (iv) Helpful in providing necessary information to the financial institutions to decide about granting of credit to the company.
- (v) Helpful in providing base for making fiscal policies.

**State any five limitations of Financial statements.**

Limitations of Financial Statements

- (i) Do not reflect current financial status of the company.
- (ii) Assets may not realise the value state in Balance Sheet as they are recorded at purchase price in the Balance Sheet.
- (iii) Vital information missing.
- (iv) Provides no qualitative information as only monetary transactions are recorded in the books of accounts.
- (v) They are only interim reports.

**Name the major heads which appears on the assets side of the Balance Sheet as per the requirements of the Indian Companies act, 1956.**

The major headings of the assets side of a company's Balance Sheet as per Schedule VI, Part I are as follows

- (i) Fixed Assets
- (ii) Investments

- (iii) Current Assets, Loans and Advances : (a) Current Assets (b) Loans and Advances
- (iv) Miscellaneous Expenditures
- (v) Profit & Loss Account (Debit balance)

**Name the major heads which appear on the liabilities side of the Balance Sheet as per the requirements of the Indian Companies Act, 1956.**

The major headings of the liabilities side of a company's Balance sheet as per Schedule VI. Part I are as follows:

- (i) Share Capital
- (ii) Reserves and Surplus
- (iii) Secured Loans
- (iv) Unsecured Loans
- (v) Current Liabilities and Provisions: (a) Current Liabilities (b) Provisions

**How are the assets and liabilities of a company usually marshaled?**

**Or**

**What do you mean by marshalling of a Balance Sheet ?**

Placement of assets and liabilities in a Balance Sheet in a particular order is known as Marshalling of Balance Sheet. There are two ways in which assets and liabilities are usually marshaled:

1. *Order of liquidity*: in this order, the most liquid assets are placed before the lesser liquid assets
2. *Order of permanence*: in this order, the fixed assets are placed before the current assets.

**Mention the items that are to be presented under the heading share capital in the liabilities side of a company's balance sheet.**

- |                                      |                                       |
|--------------------------------------|---------------------------------------|
| 1 Authorized capital/Nominal Capital | 2 Issued Capital                      |
| 3 Subscribed capital                 | 4 Called-up capital less calls unpaid |

**Mention the items that are to be presented under the heading current liabilities and provisions"** *Current Liabilities :*

- |                                     |                                  |
|-------------------------------------|----------------------------------|
| (1) Acceptance                      | (2) Sundry creditors             |
| (3) Advance payment                 | (4) Unclaimed dividends          |
| (5) Other liabilities provisions: ' |                                  |
| (1) Provisions for taxation         | (2) proposed dividends           |
| (3) Provident fund                  | (4) provisions for contingencies |

**Mention the item that are to be presented under the heading current assets loans advances .**

- |                                   |                          |
|-----------------------------------|--------------------------|
| 1 Interest accrued on investments | 2 Stores and spare parts |
| 3 Loose tools                     | 4 Stock-in-trade         |
| 5 Work in progress                | 6 Sundry debtors         |
| 7 Cash in hand                    | 8 Cash at bank           |

*Loans and advances:*

- 1 Advances and loans to subsidiaries
- 2 Advances and loans to partnership firm in which the company or any of its subsidiaries is a partner.
- 3 Bills of exchange

4 Prepaid expenses

5 Advances recoverable in cash or in kind

6 Balance with customs ,Port Trust etc.(where payable on demand)

**Name the items that are to be presented under the heading investments ?**

Following are the important items shown under the head Investments:

- (1) Investments in Government or trust securities
- (2) Investments in shares, debentures and bonds of others companies.

**Name the items that are to be presented under the heading Fixed Assts.**

- |                             |                        |
|-----------------------------|------------------------|
| (1) Goodwill                | (2) Land and Buildings |
| (3) Plant and machinery     | (4) Furniture          |
| (5) Trade marks and Patents | (6) vehicles           |
| (7) Livestock               |                        |

**Name the items that are to be presented under the heading Miscellaneous Expenditure '.**

Following are the important items shown under the head Miscellaneous Expenditure *(to the extent not written off or adjusted )*

- (1) Preliminary expenses
- (2) Expenses including commission or brokerage on underwritings or subscription of shares or debentures.
- (3) Discount on issue of shares of debentures.
- (4) Interest paid out of capital
- (5) Development expenditure not adjusted

*Name the items that are to be presented under the heading Reserves and Surplus*

**Reserves and Surplus:**

- (i) Capital Reserve
- (ii) Capital Redemption Reserve
- (iii) Securities Premium
- (iv) Sinking fund
- (v) Profit & Loss A/c ( Credit balance)

**Write a short note on contingent liabilities.**

A contingent liability is liability which may or may not happen in future. The happening of such liabilities depends on the occurrence of certain future uncertain event. If these uncertain events do occur, the contingent liabilities become actual liabilities. Contingent liabilities are not included in the total of liabilities side. Rather, contingent liabilities are shown as a foot-note to the balance sheet.

Following are the usual types of contingent liabilities:

- (i) Claims against a company not acknowledged as debt.
- (ii) Arrears of fixed cumulative dividend on cumulative preference shares.
- (iii) Estimated amount of contract remaining to be executed and not provided for
- (iv) Uncalled liability on shares partly paid.

**Differentiate between secured and unsecured loans.**

**Distinction between Secured and Unsecured Loans**

<b>Secured Loans</b>	<b>Unsecured Loans</b>
Secured loans are the long-term loans borrowed by the company against some security in the form of fixed assets. Examples: Debentures, secured loans and advances from banks, subsidiary companies etc.	Unsecured loans are the long-term loans borrowed by the company against which company does not give any security. Example: Public deposits, unsecured loans from the Bank etc.

**Give difference between Balance Sheet of a firm and company.**

In the case of a partnership firm, there is no prescribed form to prepare a Balance Sheet whereas in case of a company a Balance Sheet has to be prepared in the prescribed form given in Part-I of Schedule VI of the Companies Act, 1956.

**Give the headings (Main heading and sub-heading) under which the following items will be shown in a Company's Balance Sheet.**

<i>S.No.</i>	<i>Items</i>	<i>Main Heading</i>	<i>Sub-heading</i>
	Authorised Capital	Share Capital	
	Issued capital	Share Capital	
	Subscribed capital	Share Capital	
	Forfeited shares	Share Capital	Subscribed Capital (Add)
	Calls-in-arrears	Share Capital	Subscribed Capital (Deducted)
	Capital reserve	Reserves and Surplus	
	Securities Premium	Reserves and Surplus	
	Debenture Redemption Reserve	Reserves and Surplus	
	General reserve	Reserves and Surplus	
	Profit and Loss Account (Cr.)	Reserves and Surplus	
	Bank Loan	Secured Loans	
	15% Debentures	Secured Loans	
	Interest accrued and due on debentures	Secured Loans	
	Premium on redemption of debentures	Secured Loans	
	Fixed deposits	Unsecured Loans	
	Acceptances (Bills Payable)	Current Liabilities and Provision	(a) Current Liabilities
	Sundry creditors	Current Liabilities and Provision	(a) Current Liabilities
	Tax liability determined after assessment	Current Liabilities and Provision	(a) Current Liabilities

	Unclaimed dividends	Current Liabilities and Provision	(b) Provisions
	Proposed dividends	Current Liabilities and Provision	(b) Provisions
	Interest accrued but not due on debentures and loans	Current Liabilities and Provision	(a) Current Liabilities
	Provision for taxation	Current Liabilities and Provision	(b) Provisions
	Short-term loans and advances (up to 12 months)	Current Liabilities and Provision	(a) Current Liabilities
	Advances from customers	Current Liabilities and Provision	(a) Current Liabilities
	Calls-in-advances	Current Liabilities and Provision	(a) Current Liabilities
	Unclaimed liability on shares partly paid up	A footnote to Balance Sheet as a contingent Liability	
	Arrears of fixed cumulative dividend	A footnote to Balance Sheet as a contingent Liability	
	Claims against the company not acknowledged as debt	A footnote to Balance Sheet as a	
	Goodwill	Fixed Assets	
	Livestock	Fixed Assets	
	Vehicles	Fixed Assets	
	Patents, trademarks and design	Fixed Assets	
	Machinery, Buildings and Land	Fixed Assets	
	Capital work in Progress	Fixed Assets	
	Work-in-Progress	Current Assets, Loans and advances	(a) Current Assets
	Loose tools	Current Assets. Loans and advances	(a) Current Assets
	Bills of Exchanges (B.P.)	Current Assets, Loans and Advances	(b) Loans and Advances
	Interest accrued on investments	Current Assets, Loans and Advances	(a) Currents Assets
	Prepaid insurance	Current Assets, Loans and Advances	(a) Loans and Advances
	Stores and spare parts	Current Assets, Loans and Advances	(a) Current Assets
	Advances to suppliers	Current Assets, Loans and Advances	(a) Loans and Advances
	Deposit with custom	Current Assets, Loans and	(a) Loans and Advances

	authorizes	Advances	
	Investment in shares and debentures	Investments	
	Investment in immovable properties	Investments	
	Preliminary expenses	Miscellaneous Expenditure	
	Unsurprising commission	Miscellaneous Expenditure	
	Discount on issue of shares and debentures	Miscellaneous Expenditure	
	Loss on issue of debentures	Miscellaneous Expenditure	
	Brokerage on issue of shares	Miscellaneous Expenditure	
	Debentures suspense account	Miscellaneous Expenditure	

## **Financial Statement Analysis**

**What is meant by analysis of financial statements?**

**Or**

**Define Financial statement analysis.**

. Financial statement analysis is a systematic study of the information contained in the financial statements so as to identify the financial strength and weaknesses of the firm by establishing meaningful relationships between the terms of the Balance Sheet and income statement.

According to John Myers. " Financial statement analysis is largely a study of relationships among various financial factors in a business as disclosed by a single set of statements and a study of trends of these factors, as shown in a series of statements."

**Briefly explain the uses, advantages, significance of financial statement analysis ?**

Uses/ Advantages/ Significance of Financial Statement analysis

- (i) Security analysis: It is a process wherein the investor comes to know whether the firm is fulfilling his expectations with regard to payment of dividend, capital appreciation and security of money.
- (ii) Credit analysis: Such analysis is done by the firm when it offers credit to a new customer or a dealer. Such analysis is done by the banks to check his credit worthiness also before granting loan to the public.
- (iii) Debt analysis: Debt analysis is done by the firm to know the borrowing capacity of the firm. Such analysis is based on the detailed studies of the relationship between debt and equity, debt to total fund etc.

- (iv) Dividend analysis: Dividend analysis helps the firm in deciding about the rate of dividend in future years which is based on the past performance of the company and the practice of the industry
- (v) General business analysis: Such analysis helps in identifying the most profitable opportunities and business risks of the firm.

**Briefly explain the parties interested in financial statement analysis.**

Information contained in financial statements is useful to different categories of users of financial data. These interested parties groups are:

- (i) *Investors*: Analysis of financial statements helps investors and shareholders to judge the financial strength and profitability of a company. It also helps them to know whether their funds are secured or not.
- (ii) *Useful to the Finance Manager/Finance Department*: Financial analysis highlights financial strengths and weaknesses and credit worthiness of the company. It helps in predicting future financial crises and enables the finance manager to take corrective action beforehand.
- (iii) *Management*: Management of a business firm is interested in its financial health, profitability, solvency and progress. Such analysis is used by the management to exercise control over the business and to make decisions to run it more efficiently.
- (iv) *To the trade creditors*: Trade creditors are particularly interested in the firm's ability to meet their claims over a short period of time. Financial analysis helps them in knowing the firm's liquidity position.
- (v) *Lenders*: All lenders of long-term funds such as Banks, Insurance Companies, U.T.I. etc. are interested to know the profit earning capacity of the business and its long-term solvency. They are interested in regular payment of interest and repayment of principal amount on scheduled dates. Such information is provided to them by financial analysis.
- (vi) *Labour Unions (OR Employees)*: Labour union analyses the financial statements to assess whether it can presently afford a wage increase, other allowances and benefits. Thus, financial analysis helps in providing information to the labour unions in negotiating wage agreements.
- (vii) *Government*: Financial statement analysis provides useful information to various government departments like Income Tax, Sales Tax, Excise Duty etc. to determine the tax liability of the concern. On the basis of analysis of financial statements, the Government determines tax policy, import-export policy, industry policy etc.
- (viii) *Regulatory authorities*: Such as Company Law Board, SEBI, Stock exchanges, Tax Authorities etc. would like to know whether the financial statements have been prepared in

conformity with the specified laws and rules and these statements really safeguard the interest of various concerned agencies.

- (ix) *significance for other parties*: Some other parties may also be interested in the analysis of financial statements from their own point of view such as Research Institutions, Trade, Newspapers, Economists etc.

**Briefly explain the objectives or purpose of financial statement analysis.**

Financial statement analysis performs the essential function of converting mass data into useful information. Such analyses of financial information serve many and varied purposes as described below:

- (i) To know the profitability:

- (ii) To know the financial strength:
- (ii) To know the solvency:
- (iii) To make comparative study with other similar concerns:
- (iv) To know the capability of payment of dividend and interest.
- (v) To know the trend of the business
- (vi) To know the managerial efficiency
- (vii) To know the useful information:**

**Briefly explain the limitations of financial statement analysis.**

- (i) Adversely effected by limitations of disadvantages of Financial Statement:
  - (a) Financial statement provides incomplete information as it ignores qualitative factors such as quality of the product or service, employer-employee relationship, standing, reputation and managerial ability etc.
  - (b) Following of different accounting policies makes inter- firm and infra-firm comparison. e.g. one firm may charge depreciation on straight line method and other on diminishing value. Similarly, different firms may adopt different methods of stock valuation.
- (ii) *Affected by window dressing*: Window dressing means certain manipulations made in the financial statements so as to show better profitability and financial position on the date of final accounts. For example, A firm may not enter in the books, the purchases made at the end of accounting year of they may overvalue the closing stock. In such cases, the results obtained by financial analysis will be misleading.
- (iii) *Difficulty in forecasting*: Financial statements and their analysis are based on historical data and do not necessarily reflect the future. Thus it becomes difficult for a firm to forecast the change in the demand of a product, change in trade policies and level of competition etc.
- (iv) *Lack of qualitative analysis*: Financial statements record only those transactions and events which can be expressed in terms of money. But there are many factors which are qualitative in nature and cannot be expressed in monetary terms. These non-monetary factors do not find any place in the financial statements, howsoever, important these may be such as quality of the production service, employer-employee relations, reputation of business, manager's efficiency customer satisfaction, advertisement policy etc. even though they materially affect the profitability of a business.
- (v) *Limited use of single year's analysis of financial statements*: Analysis of financial statements becomes significant only when compared with the analysis of previous years' data. For example, net profit to sales is 18% whether this conclusion is satisfactory or not, will depend upon the conclusion of previous years. If the concern earned 15% of sales as net profit in the previous year, it may be treated to have performed better this year. In fact, the trend analysis of some years will provide better results instead of single year's analysis.
- (vi) *Does not reflect price level changes*: The recording in financial statements is one the basis of actual cost or historical cost whereas the value of money or price level Reeps on fluctuating. Thus, the comparison of previous year figures with current year figures may lead to misleading conclusions. For example, sales of fixed assets in 2007 would be much higher than in 2000 due to rising prices because fixed assets are still being expressed on the basis of cost incurred in the past at the time of its purchase while sales are being expressed at their current prices. As such, sufficient adjustment must be made for changes in price. level while making the analysis.



(vii) *Effect of personal ability and bias of the analyst:* Accounting data in itself is dumb, any conclusion can be drawn from these data. These, conclusions are influenced and effected, by the personal judgment of the analyst. For example, for calculating Return on Capital Employed' one analyst may take the profits after taxes as a base, whereas the other analyst may take the profit before taxes.

### **Distinguish between Horizontal analysis and Vertical analysis.**

Distinction between Horizontal Analysis and Vertical Analysis

<b><i>Basis</i></b>	<b><i>Horizontal Analysis</i></b>	<b><i>Vertical Analysis</i></b>
(i) Requirement	It requires comparative financial statements of two or more accounting periods.	It requires a financial statement of one period.
(ii) Items	It deals with same items of different periods.	It deals with different items of same period.
(iii) Calculation	Absolute and percentage changes are calculated.	Only percentage change is calculated.
(iv) Use	It is generally used for time series analysis.	It is generally used for cross-section analysis.

### **"Analysis of financial statements suffers from lack of qualitative analysis and difficulty in forecasting." Comment.**

Financial statements record only those transactions and events which can be expressed in terms of money. But there are many factors which are qualitative in nature and cannot be expressed in monetary terms. These no monetary factors do not find any place in the financial statements, howsoever, important these may be such as reputation of business, cordial management- labour relations, efficiency of management, satisfaction of customers, advertise policy even though they materially affect the profitability of a business.

### **"Analysis of financial statements is affected by window dressing and personal ability and bias of the analyst." Comment.**

Affected by window dressing: Some business concerns use window dressing for their financial statements so as to show better profitability and financial position on the date of final accounts, For example, a firm may not enter in the books, the purchases made at the end of accounting year or they may overvalue the closing stock. In such cases, the results obtained by financial analysis will be misleading.

Effect of personal ability and bias of the analyst: Accounting data in itself is dumb, any conclusion can be drawn from these data. These conclusions are influenced and affected, by the personal judgment of the analyst. for example, for calculating ' Net profit ratio' one analyst may take the profits after taxes, whereas the other analyst may take the profit before taxes.

## **Tools For Financial Statement Analysis**

### **What do you mean by comparative financial statements or comparison of financial statements?**

When financial statements for two or more years are studied and analysed side by side so as to compare the profitability and financial position of a business, it is known as comparative financial statements. These statements help in drawing meaningful conclusions regarding the changes in financial position and profitability position of a business firm.

Additional columns are drawn so as to indicate absolute change and percentage change values of different items in financial statements.

### **Briefly explain the objectives or purpose or utility or importance of comparative statement.**

Following are the main objectives served by the comparative financial statements.

- (i) Simplify the available data to make it comparable and more understandable: The basic object of preparing comparative financial statements is to present the financial data in a simpler and comparable form. This helps to understand the complex data easily and draw conclusions about change in profitability and financial position of the company.
- (ii) To facilitate inter-firm and inter period comparison: Comparative financial statements are drawn to compare the performance of the company between two years and of one firm to that of other firms in the same industry.
- (iii) Indicate trends: Study of comparative statements over a period of time helps in laying down trend in different items of the financial statements, e.g. trend of sales, gross profit margin, expenses etc.
- (iv) To evaluate financial performance of the enterprise: Financial performance of the enterprise in terms of profitability, liquidity, solvency etc. can be better evaluated with the help of comparative financial statements. This will reveal the strength and weakness of the firm.
- (v) To help in forecasting: On the basis of comparative statements drawn for past years, a company can forecast how the key items of financial statements will behave in future such as change in sales, profits, liquidity etc. in near future. It helps the enterprise to take corrective measures if it predicts an unfavorable future of the company coming ahead.

### **List the various tools/ techniques used for financial analysis.**

- |                            |   |
|----------------------------|---|
| (i) Comparative statements | (ii) Common size statements                   |
| (iii) Trend analysis       | (iv) Ratio analysis    (v) Cash flow analysis |

### **What is comparative balance sheet ?**

According to Prof. Foulkey. " Comparative balance sheet is the study of the trend of the same item, group of items and computed items in two or more balance sheets of the same business enterprise on different dates."

**How is comparative balance sheet prepared ?**

A comparative balance sheet has two columns for the date of the original balance sheets. A third column is prepared to show the increase or decrease of absolute amount in rupees in various assets and liabilities. A fourth column is generally added to show relative percentages of increase or decrease.

**Lay down the Horizontal format of comparative Balance Sheet as per Companies Act, 1956, with assumed figures.**

Format of comparative Balance Sheet ( Horizontal form as per Companies Act, 1956)

**Comparative Balance Sheets**

**as at ----- 2006 and 2007  
(With assumed figures)**

Particulars	2006 Rs.	2007 Rs.	Absolute Change (Increase or Decrease) Rs.	Percent age Change %
A. Fixed Assets	12,00,00	15,00,00	3,00,000	25
B. Investments	4,00,000	4,00,00		
C. Working Capital (Current Assets Less: Current Liabilities and Provisions)	3,00,000	6,00,000	3,00,000	100
D. Capital Employed ( A+B+C)	19,00,000	25,00,000	6,00,00	31.5
E. Less: Long-term Debts (e.g. Debentures)	6,00,000	6,00,000		
F. Shareholder's Funds	13,00,000	19,00,000	6,00,000	46
Represented by :				
Equity Share Capital	6,00,000	9,00,000	3,00,000	50
Preference Share Capital	3,00,000	6,00,000	3,00,000	100
Reserves and Surplus	4,00,000	4,00,000		
Add: Accumulated Profits				
Less: Fictitious Assets				
Shareholder's Funds				
	<b>13,00,000</b>	<b>19,00,000</b>	<b>6,00,000</b>	<b>46</b>

**What is comparative income statement?**

A comparative income statement is show the comparison between the items of income statement (profit and Loss Account) for two or more years. Such comparative study enables us to have definite knowledge about the progress of the business concern.

**What is Common Size Statement? State its utility or purpose.**

In common size statements, each item in the stated as a percentage of the aggregate, of which that item is part, e, g, In common size income statement, the net sales are reduced to 100

and in common size balance sheet, the total assets are taken as 100. All other figures are related to the total of 100 viz., net sales in the case of revenue statement and total assets in the case of balance sheet.

#### Utility of common size statement?

- (i) It shows the changes in various items in relation to Net Sales, Total liabilities
- (ii) It provides a common base for comparison between business enterprise which differ substantially in size.

#### What is common Size Balance Sheet ?

**Ans. In common size balance sheet, the total of the assets or liabilities of a particular year is taken as base or 100 and all other items of assets and liabilities of that year are expressed as a percentage of this base.**

$$\text{Common size percentage} = \frac{\text{Each individual item of asset or liability of a particular year}}{\text{Total of the assets or liabilities of a particular year}} \times 100$$

## Accounting Ratios

#### What is meant by a ratio ?

Ratio is a mathematical expression of relationship between two accounting figures obtained by dividing one figure by another. A ratio can be expressed in terms of percentage, proportion. time fraction .

[ NCERT]

#### What is meant by ratio analysis ?

Ratio analysis refers to calculation and use of different ratios to analyse and interpret financial statements for different purposes. It is the process and technique of determining relationships between different components of financial statements so as to have meaningful understanding of financial performance and position the enterprise.

#### What is meant by accounting ratio ?

Accounting ratio or financial ratio is the relationship between two accounting figures expressed mathematically, showing a meaningful relationship with each other. In open words when the ratios are based on financial statements, they are called financial ratios or accounting ratios.

**Briefly explain the objectives of ratio analysis,**

**Or**

**Briefly explain the significance (uses) or advantages of ratio analysis.**

- (i) Helpful in analysing financial statements:
- (ii) Helpful in analysing accounting data:
- (iii) Helpful to judge operating:.
- (iv) Helpful in financial forecasting and planning.

- (v) Helpful in locating weak points of the firm.
- (vi) Helpful in inter firm and interfere comparison:

**Briefly explain the limitations of ratio analysis.**

Following are the main limitations of ratio analysis:

- (i) Ratios may be misleading when based upon incorrect data provided by financial statements:.
- (ii) Ratios are unreliable if different firms follow different accounting policies:
- (iii) Accounting ratios ignore qualitative or non-monetary factors
- (iv) Ratio analysis ignores price level changes (inflation).
- (v) Ratios may be manipulated due to window dressing:.
- (vi) Ratios are the means and not the end
- (vii) Lack of ability to resolve problems
- (viii) Lack of standardized definitions
- (ix) Lack of universally accepted standard ratios
- (x) Ratios based on unrelated figures:

**Briefly explain the significance of ratio analysis to various groups of persons who are interested in the working of an enterprise.**

**or**

**Financial ratio analysis are conducted by four groups of analysts: managers, equity investors, long-term creditors and short-term creditors. What is the primary emphasis of each of these groups in evaluating ratios ?**

Following are the uses of ratio analysis for different parties:

- (i) *Utility for the creditors* : The short-term creditors are interested to know whether the firm will be able to pay short-term obligations like interest on short-term loan or the principle amount. Current ratio and quick ratio gives an idea about the current financial position of the firm.
- (ii) *Utility for investors*: Investors are interested to know about the security of their investment and their return in the form of dividend or interest. Long-term solvency ratios help in assessing financial position of the firm and profitability ratios help in determining the profitability position.
- (iii) *Utility for management*: Ratio analysis helps management to determine how effectively the assets are being used. Activity ratios such as stock turnover ratio, fixed assets turnover ratio, debt turnover ratio etc. help to assess the operational efficiency.
- (iv) *Utility for equity investors*: Equity investors (shareholders) are always interested in the overall profit ability and efficiency of the business enterprise. They are interested to earn a fairly good rate of return on their investment, Ratios like earnings per share, dividend per share help in assessing the rate of return earned by them.

*What are the categories under which the various ratios are grouped ?*

**or**

**Give the functional classification of accounting ratios.**

**or**

**What are the types of ratios ?**

**or**

*State the various types of accounting ratios according to functions*

On the basis of purpose served by different ratios, these may be classified as follows:

(i) *Liquidity ratios*: Ratios which are calculated to judge the ability of the enterprise to pay its short-term obligations or commitments as and when due, are known as liquidity ratios or short-term solvency ratios. These include current ratio and quick ratio. They are essentially short-term in nature.

(ii) *Long-term solvency ratios*: Solvency ratios are calculated to judge the ability of the firm to pay in time its long-term debts. Solvency ratios include debt-equity ratio, proprietary ratio etc. They are essentially long-term in nature.

(iii) *Activity or Turnover or Performance ratios*: Activity ratios are calculated to judge the performance of the enterprise in terms of effective utilisation of resources. These are also known as Turnover ratios or Performance ratios. These include stock (inventory) turnover ratio, fixed assets turnover ratio, working capital turnover ratio, etc.

(iv) *Profitability ratios*: Ratios that measure profitability of the enterprise in relation to sales or funds (or assets) employed in the business are known as profitability ratios. These include gross profit ratio, net profit ratio, operating ratio and return on investment ratio.

**Give the traditional classification of accounting ratios.**

**or**

**Classify accounting ratios on the basis of statement from which they are calculated.**

Ratio may be classified on any one of the following two basis:

- (i) **Income statement ratio**: These ratios are calculated between different items of the same income statement, e.g. stock turnover ratio, gross profit ratio, operating ratio, net profit ratio, etc.
- (ii) **Balance Sheet ratios**: These ratios are calculated between different items of the same balance sheet, e.g. current ratio, quick ratio, debt-equity ratio, proprietary ratio, etc.
- (iii) **Composite or mixed ratios**: These ratios are calculated between items of income statement and balance sheet e.g. return on investment, return on equity, interest coverage ratio, working capital turnover ratio, fixed assets turnover ratio, etc.

**What do you mean by liquidity ratios. Write the objective / significance of calculating liquidity ratios ?**

Ratios that help determine and evaluate liquidity position of the enterprise with regard to its ability to pay short-term creditors and liabilities as and when due, are known as liquidity ratios. Current ratio and quick ratio are the two important ratios used to determine liquidity position of a firm.

**Objective/ Significance of liquidity ratio:**

- (i) Liquidity ratios are calculated to judge the ability of the enterprise to pay its short-term obligations or commitments as and when due.
- (ii) It is calculated to assess short-term financial position of the firm.

**What is the difference between current ratio and quick rate ?**

Basis	Current Ratio	Quick Ratio
(i) Closing stock and Prepaid expenses	These are included in current assets while calculating current ratio.	These are not included in quick assets while calculating quick ratio.
(ii) Ideal ratio	2:1	1:1
(iii) Formula	Current Assets Current Liabilities	Quick Assets or Liquid Assets Current Liabilities

**What do you mean by solvency ratios ? Name the various solvency ratios.**

Solvency ratios are measure of long-term financial solvency of the firm in terms of its ability to pay its long-term obligations such as debentures and term loans as and when due. Important ratios used to judge long-term solvency of a business are: (i) Debt- equity ratio, (ii) Total assets to debt ratio and (iii) Proprietary ratio.

**State the method and significance of calculating Total Assets to Debt Ratio. .**

Meaning: This ratio explains the relation between long-term debts and total assets. It indicates what portion of total assets have been financed through long-term borrowings.

Formula	Significance
$\text{Total Assets to Ratio} = \frac{\text{Total Assets}}{\text{Debt}}$	(i) This ratio measures the safety margin for investors. (ii) Higher the ratio better it is for investors because higher ratio shows investment of more equity money in total assets than the long-term debts.

**What is meant by profitability ratio ? What are the objectives of calculating profitability ratios ?**

Profit earning is the main objective of each business concern. In fact, efficiency of a business is measured in terms of profits. Thus, profitability ratios are computed to analyse the earning capacity of a business which is the outcome of utilisation of capital employed in the business. There is close relationship between the profit and capital employed.

**What do you understand by " Activity Ratio" ? Explain the objective of activity ratios.**

Activity ratios measure how effectively the firm employs its resources. These ratios are also called turnover ratios which involve comparison between the level of sales and investment in various accounts. i.e. stock, debtors, fixed assets etc. Activity ratios are used to measure the speed at which these various elements can be converted into sales or cash.

**State the method and significance of calculating Inventory (Stock) Turnover Ratio.**

Formula	Significance
$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$	<p>(i) This ratio indicates the rate at which stock of finished goods are converted into sales.</p> <p>(ii) It is also a measure of liquidity. It determines how many year, times stock is purchased or replaced during a</p> <p>(iii) The higher the ratio, the better it is for the business, since it means that stock is being sold quickly. Concerns having too high stock turnover ratio may be operating with low margin of profit.</p> <p>(iv) Low turnover of stock may be due to overinvestment in stock. Obsolete stock or a dull business of the firm and is a danger signal.</p> <p>(v) It helps to check excess investment in stock.</p>

**State the method and significance of calculating Debtors ( Receivable) Turnover Ratio.**

Formula	Significance
$\text{Debtors Turnover Ratio} = \frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable (Debtors + B/R)}}$	<p>(i) The ratio throws light on credit and collection Policies of the business and is thus related to liquidity.</p> <p>(ii) The higher the ratio, the better it is, since it means speedier collection and lesser amount being blocked up in debtors and vice-versa</p>

**State the method and significance of calculating fixed assets turnover ratio.**

Formula	Significance
$\text{Fixed Assets Turnover Ratio} = \frac{\text{Net Sales}}{\text{Net Fixed Assets}}$	<p>(i) This ratio measures efficiency and extent of utilisation of fixed assets.</p> <p>(ii) Higher ratio indicates efficient utilisation of fixed assets while a low ratio indicates idle capacity</p>

**State the method and significance of calculating current assets turnover ratio.**

Formula	Significance
$\text{Current Assets Turnover Ratio} = \frac{\text{Net Sales}}{\text{Current Assets}}$	<p>(i) This ratio indicates the number of times current assets are being turned over in a year.</p> <p>(ii) Higher turnover means efficient utilisation of current assets and improves the liquidity position of the concern.</p>



**Comparison with the help of ratios is not possible if different firms follow different accounting policies" comment.**

Ans. If different firms follow different accounting policies, such as for valuation of stock, calculation of depreciation etc. then inter firm comparison becomes invalid.

**The debt-equity ratio of Alpha Co. and Salpha Co. are 1:2 and 2:1 respectively, which company in your opinion has got better debt equity ratio and why ? Presume that both the companies produce and sell similar kind of products having growing demand.**

Salpha Co, has a better debt equity ratio because it is taking the benefit of trading on equity. i.e, by earning more from debt as compared to the interest paid on debt. Whereas the Alpha co. is not deriving this benefit

**You are a long-term creditor of a company, Explain what ratios will you compute to examine whether your decision to lend the funds to company was justified.**

(i) Proprietary Ratio (ii) Current Ratio.

## **Cash Flow Statement**

**What is cash flow statement ?**

**Or**

**Define cash flow statement.**

A cash flow statement is a statement showing inflow and outflow of cash and cash equivalents from operating investing and financing activities of a company during a specific period.

It analyses all the inflow and outflow of cash that took place during the year in a company. It indicates the sources from which the cash is generated and also the uses to which the cash is put in.

**Name the various activities classified as per AS-3 (revised) while preparing Cash Flow Statement.**

The various activities classified as per AS-3 ( revised) while preparing Cash Flow statement are :

- (i) Cash flow from operating activities.
- (ii) Cash flow from investing activities.
- (iii) Cash flow from financing activities.

**Explain the term Cash Equivalent.**

Cash equivalents are the highly liquid short-term investment which can be converted into certain known amount of cash without any risk of loss in value.

An investment can be classified as cash equivalent if it has a maturity date of less than three months from the date of purchase e.g. (i) Treasury bill. (ii) Commercial papers (iii) marketable securities redeemable within a period of three months.

**State the uses of cash flow statement.**

**or**

**What are the objectives of preparing cash flow statement .**

The main objectives/ uses of preparing a cash flow statement are as follows:

- (i) Useful for short- term financial planning: Cash flow statement gives information about cash inflow and outflow from operation of business. Such information helps the management to plan its short- term financial need e.g. payment of day today expenses, payment to trade creditors, repayment of long- term loans, purchase of fixed assets etc.
- (ii) Provide a trend of cash receipts and payment; A cash flow statement discloses the speed at which the cash is being generated from current assets such as debtors, bills receivables, stock etc. and the speed at which the current liabilities such as creditors, bills payable etc. are being paid. This trend enables the management assess the true position of cash in future.
- (iii) Reveals the reasons for deviation of cash from earnings: A business may have made profit and yet is running short of cash. Similarly, a business may have suffered a loss and still has sufficient cash balance. A cash flow statement reveals reasons for such increases or decreases of cash balance.
- (iv) Useful in preparing the cash budget: A cash flow statement prepared on an estimated basis for the next accounting period enables the management to know how much cash can be received internally and how much it should be arranged from outside. Such estimated amounts are used for preparing cash budget.
- (v) Helpful in ascertaining cash flow from various activities separately: Cash flow statement helps in ascertaining the flow of cash from operating, investing and financing activities. separately. This helps in analysing whether the fixed assets have been financed by long- term funds or from short- term loans.
- (vi) Discloses odd situations: Cash flow statement discloses odd situations like the payment of dividend when there is negative flow of cash from operation. Similarly, it shows no dividend has been paid in spite of huge positive cash flow from the operation of business. Cash flow statement explains how this has happened.

**Briefly explain the limitations of cash flow statement.**

Cash flow statement suffers from the following limitation:

- (i) Ignores important non-cash transaction: Cash flow statement ignores many important transactions which do not involve cash receipts or payments like conversion of debentures into shares, purchase of fixed assets on credit etc.
- (ii) Historical in nature: Cash flow statement is prepared on the basis of historical record. It is not prepared on the basis of future expected receipts or payments.
- (iii) Fails to show the true picture of the liquidity of a firm: Cash flow statement involves only cash whereas liquidity does not depend upon cash alone. Firm liquidity also depends upon other assets which can be converted into cash early but not covered under cash flow statement. Thus, cash flow statement fails to show the ability of the firm to meet its liabilities when they are due for payment.
- (iv) **Cash basis v/s accrual basis of accounting: Since cash book is prepared on cash basis, it ignores the most important concept of accounting i.e. accrual concept or merchant basis of accounting.**

**What is meant by : Cash flow from operating activities " ?**

As per AS-3, operating activities are the principal revenue producing activities of the enterprise, e.g. for a company dealing in manufacturing of garments, purchase of raw materials, payment of manufacturing expenses, sale of garments etc. are the principal revenue producing activities. Cash inflows and outflows from these activities will affect the calculation of profits or loss of the business.

**What is meant by "Cash flow from investing activities"?**

Cash flow from investing activities arise from the sale and purchase of fixed assets and long-term investment included in cash equivalents. It involves sales and purchase of fixed assets which are not kept for resale purpose. e.g. building, furniture, machinery, land etc.

**What is meant by " cash flow from financing activities" ?**

Cash flows from financing activities arise from the issue of equity shares, preference shares, debentures, borrowing of long-term loan, public deposits etc, and also due to redemption of debentures, preference shares, buy back of equity shares, payment of interest and dividend etc. These activities results in changes in the size and composition of the owner's capital and borrowings of the enterprise.

**" The nature/ type of enterprise can change all together the category into which a particular activity may be classified" Do you agree ? Illustrate your answer.**

Ans. It is very true that the nature/ type of enterprise can change all together the category into which a particular activity may be classified. It is very clear with the help of following examples:

	<b>Real Estate Agent</b>	<b>Non Real Estate Agent</b>
(i) Rent Received	Operating activity Finance Company	Investing activity Non Finance Company
(ii) Dividend Received	Operating activity	Investing activity
(iii) Interest Received	Operating activity	Investing activity
(iv) Interest paid	operating activity	Financing activity
(v) Dividend Paid	Financing activity	Financing activity