UNIT 3 FINANCIAL STATEMENTS

Structure

3.0 OBJECTIVES

After studying this unit you should be able to:

- state the nature and contents of financial statements;
- know the differences between capital and revenue;
- know the prepration of non-corporate financial statements;
- be acquainted with the items peculiar to corporate financial statements; and
- prepare the profit and loss account and the balance sheet of a company as per the requirements of the Companies Act.

3.1 INTRODUCTION

Accounting involves the collection, recording, classification and presentation of financial data for the benefit of management and external agencies. For this purpose, the transactions recorded in the books of accounts are periodically summarised and presented in the form of two financial statements. One is the Balance Sheet or Positional Statement and the other is Profit and Loss Account or Income Statement.

These are periodical reports which reflect the financial position and operating results of the entire business for an accounting period, generally one year. These financial statements are the basis for decision making by the management as well as outsiders. However, the information presented in these statements must be analysed and interpreted carefully before drawing conlcusions. In this unit we shall study the preparation of financial statements both corporate and non-corporate entities as well as the salient points involved in the preparation of these statements in the light of Sections 210 to 223 and Part I and II of Schedule VI of the Companies Act, 1956.

3.2 NATURE OF FINANCIAL STATEMENTS

Financial Statements are prepared by all forms of business organizations to ascertain the result of operating, financial and investment activities and to know the financial position on the date of closing of books of accounts. In case of sole trade or a partnership firm, maintenance and preparation of financial statements is not mandatory but desirable. However, in case of Joint Stock Company, Sections 209 and 210 of the Companies' Act 1956 make it obligatory and compulsory to maintain and prepare financial statements by the end of each accounting period. Thus, main objective of financial statements is to serve the information needs of users of accounting information. These financial statements are the basis for decision making by the management as well as to the outsiders like investors and share holders, creditors and Financiers, government authorities, etc.

Objectives of Financial Statements

The primary objective of financial statement is to assist in decision making.
These statements enable the users:

i) To make rational investment, credit and similar other financial decisions.

ii) To estimate future cash flow and bankruptcy risk assessment.

iii) To ascertain NAV (Net Assets Value) or Net worth of the enterprise after evaluating the value of assets, resources owned and the claims thereon (liabilities) in order to make share purchase and sale decisions, takeovers and merger decisions.

iv) Collective bargaining decision relating to wages, working conditions and job security.

v) To make assessment of economic and financial decisions.

(vi) To form appropriate taxation and subsidy policy, regulatory policy and employment policy.

Besides, the financial statements are tools of judging earning capacity and managerial efficiency to facilitate comparison and help evaluate its own performance. Thus, these provide necessary inputs for forecasting and other relevant decision-making purposes.

According to American Institute of Certified Public Accountants "Financial statements are prepared for the purpose of presenting periodical review or *report on progress* by management and deal with the status of the investment in the business and the *results achieved during the period* under review. Financial statements reflect a combination of *recorded facts, accounting-conventions* and the *personal judgment and the judgments and conventions applied affect them materially.* The soundness of the judgments necessarily depends on the competence and integrity of those who make them and on their adherence to generally accepted accounting principles and conventions.

Hence, these financial statements must give sufficient analysis of the figures, without unnecessary details to enable the users to understand its financial implications. This calls forth for "convention of materiality" i.e. every material fact has to be disclosed which affect the decisions of the users of financial statements. It also demands that any departure from previous year's practice should clearly be indicated. In other words the "convention of consistency" should strictly be adhered to. An enterprise has to be consistent with reference to depreciation policy, inventory valuation policy and other policy to facilitate horizonal and vertical comparison. Financial statements are based on fundamental accounting assumptions of "going concern", "consistency" and accrual and are guided by major considerations governing the selection and application of accounting policies.

3.3 CONTENTS OF FINANCIAL STATEMENTS

3.3.1 Manufacturing Account

Business concerns engaged in the activities of manufacturing or production of goods which involves purchase of raw materials and in incurring of other manufacturing expenses, prepare Manufacturing Account which shows the cost of raw materials consumed, cost of conversion of raw materials into finished product and the cost of goods produced. The cost of goods produced charged to Trading Account. The cost of conversion includes–Direct Expenses, Frieght or Carriage Inward, direct labour. Productive wages/Factory wages and factory expenses, such as factory rent, fuel, power and gas, etc.

Cost of goods produced = Raw materials consumed + Cost of conversion

If, however, there is opening and closing work in progress due adjustment is made accordingly. Similarly, value of material residue, which is sold as scrap, is credited to Manufacturing Account.

Thus, we can say

Cost of goods produced = opening work-in-progress = cost of raw materials consumed + cost of conversion – closing work in progress – sale of scrap

Points to note regarding Manufacturing Account

1) ***Work in progress:*** It refers to the value of incomplete or semi-finished goods which includes cost of raw materials, and proportionate wages and direct expense incurred till this stage of semi completion. Opening and closing balances of the same are shown to the debit and credit side respectively.

2) ***Raw materials consumed:*** This shows the cost of materials used in the production process. This is arrived at by *Adding* the net purchases to the opening balance of raw materials and deducting the closing balance of raw materials at hand by the end of accounting period.

3) ***Direct expenses:*** These expenses are incurred either on procurement or purchases of raw materials and on conversion thereof into finished product. It includes productive wages, freight inward, cartage or carriage inward, etc. That is, it includes direct labour and direct expenses (factory).

4) ***Factory overheads or indirect expenses:*** Factory overheads refer to indirect material, indirect labour and indirect expenses. These include cotton waste, lubricating of machine oil, works manager, supervisor or foreman's salary, fuel and power, repairs and maintenance of factory machine, depreciation of factory assets, rent, rates and taxes of the factory building, factory insurance, etc.

5) ***Scrap:*** It denotes the value of material residue coming out of certain types of processes. It is sold as scrap and credited to Manufacturing Account to arrive at the correct cost of production.

6) ***Cost of production:*** Manufacturing Account ascertains the cost of goods manufactured during any accounting period as shown in the format of Manufacturing Account. The cost of production of goods produced is transferred to Trading Account.

3.3.2 Trading Account

Trading Account is prepared to know the result of trading operations. It shows the gross profit or gross loss arising from buying and selling of goods in which the business enterprise deals in. Gross profit or gross loss is the difference between 'sales' and 'cost of goods sold'.

Cost of goods sold = opening stock + purchases (less returns) + direct expenses – closing stock

It is to be noted that Trading Account shows the result of trading operations under **normal** conditions only. Abnormal losses (items) if any – such as loss of stock due to fire, theft or accident are credited to Trading Account, at cost.

Analysis of Items Appearing to the Debit Side of Trading Account

1) **Opening Stock:** It refers to the value of goods at hand at the end of last accounting year. It becomes the opening stock for the current accounting year. It represents the value of goods in which business deals in.

2) **Purchases:** It denotes the value of goods (in which the concern deals in) purchased either for cost or on credit for the purpose of resale. However, if the goods so purchased are *returned* or *used by proprietor* for self consumption, or *distributed as free samples* or *taken up by the employer* for their use, or *given as charity*, or to be *sent on consignment*, or used for any other purpose, except for resale, such amounts shall be deducted from the total purchases.

3) **Director Expenses:** These expenses are incurred in connection with purchase, procurement or production of goods. It also includes expenses which bring the goods up to the point of sale. Examples of direct expenses are:

a) Carriage Inwards (carriage paid on purchases)
b) Freight – Railways, Airways and Shipping
c) Transit – Insurance
d) Loading charges
e) Packing
f) Import duty
g) Export duty
h) Custom duty
i) Dock dues
j) Octroi
k) Warehousing wages

However, for a manufacturer in addition to above direct expenses include –

l) Wages and salaries
m) Fuel, coal, power, gas and water
n) Factory heating*
o) Factory insurance*
p) Factory lighting*

q) Foreman's and Supervisor's salary*

r) Other factory expenses*

s) Royalty on production*

t) Depreciation on Factory Building and machine*

* These are also known as Factory overheads or Factory indirect expenses from cost accounting point of view but for financial accounting purposes these are treated as direct expenses.

It is to be noted that a manufacturer prepares a Manufacturing Account where all the above mentioned direct expenses are debited. However, if in any case Manufacturing Account is not prepared, then all such expenses will be charged to Trading Account.

Analysis of Items Appearing to the Credit Side of Trading Account

1) **Sale:** It refers to the sale of goods in which business deals and includes both cash and credit sales. It does not include sale of old, obsolete or depreciated assets which were acquired for use in business. Similarly, goods returned by customers or goods sent to customers on approval basis or sales tax, if any, included in sales price should be excluded.

2) **Abnormal Loss:** It refers to abnormal loss of stock due to fire, theft or accident. Since Training Account is prepared under normal conditions of the business, abnormal loss, if any, is credited fully to the Trading Account.

3) **Closing Stock:** It refers to the value of goods lying unsold at the end of any accounting year. The stock at the end is valued either at cost or market price, whichever is less. Since Trial Balance generally does not include closing stock, the following entry is recorded to incorporate the effect of closing stock in the Trading Account.

Closing Stock A/c Dr
To Trading A/c

However, if closing stock forms the part of Trial Balance it will not be transferred to Trading Account but taken to Balance Sheet only.

In case goods have been sent to customer on approval (Sale/Return) basis, such goods should be included in the value of closing stock if no approval has been received from them.

Constituents of closing stock are:

i) Stock of Raw materials

ii) Work-in-progress or semi-finished goods

iii) Finished goods – remaining unsold at the end of the year,
– lying unsold at different branches, if any,
– lying unsold with the consignee

iv) Stores supplies = goods, materials required for converting the raw materials into finished product, such as machine oil, cotton waste, chemicals and machine spares (as per As-2)

- It is to be noted that Income Statement + (viz. Manufacturing/ Trading/Profit and Loss Account) is parepared on Accrual) (Mercantile) basis (Accrual concept) covering an accounting period (accounting period concept) during which expenses are matched with revenue (Matching Concept) to ascertain the profit or loss of an enterprise. That is why unpaid expenses are added as outstanding in the Income Statement and shown as liability in the Balance Sheet. Similarly income accrued but not received are credited to Income Statement and shown as asset in the Balance Sheet.

- It is important to remember that "Outstanding" Accrued or "Prepaid", if forming part of Trial Balance, then such items will be shown in the Balance Sheet only and no treatment required in the Income Statement.

- Conversely, "prepaid expenses" are shown by way of deduction in the Income Statement and treated as an asset in the Balance Sheet, whereas income received in advance are subtracted from the income received and shown as a liability in the Balance Sheet.

3.3.3 Profit and Loss Account

This account is prepared to ascertain the net profit earned or net loss incurred by the business concern during an accounting period. It starts with gross profit or gross loss as disclosed by the Trading Account. It takes into account all the remaining direct (normal and abnormal) expenses and losses related to or incidental to business. These operating and non-operating expenses are charged to Profit and Loss Account and shown to the debit side of the Profit and Loss Account.

The **operating expenses** include:

i) All office or Administrative overheads such as rent, rates and taxes, office staff salaries, printing and stationary, postage, telephone, office lighting, depreciation on office equipment, etc.

ii) Selling and Distribution overheads such as Salesmen's salaries, commission on sales, travelling expenses, advertisement and publicity, trade expenses, carriage outward, bad debts, warehouse expenses, delivery van expenses, packing expenses and rebate to customers.

Non-operating expenses include financial expenses such as interest, bank charges, discount on bill, abnormal losses (loss of goods due to fire, theft or accident) and loss on sale of fixed assets, etc.

Whereas Non-operating incomes include income from investment and financing activities, such as Interest Received, Rent Received, Dividend Received, Profit on Sale of Investment, and Insurance Claims and other Miscellaneous Receipts, like duty drawback and subsidy and apprenticeship premiums, etc. These incomes are credited to Profit and Loss Account.

It is to be noted that if an enterprise prepares a Manufacturing Account, the factory expenses (both direct and indirect) are charged to Manufacturing Account. If a Manufacturing Account is not prepared, then direct factory expenses are charged to

Trading Account and indirect factory expenses to Profit and Loss Account. *Royallties* paid on *production* should be treated as *direct expenses* and *royalties* based on *sales* as *indirected expenses.*

Some Important Points

1) ***Salaries:*** Salaries paid/payable to employees including Directors' salaries, Managers' salaries (except Work Managers salaries) should be debited to Manufacturing Account. In case a concern does not prepare Manufacturing Account, the same should be charged to Trading Account. Similarly, salaries and wages should also be charged to Profit and Loss Account. But wages and salaries be charged to Trading Account.

2) ***Brokerge:*** This refers to brokerage paid on the items in which the business trades in. Such as brokerage on buying and selling of goods in which the enterprise deals in is shown to the debit of Profit and Loss Account. However, any brokerage paid on sale or purchase of assets is treated as of capital nature and hence it is deducted from sale proceeds of the asset sold or added to the cost of the asset required.

3) ***Trade Expenses:*** These expenses are of miscellaneous nature and of small amount and sometimes termed as Sundry expenses or Miscellaneous expenses or even Petty expenses. These are debited to Profit and Loss Account.

4) ***Advertisement:*** Expenses on advertisement which are of revenue and recurring nature are charged to Profit and Loss Account. Whereas cost of heavy advertisement the benefit of which is likely to cover more than one accounting year is treated as deferred revenue expenditure. For example, a company incurs Rs. 1,00,000 on advertisement and it is estimated that the benefit of this advertisement expenditure is likely to extend over a period of four years. In this case Rs. 25,000, i.e. one-fourth of total cost of advertisement will be charged to current year's Profit and Loss Account whereas three-fourths, i.e. Rs. 75,000, will be taken to Balance Sheet to be treated as 'Deferred Revenue Expenditure'. However, advertisement expenses incurred for purchase of goods should be charged to Trading Account. Advertisement expenses paid for acquiring a capital asset are capitalised. Again, cost of advertisement in respect of sale of any capital asset is deducted from the sale proceeds of the asset concerned and hence not charged to profit and loss account.

5) ***Rebate to Customers:*** It is an allowance given to a customer when his purchases from the concern exceeds the certain limits say Rs. 200. In such cases all those customers who make purchases from the company exceeding Rs. 200 will be entitled to rebate of 1% or 2% depending upon the policy declared by the company. The amount of rebate so allowed is charged to Profit and Loss Account.

6) ***Duty drawback and subsidy:*** It is a refund of duties levied on purchases made by exporter. It serves as an incentive to exporter. The duty drawback and cash subsidy should be deducted from the purchases. But in practice it is treated as 'income'.

7) ***Apprenticeship Premium:*** It is the fee charged by the business enterprise to train persons in various trades. It is treated as revenue receipts and credited to Profit and Loss Account.

8) ***Factory Expenses:*** Factory expenses are of two types, viz. direct and indirect, and both are shown in the Manufacturing Account. If a concern does not prepare Manufacturing Account, then direct expenses are charged to Trading Account and indirect expenses are debited to Profit and Loss Account.

9) ***Royalties:*** Royalties are paid by the business concerns to the landlord, author of a patentee for the right to use their land, copyrights or patents right. Payment of such royalty sum based on sales is debited to Profit and Loss Account. However, if royalty is paid on the basis of production, it is charged to Trading Account.

10) ***Free Samples and Publicity Expenses:*** These expenses are incurred to attract cumtomers for increasing the volume of sale and as such are charged to Profit and Loss Account. Similarly, money spent on prizes given to customers under the scheme of 'sales promotion' such as 'Bumper sales', 'Dhamaka sales' are treated as selling and distribution expenses. If a large sum is incurred on heavy advertisement under a contract or whose benefits may accrue over a period of more than one year, say four years, such expenses are spread over the period of its benefits and a proportionate part is charged to Profit and Loss Account and remaining is taken to Balance Sheet as deferred revenue expenditure.

11) ***Abnornal Losses and Insurance Claims:*** As a rule, the entire amount of abnormal losses either arising from accident, fire or tgheft are credited to Trading Account and debited to profit and loss account irrespective of the insurance claims. The amount so received/settled/receivable from the insurance company is credited to Profit and Loss Account.

Alternatively, Trading Account may be credited with the net abnormal loss (abnormal loss insurance claim, if any) and insuracne claims and Profit and Loss Account may be debited by net abnormal loss only.

3.3.4 Profit and Loss Appropriation Account

This account shows the distribution or appropriation of profit after the same has been earned and computed. In case of sole proprietor, since entire amount of profit belongs to him, no Profit and Loss Appropriation is prepared. However, this account is prepared by partnership firms and Joint Stock Companies where there are several claimants in the net profit. A partner shares earnings of the firm in the form of salary, commission, interest and profit and credited to Profit and Loss Appropriation Account.

However, a company's Profit and Loss Appropriation account shows the transfer from Profit and Loss Account an amount equivalent to "currnet year's profit after tax". This account is further credited by the reserves and provisions made last year, now no longer required, such as Development Rebate Reserve and Provision for Tax, etc. The following items are debited to Profit and Loss Appropriation Account:

- Transfer to General Reserve
- Transfer to Capital Reserve
- Dividend Paid
- Proposed Dividends
- Bonus to Shareholders
- Excess of actual tax liability over the provisions made last year
- Corporate Dividend Tax, if any.

However, a detailed explanation of Profit and Loss Appropriation Account is to be made under Corporate Financial Statements under 3.7 of this unit.

3.3.5 Balance Sheet

Balance sheet is a statement of assets and liabilities which helps us to ascertain the financial position of a concern on a particular date, i.e. on a date when financial statements or final accounts are prepared or books of accounts are closed. In fact, it treats the balances of all those ledger accounts standing to the debit or credit column of the Trial Balance and which have not been squared up. These accounts relate to assets owned, expensed incurred but not paid or not due, expenses due but not paid, incomes accrued but not received or certain receipts which are not due or accrued. In fact it deals with all those “real” and “personal accounts” which have not been accounted for in the Manufacturing, Trading and Profit and Loss Accounts. Besides, the balance sheet also treats all those items in the adjustments, whch affect Real or Personal Accounts. The Nominal Accounts are treated in the Income Statement (P&L A/c). A Balance Sheet aims to ascertain nature and amount of different assets and liabilities so that the financial position could clearly be known to all those concerned. Thus, the main function of the Balance Sheet is to depict the true picture of the concern on a particular date.

Preparation and Presentation of Balance Sheet

The process of preparation and presentation of balance sheet involves two steps: (i) Grouping and (ii) Marshalling. The first step refers to proper grouping of the various items, which are of similar nature. For example, amount due from persons who were sold goods on credit basis must be shown under the heading ‘Trade Debtors’ and must be distringuished from money owing other than due to credit sales of goods. The second step involves ‘marhsalling’ of assets and liabilities. It means orderly arrangement in which assets and liabilities are presented or shown in the Balance Sheet. There are two methods of presentation: (i) In order of “Liquidity, and (ii) In order of “permanence”.

Under the “Liquidity Order”, assets are shown on the basis of liquidity or realisability. These are arranged in order of “most liquid”, more liquid”, “liquid”, “least liquid” and “not liquid” (fixed) assets. Similarly, liabilities are arranged in the order in which these are to be paid or discharged. The liquility form is suiable for banking and other financial companies.

Under the ‘‘Order of Permanence”, the assets are arranged on the basis of their useful life. The assets which are to serve business for the longest period of time are shown first, i.e. Fixed Assets, Semi Fixed, Current, Liquid and Most Liquid. Similarly, in case of liabilities, after Capital, the liabilities are arranged as long term, medium term, short term and current liabilites. The Companies Act has adapted permanency form preparing balance sheet.

Some Important Items

1) **Fixed Assets:** Fixed assets are those assets, which are reuired for the purposes of producing goods or rendering services. These are not held for resale in normal course of business. Fixed assets are used for the purpose of earning revenue and these are held for a longer period of time. These are also treated as ‘Gross Block’ (Fixed assets after depreciation) and ‘Net Block’ (Fixed assets after depreciation). Investment in these assets is known as ‘Sunk Cost’. Examples of fixed assets are Land and Building, Plant and Machinery, Furniture and Fixtures, Tools and Equipments, Motor Vehicles, etc. All fixed assets are ‘tangible’ by nature.

2) **Intangible Assets:** Intangible assets are those capital assets which do not have any physical existence. Though cannot be touched or seen yet they have long life and help to generate income. Such assets have value by virtue of the rights conferred upon the owner by mere possession. Goodwill, trademarks, copyrights and patents are the examples of intengible assets.

3) **Current Assets:** Current assets include cash and other assets which are converted or realized into cash within a normal operating cycle or say within a year.

These are acquired either for the purpose of resale, or assisting and helping process of production or rendering of service or supplying of goods. These assets constantly keep on changing their form and contribute to routine transactions and operations of business. Examples are, Cash in Bank, Bills Receivables, Debtors, Stock, Prepaid Expenses, etc. Current assets are also known as floating assets or circulating assets.

4) **Liquid or Quick Assets:** Those current assets whch can be converted into cash at a very short notice or immediately without incurring much loss or exposing to high risk. Quick assets can be worked out by deducting Stock (Raw materials, work in progress or finished goods) and prepaid expenses out of total current assets.

5) **Fictitious Assets:** These are the non-existent worthless items which represent unwritten off losses or cost incurred in the past which cannot be recovered in future or realized in cash. Examples of such assets are preliminary expenses (formation expense), Advertisement suspense, Underwriting - commission, discount on issue of shares and debentures, Loss on issue of debentures and debit balance of Profit and Loss Account. These fictitious assets are written off or wiped out by debiting to Profit and Loss Account.

6) **Wasting Assets:** Assets with limited useful life by nature deplete over a limited period of time are called wasting assets. These assets become worthless once its utility is over or exhaust fully. Such assets are natural resources like, timer, coal oil, mineral deposits, etc.

7) **Contingent Assets:** Contingent assets are probable assets which may or may not become assets as it depends upon occurrence or non-occurrence of a specified event or performance of a specified act. For example, a suit is pending in the court of law against ownership title of any dispsuted property and if the suit is decided in favour of the business concern it becomes the asset of the concern. On the other hand, if the decision goes against the concern, the company cannot claim to enjoy ownership rights. Thus, it remains a contingent asset as long as the judgment is not pronounced by court. Such assets are shown by means of footnote and hence do not form part of assets shown in the Balance Sheet. Beside this hire purchase contract, uncalled share capital etc. are the other examples of contingent assets.

8) **Classification of Liabilities**

Long Term Liabilities: These are the obligations which are to be met by the business enterprise after a relatively long period of time. Such liabilities do not become due for payment in the ordinary course of business operation or within normal operating cycle. Debentgures, long term loans from Bank or financial institutions are the examples of long-term liabilities.

Current Liabilities: Current liabilities are those liabilities which are payable within normal operating cycle, i.e. within an accounting year. These may arise either out of realization from current assets or by creating fresh current liability (obligation). Trade creditors, Bill payable, Bank overdraft, Outstanding expenses, Short-term loan (payable within twelve months or within accounting year) are examples of current liabilities.

Contingent Liability: It is not an actual liability but an anticipated (probable liability which may or may not become payable). It depends upon happending of certain events or performance of certain acts. An element of uncertainty is always attached. A contingent liability, thus, may or may not become a sure liability. Examples are, liability for bills discounted, liability for acting as surety, liability arising on a suit for damages pending in the court of law, liability for calls on partly paid shares, etc. Contingent liabilities are shown as footnote under the Balance Sheet.

3.4 CONCEPTS OF CAPITAL AND REVENUE

You know that a firm prepares Profit and Loss Account for ascertaining the net result of business operations and the Balance sheet for determining the financial position of the business. These are prepared with the help of Trial Balance which shows the final position of all ledger accounts. All items appearing in the Trial Balance are transferrd either to the Profit and Loss Account or to the Balance Sheet. As per rules, the items of revenue nature are taken to the Profit and Loss Account and the items of capital nature are shown in the Balance Sheet. In other words whether an item appearing in the Trial Balance is to be taken to the Profit and Loss Account or the Balance Sheet depends upon the capital and revenue nature of the item. If any item is wrongly classified i.e., if an item of revenue nature is treated as a capital item or vice versa, the Profit and Loss Account will not reveal the correct amount of profit and the Balance Sheet will not reflect the true and fair view of the affairs of the business. It is therefore necessary to determine correctly whether an item is of capital nature or of a revenue nature and record it in the books accordingly. There are certain rules governing the allocation of expenditures and receipts between capital and revenue which should be clearly understood.

Capital and Revenue Expenditures

You incur expenditure on various items every day. You buy food items, stationery, cosmetics, utensils, furniture, etc. Some of them are consumables and some are durables. The benefit of expenditure on consumables like stationery, cosmetics, etc. is derived over a short period. But in case of durables like furniture, utensils, etc., the benefit spreads over a number of years. Same is true of business also. In business you incur expenditure on two types of items: (i) routine items like stationery, and (ii) fixed assets like machinery, builing, furniture, etc., whose benefit is available over a number of years. In accounting terminology the first category of expenditure is called revenue expenditure and the second one is called capital expenditure. Let us now study the exact nature of capital and revenue expenditures.

Capital Expenditure: As stated above, when the benefit of an expenditure is not exhausted in the year in which it is incurred but is available over a number of years it is considered as capital expenditure. The following expenditures are usually treated as capital expenditures:

1) Any expenditure which results in the acquisition of fixed assets such as land, buildings, plant and machinery, furniture and fixures, office equipment, copyright etc. you should note that such capital expenditure includes not only the purchase price of the fixed asset but also the expenses incurred in connection with their acquisition. Thus, the brokerage or commission paid in connection with the acquisition of an asset, the freight and cartage paid for transportation of machinery, the expenses incurred on its installation, the legal fees and registration charges incurred in connection with purchase of land and buildings are also treated as capital expenditure.

2) Any expenditure incurred on a fixed asset which results in (a) its expansion, (b) substantial increase in its life, or (c) improvement in its revenue earning capacity. Improvement in the revenue earning capacity can be in the form of (i) increased production capacity, (ii) reduced cost of production, or (iii) increased sales of the firm. Thus, cost of making additions to buildings and the amount spent on renovation of the old machinery are also regarded as capital expenditures. If you buy a second hand machinery and incur heavy expenditure on reconditioning it, such expenditure is also to be treated as capital expenditure. Similarly, expenditure on structural improvements or alterations to existing fixed assets whereby their revenue earning capacity is increased, is also treated as capital expenditure.

3) Expenditure incurred, during the early years, on development of mines and land for plantations till they become operational.

4) Cost of experiments which ultimately result in the acquisition of a patent. The cost of experiments which are not successful is not to be treated as capital expenditure. It is treated as a deferred revenue expenditure which is written off within two to three years.

5. Legal charges incurred in connection with acquiring or defending suits for protecting fixed assets, rights, etc.

Revenue Expenditure: When the benefit of an expenditure is not likely to be available for more than one year, it is treated as revenue expenditure. So all expenses which are incurred during the regular course of business are regarded as revenue expenditures. The examples of such expenses are:

1) Expenses incurred in day-to-day conduct of the business such as wages, salaries, rent, postage, stationery, insurance, electricity, etc.

2) Expenditure incurred for buying goods for resale or raw materials for manufacturing.

3) Expenditure incurred for maintaining the fixed assets such as repairs and renewals of building, machinery, etc.

4) Depreciation on fixed assets. This can also be termed as revenue loss.

5) Interest on loans borrowed for running the business. You should note that any interest of loan paid during the initial period before production commences, is not treated as revenue expenditure. It is treated as capital expenditure.

6) Legal charges incurred during the regular course of business such as legal expenses incurred on collection from debtors, legal charges incurred on defending a suit for damages, etc.

Deferred Revenue Expenditure

Sometimes, certain expenditure which is normally treated as revenue may be unusually heavy and its benefit is likely to be available for more than one year. In such a situation, it is considered appropriate to spread the cost of the expenditure over a number of accounting years. Hence, it is capitalised and only a portion of the total amount spent is charged to the Profit and Loss Account of the current year. The balance is shown as an asset which wil be written off during the subsequent accounting years. Such expenditure is called a Deferred Revenue Expenditure because its charge to Profit and Loss Account has been deferred to future years. Some example of such expenditure are:

1) Expenditure incurred on advertising campaign to introduce a new product in the market.

2) Expenditure incurred on formation of a new company (preliminary expenses)

3) Brokerage charges, underwriting commission paid and other expenses incurred in connection with the issue of shares and debentures.

4) Cost of shifting the plant and machinery to a new site which may involve dismantling, removing and re-erection of the plant and machinery.

Let us take the case of expenditure on advertising campaign. It is not a routine advertisement and the amount involved is unusually heavy. Its benefit will not completely exhaust in one accounting year but will contunue over two to three years. Hence, it is not proper to charge such expenditure to the Profit and Loss Account of one year. It is better to distribute it carefully over three years. So, in the first year we may charge one-third of the amount spent to the Profit and Loss Account and show the balance in the Balance Sheet as an asset. In the second year again we may charge a similar amount to the Profit and Loss Account and show the balance as an asset. In the third year. we may charge this balance to the Profit and Loss Account. Every expenditure which is regarded as deferred revenue is treated in this way in the final accounts.

Look at Illustration 1 and note how each expenditure has been treated and why.

Illustration 1

State whether the following items of expenditure would be treated as (a) capital expenditure, (b) revenue expenditure, or (c) deferred revenue expenditure:

i) Carriage on goods purchased Rs. 25.

ii) Rs. 2,000 spent on repairs of machinery.

iii) Rs. 5,000 spent on white washing.

iv) Rs. 8,000 paid for import duty and cartage on the purchase of machinery from west Germany.

v) Rs. 25,000 spent on issue of equity shares.

vi) Rs. 14,000 spent on spreading new tiles on factory floors.

vii) Rs. 4,000 spent on dismantling, transportation and reinstalling plant and machinery to new site.

viii) Rs. 60,000 spent on construction of railway siding.

ix) Rs. 20,000 spent on some major alterations to a theatre which made it more comfortable and attractive.

x) A second hand maching was bought for Rs. 10,000 and an amount of Rs. 6,000 was spent on its overhauling.

Solution

i) It is a revenue expenditure as it relates to the goods for resale.

ii) It is a revenue expenditure as it relates to the maintenance of a fixed asset.

iii) Same as no. (ii).

iv) It is a capital expenditure as it is spent in connection with the purchase of a fixed assets.

v) It would be treated as deferred revenue expenditure. It is a heavy amount incurred in connection with reising of capital for the company and so capitalised. Even under the Indian Companies Act and the Indian Income Tax Act this expenditure is allowed to be written off over a number of years.

vi) It is a revenue expenditure so it is treated as a sort of repairs not leading to any increase in the earning capacity of a fixed asset.

vii) Normall expenditure on transportation etc. is revenue in nature. But this expenditure has been incurred on shifting to new site which is non-recurring in nature and involves a heavy amount. Hence it shall be treated as a deferred revenue expenditure.

viii) It is a capital expenditure as it is incurred on the construction of railway siding, a fixed asset.

ix) It is a capital expenditure as the alterations made the theatre more comfortable and attractive which is likely to increase its collections.

x) It is a capital expenditure as it is incurred on making the newly bought second hand machinery operational.

Capital and Revenue Receipts

Receipts refer to amounts received by a business i.e., cash inflows. Receipts may be classified as Capital Receipts and Revenue Receipts. It is necessary to note this distinction clearly because only the revenue receipts are taken to the Profit and Loss Account and not the capital receipts.

Capital Receipts: Capital receipts are the amounts received in the form of (a) additional capital introduced in the business, (b) loans received, and (c) sale proceeds of fixed assets. You are aware that a loan taken by the business is repayable sooner or later. Similarly, additional capital received represents an increase in the proprietor's claim over the business assets. Thus these two items represent increase in liabilities of the business and obviously are not incomes or revenues. These are capital receipts and should be treated as such. The sale proceeds of a fixed asset are also treated as a capital receipt because the amount received is not revenue earned in the normal course of business. The capital receipts increase the liabilities or reduce the assets. They do not affect the profit or loss.

Revenue Recipts: Revenue receipts are the amounts recived in the normal and regualr course of business. They take the form of (a) sale proceeds of goods, and (b) incomes such as interest earned, commission earned, rent received, etc. These receipts are on account of goods sold or some services rendered by the business and as such they are not repayable. All revenue receipts are treated as incomes and shown on the credit side of the Profit and Loss Account.

3.5 REVENUE RECOGNITION

Revenue arises in the ordinary course of business activities of an enterprise from:

– sales of goods,
– rendering of services, and
– use by others of enterprise resources yielding interest, royalties and dividends.

Revenue recognition is mainly concerned with the timing of recognition revenue in the statement of profit and loss. According to AS-9, "revenue is the gross in flow of cash, receivables, or other consideration arising in the course of ordinary activities of an enterprise."

The basic problem of revenue recognition lies in identifying of the "accounting period" during which revenues are earned. There are several stages or activities in a business before the revenues are earned and realized. Hence the problem arises – should revenue be recognized at the point of production, sale, delivery or receipt of cash. According to "Realisation Concept" revenues are recognized at the point of sale or services are rendered. However, there is no single uniform practice to recognize various types of revenues according to one common principle. There are guidelines, which help us in recognizing operating revenues and non-operating revenues. Non-operating revenues include interest, dividend and rent and other incomes which are not related to normal course of operation of the enterprise.
It is advisable to show operating and non-operating revenues separately in the Profit and Loss Account.

Following are some of the established practices to recognize revenue as per AS-9.

3.5.1 Revenue Recognition in Sale of Goods

Trading and Manufacturing organizations, in general, recognize revenue when sale is effected. However, the following conditions should be satisfied:

i) The "property in goods" is transferred for a price.

ii) All significant risks and rewards have been transferred and no effective control is retained by the seller.

iii) No significant uncertainty exists regarding the collection of amount of consideration.

Special Cases of "Sale of Goods" and applicability of AS-9

a) **Delivery of goods delayed at buyer's request and buyer takes title and accepts billing:** Revenue should be recognized and the "goods to be delivered" at any subsequent date should not be included in the inventory.

b) **Goods delivered subject to installation and inspection:** Revenue should be recognized only after the installation and inspection is completed.

c) **Sale on Approval**: In case of sale on approval or return basis, revenue should be recognized only when acceptance is received from buyer.

d) **Sale subject to warranty**: If sales are subject to a warranty, revenue recognition should not be deferred but a provision should be made to cover the liability which may arise under the terms and period of warranty.

e) **Guaranteed Sales:** Sometimes goods are sold and delivery is made giving the buyer the unlimited right to return. This is under "Money back guarantee", if not completely satisfied. Under this situation it is apparent to recognize the 'revenue' at the point of sale and to make provisions for returns as well.

f) **Consignment Sales:** Revenues are recognized when the goods are sold to customers by the consignee and at the time of dispatch of goods of consignor.

g) **Cash on delivery Sales:** If a sale has been effected under the terms of "Cash-on-delivery", revenue should be recognized only when cash is received by seller.

h) **Installment Sales:** Revenues are recognized on delivery to the extent of normal cash down price. However, interest on deferred payment should be recognized in the ratio of amount outstanding.

I) **Special Order:** Where payment is received against the specific order of goods, which are not in stock. Revenue from such sale should be recognized only when goods are purchased or manufactured and are ready for delivery.

j) **Sale/Repurchase Agreement:** Where seller concurrently agrees to repurchase the same goods at some late date, the flow of cash under such a situation will not be recognized as revenue.

k) **Sales to Distributors to Dealers for Resale**: Revenues are recognized only if significant risks of ownership have passed on distributors/dealers.

3.5.2 Revenue Recognition in Case of Rendering of Services

Revenue recognition in case of rendering services care based on the following conditions:

i) Revenue recognized either on completed service method or 'proportionate completion' method.

ii) No significant uncertainty exists regarding amount of consideration.

iii) It is reasonable to expect ultimate collection of consideration.

Under **completed service method** revenue are recognized only on completion of service. In cases there are more than one act involved, revenue are recognized on execution of all these acts.

Proportionate completion method recognized revenue proportionate with the degree of completion of services. If there are more than one act involved revenue are recognized on execution of certain acts. Some examples of recognition of service revenue are –

1) **Installation Fee:** In cases where installation fees are other than incidental to sales, the revenue should be recognized only when the equipment is installed and accepted by the customer.

2) **Advertising and Insurance Agency Commission:** Revenue should be recognized when service is completed. For advertising agencies, media commission will normally be recognized when the related advertisement or commercial appears before the public, and the necessary intimation is received by the agency. Insurance agency commission should be recognized on the effective commencement renewal dates of the related policies.

3) **Financial Service Commissions:** A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charge for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made or added to a loan or other account and settled in stages.
The recognition of revenue should therefore have regard to:

   a) Whether the service has been provided one and for all or in an continuing basis.

   b) The incidence of cost relating to service.

   c) Commission charged for arranging and granting of loan or other facilities, should be recognized when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or service should normally be recognized over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the service provided and timing of the costs relating thereto.

Admission Fees: Revenue from artistic performance, banquets and other special events should be recognized when the event takes place. When fees to a number of events, it should be allocated to each event on a systematic and rational basis.

Tution Fees: Revenue should be recognized over the period of instruction.

Entrance and Membership Fees: AS.9 recommends capitalization of entrance fees. If membership fee permits only membership and all other services of products are paid for separately or if there is a separate annual subscription, the fee should be recognized as revenue when received. If the membersyhip fee entitles the member to services or publications to be provided during the year, it should be recognized on a systematic and rational basis having regard to the timing and nature of all services provided.

Subscription for Publications: Revenue received or billed should be deferred and recognized either on straight-line basis over time or where the items delivered vary in value from period to period revenue should be based on the sales value of the items delivered in relation to total sales value of all items covered by the subscription.

Exceptions to General Rule

1) **Revenue recognition at the point of production (Completed Production Method):** Under this method revenue are recognozid at the point of production. It applies to case of agriculture. Extractive industries like gold, silver, uranium, other metals and oil (crude) etc. revenue are recognized just after completion of production even before the sales take place.

2) **Cash Basis:** Under this, revenue are not recognized at the point of sale but when cash is realized including outstanding, if any. This basis is applicable in case of hire-purchase system where revenue are recognized on the basis of cash received and installments due during the year.

3) **Revenue Recognition during the production period on percentage of completion method:** Under this method revenue are recognized on the basis of contract value, associated costs, number of acts or other susitable basis. It is applicable in case of long-term construction contracts where revenue are recognized on the basis of degree of completion or what work certified bears to cash received by the contractor.

4) **Time Basis:** In many cases revenue are realized on the basis of time or period. For example, interest on fixed deposits is credited to Profit and Loss Account on time proportion basis, i.e. interest accrued yet not payable.

It is to be noted that revenue in case of "Royalties" are recognized on an **accrual basis** in according with terms of agreement and, **Dividends** are recognized when the right to receive payment is established.

3.6 FORMAT OF FINANCIAL STATEMENTS (NON-CORPORATE ENTITIES)

The financial statements may be prepared and presented either in conventional (also known as 'T' form) or Vertical form. The basic purpose is to serve the information needs of the users of accounting information. The idea is to present these accounting figures in such a way that provides maximum input for decision-making purposes. The income statement gives the clear picture operating efficiency of the enterprises by disclosing the amount of gross profit or loss through Trading Account. At the same time Profit and Loss Account reveals the overall 'net' result – the "net profit" or "net loss". The Balance Sheet, which is also known as "position statement" is required to depict the true and fair view of state of affairs of business enterprise. Sole traders and partnership firms are not requqired to comply any legal provisions as far as presentation and formats of financial statements are concerned. However, these income statements, meant basically for self consumption, must be prepared in conformity with the accounting concepts, conventions and applicable accounting standards.

The financial statements of non-corporate entities may be presented either of the following ways:

1) Conventional Format, and

2) Vertical Format

3.6.1 Conventional Format

Following are the conventional formats of 'Income' and 'Position statements':

Format of a Manufacturing Account

For the year ended 31st March....

Dr.			Cr
	Rs.		Rs.
To Opening Work-in progress	-----	By Closing Work-in- Progress	-----
To Raw materials consumed	-----	By Sale of Scrap	-----
Operating stock of Raw material		By Cost of goods	
Add: Purchases		produced-transferred	
Less: Closing stock of	-----	to Trading Account	-----
Raw material			
To Direct Expense			
Productive Wages	-----		
Freight Inward Raw material	-----		
Cartage/Carriage Inward	-----		
To Factory overheads			
Salary of Works Manager	-----		
Gas, Fuel and Power	-----		
Factory Light	-----		
Rent, Rates and Taxes	-----		
Insurance of factory assets	-----		
Repairs of factory assets	-----		
Depreciation of factory assets			
Other Factory Expenses	-----		
	***		***

Trading Account (A format)

For the year ended 31st March ....

Dr.			Cr
	Rs.		Rs.
To Opening Stock (Finished Goods)	-----	By Sales less Returns	-----
To Transfer from Manufacturing A/c	-----	By Abnormal Loss:	
or/and Purchases less returns		(Transferred to	
To Direct Expense		Profit and Loss A/c)	
Carriage/cartage Inward		Loss by Fire	
Freight		Loss by Accident	
Insurance-in-transit	-----	Loss by Theft	-----
Wages	-----	By Closing Stock	-----
* Fuel and Power	-----	By Gross Loss A/c	
* Coal, Gas and Water	-----	(Balancing figure)	
Packing (essential)	-----		
Octroi	-----		
Import duty			
* Consumable Stores	-----		
Royalty (based on output)	-----		

* Manufacturing Expenses	-----		
* Excise Duty	-----		
Dock dues			
To Gross Profit A/c			
(Balance fiture)**	-----		
	* * *		* * *

* Concerns not preparing Manufacturing Account separately

** Balancing figure will be either gross profit or gross loss.

Profit and Loss Account (A format)

For the year ended 31st March ....

Dr. Cr

	Rs.		*Rs.*
To Gross Loss* b/d	-------	By Gross Profit b/d*	------
To **Office & Administration Expenses:**		By Interest Received	------
Salaries of Office Staff		By Dividend Received	------
Office Rent, Rates and Taxes		By Rent Received	------
Printing and Stationery	-------	By Discount Received	------
Postage and Telephone	-------	By Profit on sale of fixed assets	------
Fire Insurance Premium	-------	By Profit on sale of Investment	------
Audit Fees	-------	By Insurance Claims	------
Repairs and Maintenance	-------	By Duty–Draw Backs	------
Legal Expenses	-------	By Apprenticeship Premium	------
Office Lighting	-------	By Miscellaneous Receipts	------
Depreciation-office assets	-------	By Bad debts Recovered	------
Other Office Expenses	-------	By Net loss transferred	------
To **Selling and Distribution Expenses:**		to Capital account	
Salesmen's Salaries		(Balancing figure)**	------
Commission on Sales			
Travelling Expenses			
Brokerage			
Trade Expenses			
Advertisement and Publicity			
Sales Promotion Expenses			
Carriage Outward			
Bad Debts			
Provision for Bad Debts			
Repairs of Vehicles			
Depreciation on Vehicles			
Warehouse Expenses			
Warehouse Insurance			
Warehouse Rent			
Delivery Van Expenses			
Packing Expenses			
Rebate to Customers			
Royalty on Sales			
To **Financing Expenses:**			
Discount Allowed			
Interest on Capital			
Discount of Bills			
Bank Charges			

To **Abnormal Losses:** Transferred from Trading Account – (loss by – Fire – Accident – Theft)			
To Loss on sale of Fixed Assets			
To Miscellaneous Expenses			
To Net Profit Transferred to Capital A/c (Bal. Figure)**			
	* * *		* * *

* Balancing b/d may be either Gross Profit or Gross Loss

** The Balancing figure may be either Net Profit or Net Loss

Profit and Loss Appropriation Account (A format)

For the year ended 31st March ....

Dr. Cr

	Rs.		*Rs.*
To Profit and Loss A/c (Net Loss)*	——	By Profit and Loss A/c (Net Profit)*	——
To Interest on Partner's Capitals	——	By Interest on Drawings	——
To Salary to Partners	——	By Balance (transferred to Partner's Capital Account)	——
To Commission to Partners			
To Balance (Transferred to Partner's Capital Accounts)**			
	* * *		* * *

* There will either be Profit or Loss

** Represent balancing fiture – a residual profit or loss to be shared by partners in the profit sharing ratio.

Balance Sheet of .... (A format)

as on 31st March ....

Liabilities		*Rs.*	*Assets*	
Capital	-----		**Fixed Assets:**	-------
Add Profit or less Loss	-----		Goodwill	-------
Less Drawings	-----	-----	Land and Building	-------
			Plant and Machinery	-------
Long Term Liabilities			Tools and Equipments	-------
Mortgaged Loan		-----	Motor Vehicles	-------
Loan from Bank		-----	Furniture and Fixtures	-------
			Patents and Trademarks	-------
Current Liabilities			Investment (Long Term)	-------
Sundry Creditors		-----	**Current Assets:**	-------
Bills Payable		-----	Stock	-------
Income Received in Advance		-----	Accrued Income	-------
Outstanding Expenses		-----	Prepared Expenses	-------
Bank Overdraft		-----	Sundry Debtors	-------
			Bills Receivable	-------
			Short Term Investment	-------
			Marketable Securities	-------
			Cash and Bank Balance	-------
			Fictitious Assets:	-------
			Advertisement	-------
			Profit and Loss Account	-------
			Miscellaneous Expenditure	-------
		* * *		* * *

*The items in the above format have been shown in order of permanence. Alternatively, this can be presented in order of liquidity as explained earlier.

2. From the following Trial Balance of Trader, you are required to prepare Trading and Profit Account for the year ended 31st March 2001 and a Balancing Sheet as on that date.

Trial Balance as on 31st March 2001

Dr. Cr.

Particulars	*Amount Rs.*	*Particulars*	*Amount Rs.*
Drawing Account	7,500	Capital	1,50,000
Plant and Machinery (1.4.2000)	1,25,000	Returns Outward	1,250
Plant and Machinery	6,250	Sundry Creditors	22,500
(1.4.2000)	19,250	Sales	2,00,000
Stock (1.4.2000)	1,02,500	Porivision for Bad	
Purchases	2,500	and Doubtful debts	500
Returns Inward	25,750	Discount Received	1,000
Sundry Debtors	6,200	Rent (up to 30.9.2002)	1,500
Furniture	12,500		
Freight	625		
Carriage Outward	5,750		
Rent, Rates and Taxes	1,000		
Printing and Stationary	500		
Trade Expenses	875		
Insurance Charges	26,625		
Salaries and Wages	25,675		
Cash in Bank	7,250		
Cash in Hand	1,000		
Postage and Telegram			
	3,76,750		3,76,750

Adjustments:

1) Stock on 31st March 2001 was valued at Rs. 15,000
2) Write off Rs. 750 as bad debts.
3) Provision for Bad and doubtful debt is to be maintained at 5% on sundry debtors.
4) Create a provision for discount on debtors and also reserve for discount on creditors @ 2%.
5) Charge depreciation @ 2% p.a. on Plant and machinery and @ 5% on furniture.
6) Insurance prepaid was Rs. 125.
7) Goods worth Rs. 6,250 were totally demaged in an accident. The insurance company admitted claim of Rs. 5,000 on 28.3.2001.

Solution

Trading Account
For the year ended 31st March 2001

Dr. Cr.

Particulars		Amount Rs.	Particulars		Amount Rs.
To Opening Stock		19,250	By Sales	2,00,000	
To Purchases	1,02,500		Less Returns	2,500	1,97,500
Less Returns	1,250	1,01,250	By Closing Stock		15,000
To Freight		12,500	By Insurance Claims		5,000
To Gross profit transterred			By Profit & Loss A/c		1,250
to Profit & Loss A/c		85,750	(Abnornal Loss)		
		2,18,750			2,18,750

Profit and Loss Account

Dr. Cr.

Particulars		Amount Rs.	Particulars		Amount Rs.
To Rent, Rates & Taxes		5,750	By Gross Profit b/d		85,750
To Printing and Stationary		1,000	By Discount Received		1,000
To Trade Expenses		500	By Rent Received	1,500	
To Insurance	875		*Less* Prepaid	750	750
Less Prepaid	125	750			
To Salaries & Wages		26,625	By Reserve for discount		450
To Postage & Telegram		1,000	on creditors		
To Bad debts		750			
To Provision for Bad and doubtful debts		750			
(New reserve Rs. 1250-Old					
reserve Rs. 500)					
To Provision for discount on debtors		475			
To Carriage outward		625			
To Abnormal loss (Accident)		1,250			
To Depreciation on:					
Furniture	310				
Plant & Machinery	25,625	25,935			
(Rs. 25000 + Rs. 625)					
To Net profit transfered A/c	540				
to capital		87,950			87,950

Balance Sheet As on 31st March 2001

Dr. Cr.

Liabilities		Amount Rs.	Assets		Amount Rs.
Add. Capital	1,50,000		Plant & Machinery	1,25,000	
Net Profit	22,540		Additions	6,250	
	1,72,540			1,31,250	
Less Drawings	7,500	1,65,040	*Less* Dereciation	25,625	1,05,62
Sundry Creditors	22,500		Furniture	6,200	
Less Provision	450	22,050	*Less* Depreciation	310	5,89
Advance Rent		750	Closing Stock		15,00
			Sundry Debtors	25,750	
			Less Bad Debts	750	
				25,000	
			Less Provision @ 5%	1,250	
				23,750	

		Less	Provision for discount	475	23,27
			Cash at Bank		25,67
			Cash in hand		7,25
			Insurance Claims		5,00
			Prepaid Insurace		12
	1,87,840				1,87,84

Illustration 3

The following is the Trial Balance of Mr. Mahesh as 31st December 2003. Prepare a Trading and Profit & Loss Account for the year ended 2003 and Balance Sheet as on 31st December 2003.

Dr. Cr

	Rs.		*Rs.*
Purchases	1,80,000	Sales	2,05,000
Opening Stock	10,000	Loan (10% interest)	10,000
Salaries Less Provident Fund	5,400	Creditors	15,000
Drawinges	5,000	Capital	55,000
Provident fund remittances including Proprietor's contribution 50%	1,200		
Rent Rs. 250 per month	2,750		
Machinery	29,000		
Wages	3,000		
Furniture & Fittings	5,000		
Electricity	550		
Trade Expenses	1,500		
Debtors	10,500		
Interest on Loan	900		
Commission	200		
Building	30,000		
	2,85,000		2,85,000

Wages include Rs. 1,000 Paid for machinery erection charges. Purchases include cost of moped scooter for Rs. 5,000 Proprietor has taken goods costing Rs. 1,000 for which no entry has been made, Electricity outstanding Rs. 50. Goods costing Rs. 5,000 were destoyed by fire and insurance claim was receied for Rs. 4,000 Provide depreciation at 10% on machinery, furniture & moped. Provide depreciation 5% on Bulding. Closing stock is Rs. 12,000

Solution

Trading And Profit and Loss Account
For the year ended 31st December 2003

Dr. Cr

	Particulars		*Amount Rs.*		*Particulars*	*Amount Rs.*
To	Opening Stock		10,000	By	Sales	205,000
To	Purchases	180,000		By	Loss by fire transferred to P&L A/c	5,000
Less	Purchase of Scooter	5,000				
Less	Drawings (goods used)	1,000	174,000	By	Closing Stock	12,000
To	Wages	3,000				
Less	Erection charges	1,000	2,000			
To	Gross Profit c/d		36,000			
			222,000			222,000
To	Salaries	5,400		By	Gross Profit b/d	36,000
Add	Subscription	600		By	Insurance claims	4,000
	Contribution	600	6,600			

To	Rent	2,750			
Add	Outstanding	250	3,000		
To	Electricity	550			
Add	Outstanding	50	600		
To	Commission		200		
To	Trade Expenses		1,500		
To	Bad debts		500		
To	Interest	900			
Add	Outstanding	100	1,000		
To	Provision for Bad debts		1,000		
To	Loss by fire (Trading A/c)		5,000		
To	Depreciation on:				
	Building		1,500		
	Machinery		3,000		
	Furniture		500		
	Scooter		500		
To	Net Profit		15,100		
			40,000		40,000

Balance Sheet
As on 31st December 2003

Dr. Cr

	Liabilities		*Amount Rs.*		*Assets*		*Amount Rs.*
	Capital	55,000			Building	30,000	
Add	Net Profit	15,100		*Less*	Depreciation	1,500	28,500
Less	Drawings (5000 + 1000)	6,000	64,100		Machinery	29,000	
				Add	Erection Charge	1,000	
						30,000	
	10% Loan		10,000	*Less*	Depreciation (10%)	(3,000)	27,000
	Creditors		15,000		Furniture	5,000	
	Rent outstanding		250	*Less*	Depreciation	500	4,500
	Interest outstanding		100		Scooter	5,000	
	Electricity Changes O/s		50	*Less*	Depreciation	500	4,500
					Closing Stock		12,000
					Debtors	10,500	
				Less	Bad debts	500	
				Less	Provision @ 10%	1,000	9,000
					Insurance claims		4,000
			89,500				89,500

3.6.2 Vertical Format

Under vertical form various items of incomes and expenses, assets and liabilities are arranged vertically to get some additional information about the operating efficiency and financial position of the business enterprise. The vertical form of Income Statement shows the gross profit, operating profit, net profit. The impact of non-operating incomes and expenses cannot be ascertained if the Trading & Profit and Loss Account is not prepared under vertical form. Similarly the Balance Sheet discloses owner’s capital, borrowed capital, net working capital, etc. It is to be noted that sole traders and partnership firms hardly adopt vertical form of financial statements. Following formats will bring about a clarity of understanding of vertical form of financial statements.

Income Statement (A format)
For the year ending 31st March .....

	Particulars	*Figures at the end of*	
		Previous Year	*Current Year*
		Rs.	Rs.
	Sales/Turnover	--------	--------
Less	Cost of Goods Sold*	--------	--------
	Gross Profit	****	****
Less	Administrative Expenses*	--------	--------
Less	Selling and Distribution Expenses*	--------	--------
	Operating Profit	****	****
Add	Other Incomes* (Non-operating Incomes)	--------	--------
Less	Financial Expenses (Non-operating Expenses)	--------	--------
	Net Profit	****	****
Less	Transfer to General Reserve and/or capital	--------	--------
	account/accounts (in the form of profit, salary, commission, etc.)	--------	--------
	* Explained earlier under conventional form.		

Operating vs Non-operating

Operating Profit/Loss

The excess of operating incomes over operating expenses represents operating profit, whereas when operating expenses exceed operating income it results in operating loss.

Operating incomes are those incomes which arise from operating activities in which the enterprise deals in. For a trading concern, revenue arising from sale of goods in which the enterprise deals in is treated as operating income. In fact, operating activities are the principal revenue-producing activities of the entertprise. Operating income measures the efficiency of a business enterprise, because these activities make-up the main business of the enterprise and are of recurring in nature. The operating activities may be:

- Purchasing and selling of goods.
- Services and even securities by a Trading concern.
- Exploration of natural resources by Extracting & Trading entity.
- Granting of loans and advances by a ‘Financial Institution’.
- Construction and development of colonies by construction enterprise.

Operating expenses are those expenses which are incurred in connection with main revenue producing activities. These operating expenses may be classified under various heads, such as **office and administrative expenses** and **selling and distribution expenses**. A detailed list of these expenses has already been given under conventional format of Profit and Loss Account under 3.6.1 of this unit. These expenses are necessary to run the business enterprise but which are not directly related to trading or manufacturing activities. These directly related expenses are termed as direct expenses, which are charged to Manufacturing/Trading/Account. Hence Operating Profit = Gross Profit – Operating Expenses (Office and Selling Distribution).

Non-operating Incomes

Such incomes arise from other than major or principal revenue earning activities. These are in the form of, in case of a manufacturing and trading concern, rent received, interest received, dividend received, which are credited to Profit and Loss Account. Profit on sale of fixed assets and the revenue arising from activities which are incidental to main business, are treated as non-operating incomes. Such types of incomes arise when unused portion of building used for business purposes is let-out or idle funds of business invested either in shares, debentures, government securities or deposited in a fixed deposit account. Since such incomes have nothing to do with the business operation of the enterprise, these incomes are treated as non-operating incomes.

> It is to be noted that "Interest" and "Dividend" received by a "Financial Institution" is treated as operating income because these incomes arise from main/principal revenue earning activity.

Non-operating Expenses

These expenses are incurred on activities other than main or principal revenue earning activities. These may be in the form of non-operating losses. Interest paid on borrowings (financial overheads), loss on sale of fixed assets, loss on sale of investment (held as an asset) are some of the examples of non-operating expenses. Such expenses are also charged to Income Statement to ascertain the overall net profit.

Balance Sheet of .... (A format)
As on 31st March ....

Assets	Figures at the end of	
	Previous Year	Current Year
Fixed Assets	--------	--------
Less Depreciation	--------	--------
Net Fixed Assets	(a) --------	--------
	****	****
Stock-in Trade	--------	--------
Sundry Debtors	--------	--------
Bills Receivables	--------	--------
Cash and Bank balance	--------	--------
Total Current Assets*	(b) ****	****
TOTAL ASSETS (a+b)	--------	--------
Liabilities and Capital		
Capital	--------	--------
Add Profit (Retained Earnings)	--------	--------
Less Drawings	--------	--------
Owner's Equity	(c) --------	--------
Sundry Creditors	--------	--------
Bills Payable	--------	--------
outstanding Expenses	--------	--------
Total Current Liabilities	(d) --------	--------
TOTAL (c + d)	--------	--------

** The list is not exhaustive*

Activity

1) What are operating and non-operating profits?
2) What do you understand by "Grouping" and "Marshalling" of assets and liabilities?
3) Write short notes on the following:
   a) Outstanding of Expenses
   b) Accrued Incomes
   c) Intangible Assets
   d) Fictitious Assets
   e) Cost of Conversion
   f) Cost of Goods Sold
   g) Direct vs Indirect Expenses
4) Draw an imaginary Balance Sheet.

3.7 CORPORATE FINANCIAL STATEMENTS

The process of preparation of financial statements of companies is similar to that of non-corporate entities except for certain peculiar items and legal requirements. The corporate reporting has assumed great importance in recent years. The Company Law Board, the Institute of Chartered Accountants of India and whole corporate world are trying to bring about a total transparency in the matter of reporting. The fundamental objective of corporate reporting is to communicate economic information about the resources and performance of the reporting entity to the users of financial statements. The professional bodies have also developed several (till date – 28) accounting standards for the purpose of preparing and disclosing accounting information in order:

1) To serve the varied needs of users for decision-making purposes.
2) To harmonise the diverse accounting practices.
3) To ensure transparency, consistency, comparability, adequacy and reliability of information-contents.
4) To make accounting information more meaningful and useful.
5) And to improve overall quality of presentation and reporting.

Since every interested party has a right to information which is merely not the outcome of statue but is based on the principle of public accountability. The financial statements which are prepared on the basis of various accounting postulates, concepts and conventions, are supposed to endowed with many qualitative characteristics, viz. understandability, relevance, materiality, reliability, faithful representation, substance over form, neutrality, prudence, completeness and comparability.

General and Legal Requirements

Section 209 to 223 of the Companies Act, 1956 deal with provision governing maintenance and preparation of financial statements.

Section 209 deals with the maintenance of proper books of accounts in respect of

1) Receipts and disbursements of money,
2) Sales and purchases of raw materials/goods,
3) Description peratining to usage of raw material and labout, etc., and
4) All assets and liabilities.

Section 209 also requires that books of accounts must show the "True and fair" view of state of affairs of the company. Section 211 requires that the Balance Sheet must give true and fair view of the results of operations. It simply implies that financial statements should disclose every material information without any concealment of facts and figures and in such a manner that working results and financial position of the reporting enterprise, may correctly be interpreted in true spirits. It should be free from personal biases and mis-statements. It will be possible only if financial statements are prepared in accordance with generally accepted accounting principles and in conformity with the various accounting standards as applicable to the reporting enterprise. Companies (Amendment) Act 1999 has made it mandatory for companies to comply with accounting standards set by ICAI. In case company fails to comply with any of generally accepted accounting assumptions or standards, the fact should be disclosed.

Section 210 requires that financial statements should be presented to shareholders at every Annual General Meeting along with the Auditor's and Directors' Reports. Every Balance Sheet and Profit and Loss Account must be duly authenticated. These statements must be signed by Manager or Secretary and by two directors, at least one of whom must be managing director (Section 215).

3.7.1 Items Peculiar to Corporate Balance Sheet

Share Capital: Under this head following details are required to be disclosed:

1) Details of Authorised, Issued and Subscribed Capital along with number and nominal value of the shares with respect to preference and equity shares.
2) Calls-in-Arrears must be deducted from Called-up Capital. However, Calls-in-arrears on shares held by directors are to be shown separately. Similarly, Calls-in-Advance should be treated as a separate items and shown accordingly.
3) Forfeited Shares Account, if any, should be added to paid-up Capital which forms the part of total of Balance Sheet. It is to be noted that the Authorised, Issued and Subscribed capitals are not considered for the purpose of total of Balance Sheet.
4) Shares issued for consideration other than cash must be disclosed. Such as shares allotted to transferor company under the agreement of takeover/merger, Issue of bonus shares and the source thereof.
5) If preference shares have been issued, the terms of redemption or conversion along with the earliest date of redemption/conversion must be specified.
6) Excess application money on account of over-subscription not requiring any adjustment, should be refunded. If not, the money refundable must be shown as part of current liabilities.

3.7.2 Reserves and Surplus

This may be in the following forms:

i) **Capital Reserves:** It refers to those profits which are not earned from normal business operations. Such profits are not available for the purpose of distribution as dividend. It is created out of profit on sale of-fixed assets or investments held as asset, profit on reissue of forfeited shares, pre-incorporation profit, profit on revaluation of fixed assets, profit on purchase/acquisition of assets or profit on purchase of business (excess of net assets over purchase price).

ii) **Capital Redemption Reserve:** It is created when fully paid preference shares are redeemed out of divisible profits of the company. This reserve may be utilized for the purpose of issuing fully paid bonus shares to the members of the company.

iii) **Securities Premium:** When a company issues shares or debentures at a price which is more than its face value, it is said to have issued shares/debentures at a premium. The premium so received is transferred to "Securities Premium Account".

According to Section 78 of Companies Act, the premium may be utilized for – issuing fully paid bonus shares, writing off preliminary expenses, discount on issue of shares or debentures, and providing premium on redemption of preference shares or debentures.

iv) **Revenue Reserves:** These may be in the form of **specific reserves** or **free reserves** and are created out of revenue profits of the company. Usually such reserves are formed from annual appropriation. **Specific Reserves** are created for specific purpose. For example, Dividend Equalisation Reserve is created to meet the shortfall in the divisible profits of the company intends to follow a stable dividend policy. Or to redeem the debentures, a sinking fund or a debenture redemption reserve may be created. Other specific reserves are Development Rebate Reserve, Investment Allowance Reserve, Export Incentive Reserve, etc.

The term 'Fund' is used when the money earmarked for any specific purpose is invested in ourside securities. For example, if money appropriated for the purpose of redemption of debentures is invested outside and business is termed as Debenture Redemption Fund, if not invested outside but retained or ploughed back in the business, it is called Debenture Redemption Reserve.

Surplus

The Credit balance of Profit and Loss Account or P&L Appropriation Account (i.e. after making necessary transfer to reserves and appropriating for proposed interim or final dividend including bonus, if any) is shown under the heading as surplus. If a company has a debit balance of Profit & Loss Account, the same should be adjusted under this head.

3) **Secured Loans:** This refers to mortgaged loan or other loans, which are fully secured either by a fixed or floating charge on the assets of the Company. It includes loans from bank, financial institutions or from other companies provided these are secured against the specific or all assets of the company. Debentures are assumed to have first floating charge on the assets of the company. It is to be noted that interest accrued and due on secured loans is to be treated as and shown under Secured Loans. Loan from or guaranteed by directors should be disclosed and shown separately. In case of debentures, the terms of redemption/conversion and its earliest date of redemption/conversion be stated.

4) **Unsecured Loans:** These are the loans against which no security stands a pledged or mortgaged. It also includes amount not covered by the value of security provided in respect of partly secured loans. It covers all loans which are not at all secured such as –

- Fixed Deposits from public
- Loans and Advances from Subsidiaries
- Short-term loans and Advances from Banks and others
- Other Loans and Advances
- It may include creditors for purchase of an asset.

5) **Current Liabilities and Provisions:** This heading is split in two sub-headings : current liabilities and prosvisions.

Current Liabilities: It refers to those liabilities which are to be paid or payable within a period of twelve months. It includes, Sundry Creditors, Bills Payable, Outstanding Expenses, Income Received in Advance, Amount payable to Subsidiaries.

It is to be noted that short-term loans and interest outstanding thereon are to be shown under "Secured" or "Unsecured Loan" as the case may be and not under Current Liabilities.

Provisions: Provisions such as Proposed dividend, Provision for Depreciation, Repairs and Renewals, Provision for Doubtful Debts, Investment Fluctuation Reserve, Provident Fund, Pension Fund etc. are shown separately under this head.

* Provision for Depreciation and Provision for Doubtful Debts may be shown on the "Assets side" as a deduction from the asset concerned.

Contingent liabilities: As explained earlier, these liabilities are shown as a footnote and include the following:

- Liability for bills discounted
- Claims against the company not acknowledged as debt
- Uncalled liability on partly paid shares
- Arrears of fixed cumulative preference dividends
- Guarantee given by the Company on behalf of directors or other officers of the Company
- Estimated amount of contracts remaining to be executed on capital account not provided for, and
- Other money for which company is contingently liable.

It is to be noted that if any provision is made against any contingent liability, the same is to be shown under the head provisions.

Fixed Assets

Under this head there are eleven types of "fixed assets" starting from goodwill to vehicles. According to AS-10 a fixed asset is an "asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business." Even assets which are not legally owned but held for the purpose of production are treated and shown under this head. These include assets acquired under hire-purchase agreement and assets taken on lease, after considering the addition and disposal, if any. Valuation of fixed assets is made at cost less depreciation after considering the addition and disposal, if any.

It is worth remembering that "goodwill" should be shown in the books only when it is acquired for some consideration. According to AS–26 internally generated goodwill should not be recognized as an asset.

*As per Schedule VI the fixed assets are classified as follows:

1) Goodwill
2) Land
3) Building
4) Leasehold
5) Railway Slidings
6) Plant and Machinery
7) Furniture and Fittings
8) Development of Property
9) Patents, Trade Marks and Designs
10) Live Stock
11) Vehicles

In case of revaluation of fixed assets, every balance sheet subsequent to such revaluation must show the revised figures with the date of increase or decrease in place of original cost. In ascertaining the cost of an asset all expenditures incurred in bringing the asset to its working condition should be included. This includes cost of transportation, expenditure on trial runs. In case of land and building, stamp duty, registration fee and architects fees should be capitalised.

Investments

As per AS-13 (Accounting for Investments), "Investments are assets held by an enterprise for earning income by way of dividends, interest and rentals, for capital appreciation or for other benefits to the investing enterprise". Assets held as stock-in-trade are not investments. Money invested outside business is termed as investments which may be long term, current investment or an investment property.

According to AS-13, a "**current investment** " by its nature as readily realizable is intended to be held for not more than one year, whereas an "investment propery" is an investment in land or building that are not intended to be occupied substantially for use by the enterprises.

Schedule VI requires investments to be shown as follows:

i) Investments in Government or Trust Securities.

ii) Investments in shares, debentures or bonds, fully paid up and partly paid up and also different classes of shares.

iii) Immovable properties

iv) Investments in the Capital of partnership firms.

The following details about the investments must be given:

a) Nature of investment.

b) Mode of valuation of Investments.

c) Aggregate amount of company's quoted investments and its market value.

d) Aggregate amount of company's unquoted investments.

e) Amount of fully paid and partly paid shares.

f) Investment in subsidiary companies.

Current Assets, Loans and Advances

This is subdivided in two sub-headings:

A) **Current Assets:** As per the Guidance note issued by ICAI, "current assets means cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering or services in the normal course of business and include:

i) Stock-in-trade (inventories of raw materials, work-in-progress finished goods, stores and spare parts to be shown separately) including mode of valuation.

ii) Debtors should show the age-wise and security-wise classification such as Debts outstanding for a period of more than six months and other debts.

Debtors considered good in respect of which company holds no security other than the debtor's personal security.

Debts considered doubtful or bad.

Debts due by directors on other officers

Debts due from other companies (subsidiaries)

Maximum amount due by directors or other officers of the company (footnote through)

Provision for doubtful debts is required to be deducted from sundry debtors

Provision should not exceed the amount considered from sundry debtors.

Provision should not exceed the amount considered doubtful or bad. Any excess provision be shown under "Reserve and Surplus".

iii) Cash and Bank balances should be shown separately. Bank balances should be classified into balances with scheduled banks and other banks along with details of current account, saving bank and fixed deposits. Bank overdraft, if any, should be shown under Sundry Creditors. This information of inclusion be disclosed in a footnote that the Sundry Creditors include bank overdraft amounting to Rs....

B) **Loans and Advances**

The disclosure rules which are applicable to sundry debtors, the same should be applied to "Loans and Advances", i.e. these should be shown in age-wise, security-wise and reliability-wise classification. In addition the following should be shown:

i) Advances and loans to subsidiaries

ii) Advances and loans to partnership firms in which the company or subsidiary is a partner

iii) Bills of Exchange

iv) Advances recoverable in cash or kind or for value (Rent, Rates and Insurance)

v) Balance with customers, port trust, etc. which are payable on demand

Miscellaneous Expenditure

These are the expenses incurred in earlier years but not written off. These include:

i) Preliminary expenses (Formation expenses incurred on preparation of Memorandum and Articles of Association, legal fees, registration fee, etc.)

ii) Share and Debentures issue expenses, such as brokerage, underwriting commission, discount on issue of share and debentures.

iii) Interest paid out of Capital during construction.

Such miscellaneous expenditure is written off over a period for which benefit is available.

Profit and Loss Account (Debit balance)

This represents past unwritten-off losses. These are adjusted and written off against the free reserves (divisible profits/revenue profits) to the available extent. Unabsorbed amount is shown under this head.

3.7.2 Items Peculiar to Corporate Income Statement

Salient Features

Though the procedure and the process of preparation of "Income Statement" of a Company and that of non-corporate entities are similar in principles, there are some differences in the method of presentation and some additional items which form the part of a corporate income statement. These differences are as under:

1) **Heading:** Non-corporate entities name income statement as "Trading and Profit and Loss Account", while companies call it "Income Statement" or Profit and Loss Account only. The items of Trading Account become the part of "Income Statement". No separate Trading Account is prepared.

2) **Appropriation:** Sole trader does not prepare any appropriation account, while partnership firms and companies do. A company's Profit and Loss Account is split up in to two parts – **"above the line"** and **"below the line"**. All items of appropriations are shown "below the line" and the remaining balance is transferred to the liabilities side of the balance sheet. A partnership firm prepares a separate Profit and Loss Appropriation Account.

3) As per AS–5 extraordinary items (abnormal nature), prior period items are shown separately whereas in case of non-corporate entities, such items are stated along with the normal and routine items.

4) **Requirement:** The Profit and Loss Account of a company should conform to the requirements of Schedule VI of Companies Act 1956 and adhere to AS–1; AS–4 and AS–5 recommendations, whereas non-corporate enterprises are not required to do so.

5) **Income Tax:** It is treated as an expense for the companies while for firms and sole trade enterprise, it is treated as drawings.

6) Companies' Profit and Loss Account should disclose the figures for the previous year along with the current year's whereas non-company enterprises are not required to show figures relating to previous year.

Treatment of Special Items of Profit and Loss Account

1) **Interest on Debenture and Loans:** This item includes interest paid and payable for the financial period for which accounts are prepared and shown to the debit side of Profit and Loss Account. Likewise, interest due but remaining outstanding is taken to the liability side of the Balance Sheet. Interest on Debentures and interest on secured loan outstanding, if any, is shown under the heading "Secured Loans" whereas interest outstanding on unsecured loan is shown under "unsecured loans".

> It is to be noted that interest on loan for the construction period should be capitalized and added to the cost of the asset concerned.

2) **Tax on Interest on Debentures:** As per Income Tax Act 1961, every company must deduct tax at source (TDS) while paying interest to the debenture holders. The amount so deducted shall be deposited with the Government treasury. The current rates for TDS are as follows:

Debentures (listed)	10.5% including surcharge
Debentures (unlisted)	21% including surcharge

If A ltd. has to pay interest on its 9% debentures (listed) of the face value of Rs. 5,00,000, then gross interest will be Rs. 45,000 and tax deducted at source Rs. 4,725 balance shall be paid to the Debenture holders Rs. 40,275. The following entry is recorded –

Interest on Debentures A/c	Dr	45,000	
To Debenture Holders A/c			40,275
To Income Tax Payable A/c			4,725

Income Tax deducted but not deposited with the Government is to be shown in the Balance Sheet under the heading "Current Liabilities".

> It should be remembered that Profit and Loss Account will always be debited with the gross amount of interest.

3) **Discount on Debentures/Loss on Issue/Debenture Issue Expenses:** Discount on issue of debentures, debenture issue expenses such as commission, brokerage, etc. are premium payable on redemption (treated as loss on issue which may include discount also) are to be written off as early as possible, or over the life span of the debentures, depending upon the policy of the company in the absence of any specific instructions in the question, such amount should be written off on the basis of debentures outstanding. The unwritten off balance is to be shown on the assets side of the Balance Sheet under the heading of 'Miscellaneous Expenditure'.

It should be remember that only written off amount is charged to Profit and Loss Account.

4) **Prelimiary Expenses:** As already explained under Balance Sheet items, it appears on the assets side of the Balance Sheet under the heading 'Miscellaneous Expenditure' as long as it is not written off. The amount written off is charged to Profit and Loss Account. If there is no specific instructions relating to the amount to be written off, then the entire amount should be shown in the Balance Sheet.

5) **Corporate Income Tax:** This is shown under three stages.

   i) ***Advance Income Tax:*** As per Income Act 1961, the companies are required to pay income tax on the profits earned. They have to deposit advance tax under PAYE (Pay As You Earn) scheme on specific dates during the financial year. The advance tax so paid is adjusted against income tax liability. The unadjusted amount of advance income tax is shown as an asset under the heading Current Assets, Loans and Advances.

   ii) ***Provision for Taxation:*** While preparing Profit and Loss Account, a provision for income tax is created on the basis of current year's profit to meet the actual tax liability. The amount so provided depends on the prevailing tax rate. The current rate of corporate tax is 35% plus 5% surcharge for domestic companies and 40% plus 5% surcharge for foreign companies. The following entry is recorded.

Profit and Loss Account Dr.
To Provision for Taxation A/c

AS–22 "Accounting for Taxes on Income" recommends that the net balance, i.e. excess of "Advance Tax" may be shown on the assets side or liabilities side of the Balance Sheet as the case may be, till the final assessment is made and actual tax liability is determined by the tax authorities.

   iii) ***Determination of Actual Tax Liability:*** As per Income Tax rules, income (profits) for the previous year is assessed and taxed in the assessment year. When the assessment is completed the provision for taxation so created may either fall short of actual tax liability or may exceed the tax liability. Such a shortfall or excess is treated as prior period item (AS–5) and therefore its adjustment is made in the Profit and Loss Account but "below the line", either to the debit side (for shortfall) or to the credit side (for excess).

   On the other hand, the actual tax liability is compared with advance income tax paid. In case actual tax liability is more than the amount of advance tax paid the same may be paid or shown as a current liability in the Balance Sheet and if advance tax paid exceeds, the difference being refund should be stated under Current Assets Loans and Advances in the Balance Sheet.

Illustration 4

Extracts from a Trial Balance of a Company
As on 31st March, 2003.

	Dr. (Rs.)	Cr. (Rs.)
Provision for Taxation (2001-02)		2,50,000
Advance Income Tax (for 2001-02)	2,60,000	
Advance income Tax (for 2002-03)	3,00,000	

Additional Information

i) The actual tax liability for the year 2001-2002 amounted to Rs. 2,75,000

ii) provision for Taxation for the year 2002-03 of Rs. 2,85,000 is required to be made.

Show the relevant information in the relevant ledgers.

Solution

Profit and Loss Account (Extracts)
for the year ended 31st March 2003

	Rs.		
To Provision on for Taxation (2002-03)	285,000		above the line
	______	______	
To provision for Taxation (2001-02) (Rs 2,75000-2,50000) Tax Liability-Provision	25,000		below the line

Balance Sheet (Extracts)
As on 31st March 2003

Liabilities	Rs.	**Assets**	Rs.	Rs.
		Loans & Advances		
		Advance Tax	3,00,000	
Current Liabilities		(Current Year)		
		Less Provision for		
Income Tax payable (2001-02) (Tax liability–Advance Tax) Rs. 2,75,000 – Rs. 2,60,000)	15,000	Taxation	2,85,000	15,000

Provision for Taxation (2001-02)

	Rs.		Rs.
To Income Tax (Tax liability)	275,000	By Balance b/d	250,000
		By Profit & Loss A/c (below the line)	25,000
	275,000		275,000

Provision for Taxation (2002-03)			
	Rs.		Rs.
To Balance C/d	2,85,000	By Profit and Loss A/c (above the line)	2,85,000
	2,85,000		2,85,000

Illustration 5: From the following extract of a Trial Balance and the additional information, show the treatment of taxation, in the relevant ledger accounts:

Trial Balance (Extracts)
As on 31st March 2002

	Dr. (Rs.)	Cr (Rs.)
Provision for Taxation		1,20,000
Income Tax	1,10,000	

Additional information: Provide Rs. 1,50,000 for provision for taxation.

Solution

Provision for Taxation A/c (old)

To Income Tax	1,10,000	By balance b/d	1,20,000
To Profit and Loss A/c. (below the line)	10,000		
	1,20,000		1,20,000

Provision for Taxation A/c (New)

	Rs.		Rs.
To balance c/d (To be taken to liabilities) side of B/S	150,000	By Profit and Loss A/c. (above the line)	150,000
	150,000		150,000

Profit and Loss Account (Extracts)

	Rs.		Rs.	
To provision for Taxation (New)	150,000			-Above the line
		By Provision for Taxation	10,000	- below the line

Balance Sheet (Extracts)
As on 31st March 2002

liabilities		Assets	Rs.
<u>Current liabilities and Provision</u>			
B. Provisions:			
provision for Taxation	15,000		

Illustration 6

From the following particulars prepare necessary accounts for the year ending 31st March 2003:

Trial Balance (Extracts)
As on 31st March 2003

	Dr. *Rs.*	*Cr.* *Rs.*
Provision for Taxation (1.4.2002)		4,59,000
Advanced Tax Paid (1.4.2002)	4,20,000	
Tax Deducted at Source (1.4.2002)	3,500	

On 1.1.2003, the assessment was completed and tax liability of Rs. 5,30,000 was determined Advance payment of tax for the year 2002-03 amounted to Rs. 5,10,000. A provision for taxation is to be made for Rs. 5,75,000 for the year ended 31st March 2003.

Solution

Provision for Taxation Account

	Rs.		Rs.
To Income Tax A/c (Tax liability)	5,30,000	By Balance b/d	4,50,000
		By profit & Loss A/c (below the line)	80,000
	5,30,000		5,30,000
To Balance C/d	5,75,000	By Profit & Loss A/c	5,75,000

Advance Income Tax account

	Rs.		Rs.
To Balance b/d	4,20,000	By income Tax A/c	4,20,000
	4,20,000		4,20,000

Income Tax Account (Tax liability)

Rs.	Rs.		
To Advance Income Tax A/c	4,20,000	By Provision for	5,30,000
To Tax Deducted at source A/c	3,500	Taxation A/c	
To Bank A/c. (Balance Paid)	1,06,500		
	5,30,000		5,30,000

Profit and Loss Account
For the year ended 31st March 2003

	Rs.		Rs.
To Provision for Taxation (2002-03)	5,75,000	} Above the line	
To Provision for Taxation (2001-02)	80,000	} below the line	

6) **Managerial Remuneration**

The payment of managerial remuneration is governed by the provisions of sections 198 and 309 either by the Articles or by a ordinary/special resolution passed by the company in general meeting. Managerial personnel refers to managing director, whole-time director, part-time director and manager. The provisions of Companies Act shall apply to a public company and private company and a private company which is a subsidiary of a public company but to no other private company.

The over all managerial remuneration payable by a public company or a private company which is a subsidiary of a public company to it's managerial personnel shall not exceed 11% of the net profits for that financial year. **Remuneration limit does not include fees**. Within the maximum limit of 11% a company may pay a monthly remuneration to its managing or whole-time director in accordance with the provisions of Section 309 or to its manager in accordance wit the provisions of Section 386 of the Companies Act. In case there is no profit or inadequate profit for any year, the company may pay remuneration as per the provisions of Schedule XIII of the Company Act.

7) **Contribution/donation to a Political party**

Any contribution or donation to any political party must be disclosed separately in the Profit and Loss Account. According to section 293, Government companies and companies with less than three years are not allowed to make any political contribution or donation. Those allowed can make such contribution up to 5% of it's average profit. The average net profit for this purpose are to be determined on the basis of the three immediately preceding financial years' profit as determined in accordance with the provision of Section 349 of the Company Act.

8) **Prior Period Items**

The nature and amount of prior period items should be separately disclosed in the Profit and Loss Account in a manner that there impact on the current profit or loss can be perceived. In case, accounts are adopted in the annual general meeting and if some adjustments relating to previous year are to be made, these should be stated below the line, i.e. in the Profit net Loss Appropriation account as per AS-5.

9) **Extra-Ordinary items**

Extraordinary items are incomes or expenses that arise from events or transactions which are clearly distinct from the ordinary activities of the enterprise and therefore, are not expected to recur frequently or regularly, these items should be disclosed in the statement of profit and loss as a part of profit or loss for the period (AS-5). "Fixed assets destroyed in an earthquake" is an example of "Extraordinary items".

10) **Contingencies and Events occurring** after balance Sheet Date

As per AS-4, the amount of a contingent loss should the be provided for by a charge in the statement of Profit and loss if:

i) it is possible that future events will confirm that an asset has been impaired or a liability has been incurred as at the Balance Sheet date and

ii) A reasonable estimate of the amount of the resulting loss can be made.

The existence of a contingent loss should be disclosed in the financial statements if either of the above condition is not met, unless the possibility of loss is remote. **Contingent gains** should not be disclosed in the financial statements. Only virtually certain gains should be recognized.

11) **Appropriation and Disposition of Profits**

Once the profits have been ascertained as per the statement of profit and loss, the next step is the appropriation and disposition of the available profit. It includes:

i) Transfer to general reserve and other reserves such as capital redemption reserve. Development rebate reserve etc.

ii) Transfer to sinking fund.

iii) Transfer to Dividend Equalization fund.

iv) Providing for interim or final dividend, and

v) Paying bonus to share holders.

All these items are treated “below the line” or a separate “Profit and loss Appropriation Account” is prepared.

12) **Dividends**

Dividends refers to that amount of divisible profits which is distributed among the share holders of the company. A member (shareholder) is entitled to receive dividend when it is declared by the Board of directors as per the provisions of the Article. The Board has absolute right to recommend the rate of dividend to the declared subject to the approval of shareholders and provisions of Articles of Association. However, the shareholders cannot compel the Board recommend & declare dividend. It is to be noted that dividend is always declared for the working of one financial year at the annual general meeting. In case the dividend could not be declared at the annual general meeting the same can be declared at the Extraordinary meeting. The power to declare dividend is implied and does not require express authority either in the Articles or Memorandum of Association. It should be remembered that, where a dividend has been declared at Annual General Meeting, neither he company nor the directors can declare a further dividend for the same year at the subsequent general meeting. It is known as Final Dividend.

No devidend should be paid out of capital. Dividends should be paid in proportion to the amount paid up on each share. No dividend shall be payable on calls in advance unless authorised by the Articles. Dividend should be payable in cash except when it is adjusted towards unpaid amount on shares or where bonus shares are issued. According to Section 205 (2A) no company shall declare or pay dividend for any financial year out of the profits from that year unless certain percentage of profit as prescribed by Central Government not exceeding 10% has been transferred to reserve. However, the company may voluntarily transfer higher percentage of the profit to its revenue subject to the rules laid down under the Companies (Transfer of Profits to Revenue) Rules 1975 as amended in 1976. A newly incorporated company is prohibited to transfer more than 10% of its profits to revenue for the initial three years.

i) **Preference Dividend:** The preference dividend is paid to Preference shareholders at a pre-determined fixed rate on priority basis. These holders are entitled dividend in preference to equity shareholders. However the preference shareholders can claim dividend only out of profits and if it is declared at the annual general meeting. If preference shares are of cumulative nature, the arrears of preference dividend if any, shall be payable to preference shareholders before any equity dividend. It should be noted that preference shareholders cannot force the company to pay all the dividends including arrears. If equity shareholders are not paid any dividend, preference shareholders cannot claim any dividend from the company. It is to be noted that the arrears of preference dividend are treated as a contingent liability which appears as a foot note under the Balance Sheet.

Not–cumulative preference shares are not entitled to any arrears resulting from non-payment of dividend due to losses or inadequate profits. If a company has issued participating preference shares with a right to participate in the balance of profits, left after paying fixed preference dividend and a certain percentage of equity dividend, then the participating preference shareholders are entitled against a certain percentage out of the balance (residua) profit as per the items of issue. For example 9% preference shares may be issued with a further right to 40% of the excess dividend over 20% paid to equity shareholders. If a company declares 25% dividend to equity to equity shareholders, the preference shareholders will get 11% dividend. (9% plus 40% of (25%-20%) i.e., 2%).

ii) **Unclaimed Dividend:** According to Section 205 A of the companies Act 1956 dividends remaining unpaid must be deposited in the "unpaid unclaimed Dividend account within 42 days of declaration of dividend. Any claim thereafter, must be met out of the unclaimed dividend account. Money so transferred to the aforesaid account which remains unpaid or unclaimed for a period of seven years from the date of such transfer, shall be transferred to "Investor Education and Protection Fund" maintained u/s 205 of Companies (Amendment) Act 1999.

Unclaimed dividend appears on the liabilities side of Balance Sheet under the head **"Current liabilities & Provisions"**.

iii) **Proposed Dividend:** Dividend recommended by the directors to be paid to shareholders for any accounting period on or after the close of books of accounts but before the Annual General Meeting, is known as proposed dividend. Once it is approved by the shareholders in the General meeting, it becomes final dividend. It is to be noted that rate of dividend declared cannot exceed the proposed dividend. Proposed dividend is an appropriation of profit, hence it is shown to the debit side of profit and loss Appropriation Account and on the liabilities side of balance sheet under the heading **"Current liabilities and Provisions"**.

iv) **Final Dividend:** It is a dividend which is declared at the annual general meeting of the shareholders. Such dividend is declared only after the close of books of accounts; the share holders may reduce the rate of final dividend but cannot increase it. Once the final dividend is declared it becomes the liability of the company. It should be noted that when a final dividend is declared then interim dividend is not adjusted unless there is any specific resolution for such adjustment. Final dividend is paid on paid up Capital for the whole year as against the interim dividend, which is usually paid only for six months. For example N Ltd. has 5,00,000 shares of 10 each Rs. 8 paid, declares 5% p.a. interim dividend and final dividend @ 10% p.a., then the total dividend will be Rs. 5,00,000 i.e. (Rs. 1,00,000 interim dividend + Rs. 4,00,000 final dividend)

I.D. = (4, 00,000 5/100 × 6/12 = 1,00,000) + F.D. = (4,00,000 × 10/100)

v) **Interim Dividend:** A dividend declared by the Directors between two annual general meetings of the company is known as interim dividend, where the directors believe that the company will have sufficient profits available for dividends at the end of the year, they may distribute a part of the profit as a part payment on account. Payment so made in anticipation and on account of total dividend to be paid for the year is treated as interim dividend. However, such payment must be authorised by the Articles. Interim dividend should be declared only when the company has even a better prospects for the second half as well. Regulation 86 of Table–A provides that "Board may from time to time pay to the members such interim dividend as it appears to be justified by the profits of the company." Thus, there is no limit on the number of interim dividend the company may pay in a year. The payment of interim dividend does not require approval of general meeting.

Companies (Amendment) Act 2000 has granted statutory recognition to the right of directors to declare interim dividend. The term dividend now includes interim dividend also. All provisions the Companies Act which apply to dividends have now become applicable to interim dividends also. A company cannot declare any interim dividend unless it has made:

i) necessary provision for depreciation for the whole year.

ii) prior adjustment of accumulated losses, if any

iii) and transfer to general reserve as required u/s 205 (2A)

Once an interim dividend is declared it becomes legally enforceable debt against the Company. Prior to the Amendment Act 2000 the interim dividend was not an enforceable debt Board had right to rescind the resolution already passed.

The period, for which an interim divided is paid, is usually six months. However, students should note that whether the rate of dividend includes the words "per annum" or not. For example the directors of a company declare an interim dividend @ 12% per annum, the interim dividend shall be calculated only for six months. If the rate declared by directors is 12% and the words "per annum" are not mentioned, then the dividend shall be calculated @ 12% without reference to time. i.e. 12% x amount of paid up Capital. If the Capital of the company is Rs. 10,00,000 then in the first case interim dividend will amount to Rs. 60,00 and in the second case Rs. 1,20,000.

vi) **Corporate Dividend Tax**

Finance Act 1997 had exempted the dividend in the hands of shareholders and introduced corporate dividend tax to be paid by the dividend paying company. Thereafter, the corporate dividend tax was withdrawn by the Finance Act 2002 and the burden of tax was shifted on the shareholders and hence company was not liable to pay any tax on dividend declared, distributed or paid between 1.4.2002. to 31.3.2003.

The Finance Act 2003 has again shifted the liability of such tax on the domestic companies who shall be liable to pay additional tax on the amount declared, distributed or paid by way of dividends on or after 1.4.2003. The rate of tax being 12.5% plus surcharge @ 2.5% which is equal to 12.8125%* This rate is applicable for the financial year 2003-04.

Note: Students should verify the rate applicable because this rate may be changed by the Finance Act 2004 or by the subsequent Finance Act. It is further to be noted that dividends from domestic companies in the hands of shareholders are totally exempt again. As per guidance not it is be treated as appropriation.

13) **Transfer to General Reserve**

According to section 205 (2A) no company shall declare or pay dividend for any financial year out of the profits for that unless a certain percentage of profits as prescribed by the Central government not exceeding 10%, has been transferred to reserve. As per the Central Government rules transfer to revenue should be made as follows:

The Central Government has prescribed the following rules under the companies (Transfer of profits to reserve) Rules 1975 as amended in 1976.

	Rate of Dividend				Percentage of profits* to be transferred to reserve
(i)	If the rate of dividend exceeds	10%	but not	12.5%	2.5%
(ii)	"	12.5%	to	15%	5%
(iii)	"	15%	to	20%	7.5%
(iv)	If the rate of dividend exceeds	20%			10%

Accounting Treatment of Dividend

Illustration 7

X Ltd. has a paid up capital of Rs. 30,00,000 dividend into 2,00,000 equity shares of Rs. 10 each and 10% 1,00,000 preference shares of Rs. 10 each. Other particulars were as under.

	Rs.
Opening balance of Profits and loss Appropriation Account	57,500
Net profit earned during the year (after Tax)	7,50,000
Dividend Declared for the year	22%

Prepare Profit and Loss Appropriation Account. Comply with necessary statutory provisions.

Solution

Profit and Loss Appropriation Account

		Rs.			Rs.
To	General Reserve (1)	75,000	By	Balance b/d	57,500
To	Preference Dividend (2)	1,00,000	By	Net Profit	7,50,000
To	Equity Dividend	4,40,000			
To	Corporate Dividend (3)	67,500			
	Tax	1,25,000			
To	Balance c/d				
		8,07,500			8,07,500

Working notes

(1) As per the provisions of the section 205 on a dividend of 22% a statutory transfer of 10% on the net profit to be made.

(2) Declaration of equity dividend will automatically make the company liable to pay preference dividend. No equity dividend can be paid without paying preference dividend.

(3) A corporate dividend Tax (C.D.T.) @ 12.5% has been provided. A surcharge of 2.5% has been ignored for the sake of simplicity. However, the effective rate of C.D.T. is 12.8123% including surcharge.

Illustration 8

Victor Ltd. disclosed the following particulars:

		Rs.
9% 80,000	Preference shares of Rs. 10 each fully paid	8,00,000
50,000	Equity shares of Rs. 10 each fully paid	5,00,000
30,000	Equity shares of Rs. 10 each Rs. 8 paid up	2,40,000
20,000	Equity shares of Rs. 10 6 paid up	1,20,000

The directors proposed a dividend of 15% or equity shares and resolved to make the following appropriations:

– Transfer to general reserve as per the provisions of the section 205

– Transfer to dividend equalisation fund Rs. 1,75,000

– Transfer to debenture Redemption Fund Rs. 1,00,000

– Transfer to Investment Allowance Reserve Rs. 1,25,000

The net–profit (before tax) for the year amounted to Rs. 12,50,000 you are required to prepare Profit and Loss Appropriation Account. Provide for income tax @ 50% and Corporate Dividend Tax @ 12.5%

Solution

Profit and Loss Appropriation Account

		Rs.		Rs.
To	General Reserve[1]	31,250	By Net Profit (After tax)	6,25,000
To	Dividend Equalisation fund	75,000		
To	Debenture Redemption Fund	1,00,000		
To	Investment Allowance Reserve	1,20,000		
To	Proposed Dividend			
	– Preference Dividend	72,000		
	– Equity Dividend	1,29,000		
To	Corporate Dividend Tax[2]			
	On Rs. (72000 + 1,29,000)	25,125		
To	Balance c/d	67,625		
		6,25,000		6,25,000

Working

1. As per the statutory requirement, a transfer of 5% of the net profit after tax" has been made to General Reserve
2. Corporate dividend tax has beesn provided on the total dividend.

3.8 REQUIREMENTS FOR CORPORATE FINANCIAL STATEMENTS AS PER SCHEDULE VI

The Balance Sheet of a company like any other business organisation is a statement of assets and liabilities. However, in the case of a company, the nature of the details to be shown and the order of the arrangement of the items must conform to the requirements prescribed in Schedule VI, Part I of the Companies Act. There items are already discussed under 3.7.1 of this Unit.

The requirements as to Profit and Loss Account are as follows:

i) The Profit and Loss Account shall be so made out as clearly to disclose the result of the working of the company during the period covered by the P&L account and shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transaction or transactions of an exceptional nature.

ii) The Income Statement is not required to be split in the parts, such as Trading Account, profit earned and appropriated. Schedule VI only recommends to disclose gross profit, net profit and it's appropriation there of. This may be shown under one head of Income Statement or Profit and Loss Account. Chargeable items are shown *"above the line"* whereas appropriations *"below the line"*.

iii) Figures relating to previous year should also be shown along with the current year's figures in a separate column.

iv) As far as possible information given in the statement must be complete in all respects. Such as the details of "turnover" made by the company should disclose sales in respect of each class of goods & their quantities separately. Likewise commission paid to sole selling agents and to other agents should be shown along with the brokerage.

v) The Account should disclose quantities and values of various types of raw-material purchased and quantities and values of various products produced/ purchased including opening and closing balances there of and that of work-in-progress.

vi) The amount provided for depreciation, renewals or diminution in value of fixed assets and the method adopted for making such provisions.

If no such provision has been made- the fact should be disclosed by way of note including arrears of depreciation.

vii) The amount of interest on company's debentures and on other fixed period loans be stated separately, including interest paid or payable to directors.

viii) The amount of Income Tax on profits as per Income Tax Act 1961 at the pre-scribed rate including other taxes if any, should be shown separately.

ix) Expenditure incurred on each of the following items be disclosed separately–

a) Consumption of stores and spare parts

b) Power and fuel

c) Rent

d) Repairs to Building

e) Repairs to Machinery

f) i) Salaries, Wages and bonus

ii) Contribution to provident and other funds

iii) Workmen and staff welfare expenses

g) Insurance

h) Rates and Taxes (excluding income tax)

i) Miscellaneous expenses provided any item exceeds 1% of revenue of Rs. 5,000

Whichever is higher be shown separately.

j) Payment to Auditor

a) as auditor

b) as advisor in respect of

i) Taxation matter

ii) Company law matters

iii) Management services

k) Remuneration received by managing directors or managers either from the company or it's subsidiaries should be indicated separately including it's computation.

x) The Profit and Loss Account should disclose the various items of incomes arranged under appropriate heads.

a) *Turnover* giving details in respect of each class of goods indicating quantities of such sales for each class separately.

b) *Amount of income from interest* specifying the nature of the income

c) *Income from investment* stating from trade investments & other investments

d) Profit or losses or investments

e) *Dividends* including dividends from subsidiary companies

f) *Miscellaneous* incomes such as royalty, fees etc.

g) *Foreign exchange* earnings, if any

The Profit and Loss Account must be made out in such a manner that discloses "true and fair" view of the profit or loss of the company for the current accounting year. This means that items of extraordinary nature or those unrelated to company's business or items relating to previous years (Prior Period items) should be separately stated, if these are material.

Similarly amount drawn from reserves, profits from revaluation of assets or profits arising due to change in method of accounting or major policy change in the method of valuation higher the operating efficiency or position much better that it actually is would be contraray to the spirit of law.

3.9 BASIC PRINCIPLES GOVERNING THE PREPARATION OF FINANCIAL STATEMENTS

1) **Materiality:** It is a relative term. What is material for one company may be immaterial for other. According to American Accounting Association (AAA) an item should be regarded as material if there is reason to believe that knowledge of it would influence the decision of informed investors, banks, creditors & other interested parties. AS-5 sates that all material information and items should be disclosed which are necessary and vital to make the financial statements more clear and understandable – operating efficiency — wise and financial-position-wise. Treatment of certain expenditure as capital by one company and revenue by the other is a clear example of it. Hence materiality is purely matter of personal judgment which is guided by size and nature of enterprise.

2) **Prior Period Items: (AS-5)**

As a matter of fact the Profit and Loss Account should disclose the profit or loss for the period for which accounts are prepared, that is for the reported (current) period. If, however, some items were omitted to be accounted for in the preparation of financial statements then it is not possible to reopen the accounts for the previous year after it has been adopted by the shareholders in the annual general meeting. The ICAI defines "Prior Period Items" as incomes or expenses which arise in the current period as a result of errors or omissions in the preparation financial statements of one or more periods". The errors may occur as a result of mathematical mistakes, oversight (omissions), misinterpretation of facts and wrong application of accounting policies or a wrong or inaccurate estimate. Hence these items should be shown "below the line" i.e. in the Profit and Loss Appropriation Account. However, prior period adjustments do not cover–

– Minor omissions of accruals and prepayments
– Prior period's revenue which was not accounted for on the ground of prudential practice.
– Recovery of bad debts written off earlier
– Adjustments to the useful life of the depreciable assets

3) **Extra Ordinary Items: (AS–5)**

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently and regularly (AS-5). These items are shown in the Profit and Loss Account for the period but the nature of such items should be disclosed separately. These include

- Write down of inventories to "net realizable value"
- Profit or loss on sale of fixed assets or long-term investments.
- Reversals of provisions
- Reversals of writing off of the fixed assets
- Losses sustained on account of an earthquake.

4) **Change in Accounting Policies: (AS-5)**

Accounting policies are the specific accounting principles and the methods of applying these principles adopted by an enterprise in the preparation and presentation of financial statements. A change in accounting policy is required by statue or by the accounting standard setting body or if it is considered that the change will result in a more appropriate presentation of the financial statements of the enterprise. Any material effect of such a change in the current or subsequent periods should be quantified and disclosed together with the reasons for the change. Following are the change in policy:

- A change in the method of charging depreciation from written down value (WDV) to straight line method (SLM) and vice versa.
- A change in the method of valuation of inventories.

  However, a change in the estimated life of a machine is not a change in policy but a change in estimate.

3.10 PREPARATION OF CORPORATE FINANCIAL STATEMENTS

As already stated, the Board of Directors of the company shall present a Balance Sheet as at the end of the period; and a Profit and Loss Account for that period at the annual general meeting. In case of company not carrying on business for profit, an Income and Expenditure Account shall be laid at the annual general meeting instead of Profit and Loss Account. Every Profit and Loss Account shall also give a "true and fair" view of profit or loss of the company for the financial year and shall comply with the requirements of schedule VI. Every Insurance or Banking company or any company engaged in the generation of electricity or any other class of company for which the Profit and Loss Account has been specified under the Act governing such class of company need not follow the Form given in Schedule VI to this Act. Similarly every Balance Sheet shall give a "true & fair" view of the state of affairs of the company as per Schedule VI. Any Insurance or Banking company or any company engaged in generation or supply of electricity or any other class of company for which a form of Balance Sheet has been prescribed under the Act governing such class of company need not to follow such form.

Recently the Companies (Amendment) Act 1999 has made the compliance of accounting standards mandatory. Accordingly every Profit and Loss Account and Balance Sheet of the Company shall comply with the "Accounting Standards". However, in case of non-compliance the company must disclose the 'deviation' from the accounting standards. It should also state "reasons" for such deviation; and "financial effect" if any, due to such deviation.

On the basis of requirements of Schedule VI and accounting standards following is the format of Profit and Loss Account of a Company.

Profit and Loss Account of ....

For the year ended 31st March ....

Figure for the previous year Rs.		Figures for the current year Rs.	Figure for the Previous year Rs.		Figures for the current year Rs.
...	To Opening Stock		...	By Sales Less Returns	...
...	Raw Material	...	...	By Income from Services	...
...	Finished Goods	...	...	By Closing Stock	...
...	To Purchases (Raw materials)	...	...	Raw Materials	...
...	Less Returns	...	...	Work-in-progress	...
...	To Stores & Spares (consumed)	...	...	Finished Goods	...
...	To Power and Fuel	...			
...	To Wages (Productive)	...			
...	To Manufacturing Expenses	...			
...	To Gross Profit c/d				
		xxx			xxx
...		...	...	By Gross Profit b/d	...
...	To Rent	...	...	By Income from Investments	...
...	To Repairs to Building	...		By Profit on Sale of Investment	...
...	To Repairs to Machinery	...		By Dividend Income	...
...	To Salaries & Bonus	...		By Miscellaneous Incomes	...
...	To Contribution to Provident Fund	...			
...	To Staff Welfare Expenses	...			
...	To Contribution to Pension/Gratuity Fund	...			
...	To Insurance	...			
...	To Rates & Taxes	...			
...	To Printing & Stationery	...			
...	To Postage, Telegrams, Fax & Telephone	...			
...	To Commission, Brokerage and Discount	...			
...	To Bank Charges & Interest	...			
...	To Depreciation	...			
...	To Loss on sale of Investments	...			
...	To Remuneration payable to	...			
...	Directors & other	...			
...	Managerial Personnel	...			
...	To Auditor’s Fee	...			
...	To Provision for Taxation	...			
...	To Net Profit (transferred to	...			
	Profit & Loss Account)	...			
xxx		xxx	xxx		xxx

Schedule VI
(Part I - Form of Balance Sheet)
(Conventional Format)

Balance Sheet of...............
As on 31st March.............

Figure for the previous year Rs.	*Liabilities*	*Figures for the current year Rs.*	*Figure for the Previous year Rs.*	*Assets*	*Figures for the current year Rs.*
	Share Capital **Authorised***.... shares of Rs. ...... each. **Issued**..... shares of Rs. Each (*Various classes of shares and their called up amount including details of - Shares issued for consideration other than Cash - Bonus Issue made, if any Less Call Unpaid (i) By Directors (ii) By Other Add. Forfeited shares (amount actually paid) **Reserves & Surplus** (1) Capital Reserve (2) Capital Redemption Reserves (3) Securities Premium (4) Others Reserves & specifying the nature of each reserve and amount in respect there of **Loss** Debit balance of P&L A/c (5) Surplus-Balance in Profit and Loss Account after providing for proposed allocation namely Dividend-Bonus, or Reserves (6) Proposed Additions to Reserves (7) Sinking Fund **Secured Loans** (1) Debentures (2) Loans & Advances from Banks (3) Loans & Advances from subsidiaries (4) Other loans & Advances * Interest accrued and due should be Included in the respective sub-head) * Nature of security to be specified in each case) * Terms of redemption or conversion of debentures to be stated together with earliest date of conversion/redemption. **Unsecured Loans** (1) Fixed Deposits (2) Loans & Advances from subsidiaries (3) Short-term loans & advances (a) From Banks (b) From Others (4) Other loans and advances (a) From Banks (b) From Others			**Fixed Assets** Goodwill Land Building Leasehold Railway sidings Plant and machinery Furniture and Fittings Development of Property Patents, Trade Marks and Designs Live Stock and Vehicles etc. **Investments** Showing nature of Investment and mode of valuation-cost Or market value, and distinguishing between (1) Investments in Government or Trust Securities (2) Investments is Shares, Debentures or bonds (Giving details of classes of shares along with their paid up value) (5) Immovable Properties (4) Investments in Capital of Partnership firms. **Current Assets, Loans and Advances** (A) Current Assets (1) Interest Accrued on Investments (2) Stores and Spare parts* (3) Loose Tools (4) Stock in Trade* (5) Work-in Progress* * Mode of valuation and Amount in case of raw materials **Sundry Debtors** (a) Debts outstanding for a period exceeding six months (b) Other debts (Less Provision) In regard to sundry debtors, particulars to be given separately (i) Debts considered good and In respect of which company is fully secured (ii) Debts considered good	

Current Liabilities & Provisions A. Current Liabilities (i) Acceptances (ii) Sundry Creditors (iii) Subsidiary Companies (iv) Advance payments and Unexpired discounts for the portion for which value has still to be give e.g. in the following classes of companies Newspaper, Fire-Insurance, Theaters, Clubs, Banking & Steamship Companies (5) Unclaimed Dividends (6) other Liabilities, if any (7) Interest accrued but not due on loans B. Provision (8) Provision for taxation (9) Proposed dividends (10) For Contingencies (11) For Provident Fund Scheme (12) For Insurance, Pension and Similar Staff Benefit schemes (13) Other provisions			for which company holds no security other than the debtor's personal security. (iii) Debts considered doubtful doubtful or bad. (iv) Debts due by directors or Other officers or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director or a member–to be separately stated. (7a) Cash Balance at hand (7b) Bank Balances (i) With Scheduled banks & (ii) With Others (B) Loans and Advances (8) (a) Advances loans to Subsidiaries. (b) Advances and loans to Partnership firms in which company or any of it's subsidiaries is a partner. (9) Bills of Exchange (10) Advance receivable in cash or in kind or for value to be received e.g. rate, taxes Insurance etc. (11) Balances on Current Accounts with managing Agents, secretaries and Treasures. (12) Balances with customs Port trust (where payable on Demand) **Misc. Expenditure** (1) Preliminary Expenses (2) Expenses including commission, or brokerage on underwriting or subscription of shares or debentures. (3) Discount on issue of Shares or debentures (4) Interest paid out of capital during construction period (5) Development Expenditure not adjusted (6) Other items (specifying nature) **Profit and Loss Account** (Debit balance of P&L A/c Carried forward after adjusting uncommitted (free) reserves, is any.)	
xxx	xxx	xxx		xxx

Footnote: to be shown separately such as:

1) Claims against the Company not acknowledged as debts.
2) Uncalled liability on shares partly paid
3) Arrears of cumulative dividends
4) Estimated amount of contracts remaining to be executed on capital account and not provided for.
5) Other money for which company is contingently liable.

Preparation of Financial Statements–Conventional Format

Illustration 9

From the following Trial Balance of A Ltd., prepare a Profit and Loss Account of the company for the year ended 31st March 2003 and a Balance Sheet as on that date.

	Rs.	Rs.
5,00,000 Equity shares of Rs. 10 each fully called		50,00,000
9% Debentures (Rs. 100 each)		20,00,000
Freehold Building	40,50,000	
Plant and Machinery	28,00,000	
Profit and Loss Account		2,75,000
Stock (1.4.2002)	7,50,000	
S. Debtors and Creditors	9,50,000	4,25,000
Bills Payable		3,75,000
Purchases and Sales	19,75,000	45,25,000
Provision for Bad Debts		45,000
Bad Debts	25,000	
General Reserves		3,50,000
Calls in Arrears	75,000	
Goodwill	3,00,000	
Interim Dividend Paid (1.11.2002)	4,92,500	
Cash at Bank	1,60,000	
Wages and Salaries	6,95,500	
Office Expenses	77,000	
Salaries of office and marketing staff	5,15,000	
Interest on Debentures	90,000	
Discount on Issue of Debentures	40,000	
	1,29,95,000	1,29,95,000

Adjustments:

i) Stock on 31st March 2003 was Rs. 8,75,000

ii) Depreciate Plant & Machinery by 10% and write off 1/8th of the discount con issue of debentures

iii) Maintain 5% provision for doubtful debts on debtors.

iv) Interest on debentures has been paid only for the first half

v) Income tax @ 50% is to be provided. Corporate dividend tax is 12.5%

vi) There is a claim for Rs. 50,000 for workmen's compensation, which has been disputed by the company. The case is pending in the country of law.

Solution

Profit and Loss Account
For the year ended 31st March 2003

	Rs.		Rs.
To Stock (1.4.2002)	7,50,000	By Sales	45,25,000
To Purchases	19,75,000	By Closing Stock	8,75,000
To Wages and Salaries	6,95,500		
To Gross Profit c/d	19,79,500		
	54,00,000		54,00,000
To Salaries	5,15,000	By Gross Profit b/d	19,79,500
To Office Expenses	77,000		
To Bad Debts	25,000		
To Provisions for bad debts (Rs. 47,500 – Rs. 45,000)	2,500		
To Depreciation	2,80,000		
To Interest on Debentures Rs. 90,000 Add outstanding interest Rs. 90,000	1,80,000		
interest on Debentures			
To Discount on issue of Deb.	5,000		
To Provision for Tax	4,47,500		
To Net Profit c/d	4,47,500		
	19,79,500		19,79,500
To Interim Dividend	4,92,500	By Balance b/d	2,75,000
To Corporate Dividend Tax (Interim dividend Rs. 4,92,500 x 12.5%)	61,563	By Profits and Loss A/c (Net Profit)	4,47,500
To Balance c/d	1,68,437		
	72,22,500		7,22,500

Balance Sheet of A Ltd.
As on 31st March 2003

Liabilities		Rs.	Assets	Rs.
Called up & paid up Capital			Fixed Assets	
5,00,00 shares of Rs. 10 each	Rs. 50,00,000		Goodwill	3,00,000
Less Calls-in-Arrears	Rs. 75,000	49,25,000	Freehold Building	40,50,000
Reserve & Surplus			Plant & Machinery (Rs. 28,00,000–Rs. 2,80,000)	25,20,000
General Reserve		3,50,000	Current Assets, Loans Advances	
Profit and Loss Account		1,68,437	Current Assets	
Secured Loan			Stock	8,75,000
9% Debentures	Rs. 20,00,000		Debtors (Rs. 9,50,000–Rs. 47,500)	9,02,500
Interest outstanding	Rs. 90,000	20,90,000	Cash at Bank	1,60,000
Current Liabilities and Provisions			Miscellaneous Expenditure	
Current Liabilities				
Sundry Creditors		4,25,000	Discount on Issue of Debentures (Rs 40,000–written off Rs 5000)	35,000
Bills Payable		3,75,000		
Provisions:				
Provision for Tax		4,47,500		
Corporate Dividend Tax		61,563		
		88,42,500		88,42,500

Note: There is a contingent liability of Rs. 50,000 for workmen's compensation

ι No statutory transfer to general reserve is made, as the dividend paid does not exceed 10% of paid up capital.

For the sake of simplicity surcharge on corporate dividend tax not taken into account.

Illustration 10

Following in the Thial Balance of a limited Company as at 31st December, 2004.

Particulars *Credit*	*Debit*	
Share Capital		4,00,000
Cash in Hand	6,200	
Rent	5,300	
Prepaid Expenses	4,600	
Repairs & Maintenance	8,600	
Advances from Customers		50,000
General Reserve		3,00,000
Raw Materials at Cost	2,67,000	
Sundry Creditors	3,40,000	
Plant and Machinery	4,30,000	
Power	8,800	
Travelling and Conveyance	4,100	
Auditors' Fees	1,500	
Cash at Bank	8,000	
Land	30,000	
Provision for Taxation	2,10,000	
Furniture	12,200	
Staff advances	5,300	
Sundry Debtors	1,40,000	
Misc. Income	54,600	
Finished Goods at cost	3,10,000	
Income-tax Advances	3,00,000	
Misc. Expenses	61,400	
Raw Materials consumption	28,60,000	
Sales	42,30,000	
Development Rebate Reserve	1,00,000	
Building	74,100	
Salaries, Wages & Bonus	11,60,000	
Cash Credit from Bank	12,500	
Total	56,97,100	56,97,100

The following additional information is also available:

i) The authorised capital of the company is 80,000 equity shares of Rs. 10 each of which 50% has been issued and has been recommended by the directors.

ii) A dividend of 15% on the paid up capital has been recommended by the directors.

iii) The closing stock of finished goods at cost is Rs. 5,60,000.

iv) The development rebate reserve is no langer required.

v) Depreciation on plant and machinery amounting to Rs. 43,000 on furniture amounting to Rs. 1,300 and on building amounting to Rs. 3,800 has been debited to miscellaneous expenses.

vi) Surplus in profit and loss account after proposed dividends, is to be transferred to general reserve.

vii) Income-tax assessment for a prior year has been completed, fixing the income tax liability at Rs. 1,55,000 (against which a provision of Rs. 80,000 and advances of income tax of Rs. 70,000 exists in the books).

You are required to prepare:

i) profit and loss account for the year ended 31st December, 2004; and

ii) Balance sheet in the prescribed form as on that date.

Solution

A Company Limited
Profit and Loss Account
for the year ended 31st December, 2004

Particulars	*Rs*	*Particulars*	*Rs*
To Open. Stock of finished goods	3,10,000	By Sales	42,30,000
To Raw Materials consumed	28,60,000	By Clos. Stock of Finished Goods	5,60,000
To Gross Profit c/d	16,20,000		
	47,90,000		47,90,000
To Salaries, Wages and Bonus	11,60,000	By Gross Profit b/d	16,20,000
To Power	8,800	By Miscellaneous Income	54,600
To Rent	5,300		
To Repairs and Maintenance	8,600		
To Aduditors' Fees	1,500		
To Travelling and Conveyance	4,100		
To Depreciation on:			
Plant and Machinery	43,000		
Furniture	1,3000		
Building	3,800		
To Miscellanceous Expenses	13,300		
To Provision for Taxation	169960		
To Net Profit for the year	254940		
	16,74,600		16,74,600
To Provision for Taxation (for a prior year)	75,000	By Net Profit for the year	2,54,940
To Statutory Reserve	12747	By Development Rebate Reserve written Back	1,00,000
To Proposed Dividend	60,000		
To General Reserve (transfer)	2,07,193		
	354940		354940

Note: Provision for taxation for the year is assumed to be 40% of the profit.

A Limited Company
Balance Sheet
as on 31st December, 2004

Particulars		*Rs*	*Particulars*		*Rs*
Share Capital:			**Fixed Assets:**		
Authorised:			Land at cost	Rs.	30,000
80,000 Equity shares of Rs. 10 each		8,00,000	Building	77,900	
Issued: Subscribed and Paid up:			*Less:* Depreciation	3,800	74,100
40,000 Equity shares of Rs 10 each			Plant and Machinery	4,73,000	
fully paid up		4,00,000	*Less:* Depreciation	43,000	4,30,000
Reserves and Surplus:			Furniture	13,500	
General Reserve:	Rs.		Less: Depreciation	1300	12,200
Brought forward	3,00,000		Investments		–
Add: ransfer from			**Current Assets, Loans and**		

Profit and Loss A/c	207193	5,07,193	**Advances:**	
Satutory Reserve		12,747	*A.* Current Assets:	
Development			Raw Materials at cost	2,67,000
Rebate Reserve:	1,00,000		Finished Goods at cost	5,60,000
Less: Transferred to			Sundry Debtrors	1,40,000
Profit and Loss A/c	1,00,000	–	Cosh in Hand	6,200
Secured Loans:			Cash at Bank	8,000
Cash Credit from Bank		12,500	*B.* Loans and Advances:	
Unsecured Loans:		–	Staff Advances	5,300
Current Provisions:			Prepaid Expenses	4,600
A. Current Liabilities:			Income Tax Advance	2,30,000
Sundry Creditors		3,40,000		
Income Tax Payable		85,000		
Advances from Customers		50,000		
B. Provisions:				
Provisions for Taxation		2,99,960		
Proposed Dividend		60,000		
Total		17,67,400		17,67,400

Working Notes:

(i)	Provision for Taxation:	Rs
	As per Trial Balance	2,10,000
	Less: Adjustment for prior year provision	80,000
		1,30,000
	Add. Provision for current year taxation	169,960
	Provision taken to Balance Sheet	2,99,960
(ii)	Prior year tax Adjustments:	
	Income Tax Liability for Prior Year	1,55,000
	Less: Prior Provision	80,000
	Additional Provision to be made in current year	75,000
	Total Tax Liability	1,55,000
	Less: Advance Tax	70,000
	Tax Payable	85,000
(iii)	Advances Income Tax	3,00,000
	Less: Adjustment against prior year completed assessment	70,000
	Balance in Advance Income tax	2,30,000

(iv) A sum equal to 5% to the net profits is required to be transferred to statutory reserve as the rate of dividend is 15%.

Illustration 11

The Bangalore Manufacturing Co. Ltd., was registened with a nominal capital of Rs. 15,00,000 divided into equity shares of Rs. 100 each. On 31st March 2004 the follwing ledger balances were extracted from the company's books.

	Rs.		*Rs.*
Equity Share Capial Called		Preliminary Expenses	12,500
up and paid up	11,50,000	Freight and Duty	32,750
Calls-in-arrears	18,750	Goodwill	62,500
Plant and Machinery	9,00,000	Wages	2,12,000
Stock (1-4-2003)	1,87,500	Cash in hand	5,875
Fixtures	18,000	Cash at Bank	95,750
Sundery Debtors	2,17,500	Directors' Fees	14,350
Buildings	7,50,000	Bad Debts	5,275
Purchases	4,62,500	Commission paid	18,000
Interim Dividend Paid	18,750	Salaries	36,250
Rent	12,000	6% Debentures	7,50,500
General Expenses	12,250	Sales	10,37,500
Debenture Interest	12,250	4% Government Securities	1,50,500
Bills Payable	95,000	Provision for Doubtful Debts	8,750
General Reserve	62,500	Sundry Creditors	1,15,000
Profit and Loss A/c	36,250		
(Cr.) 1-4-2003			

The stock on 31st March, 2004 was estimated at Rs. 2,52,000

The following adjustments© were to be made:

1) Final Dividend at 5% to be provided.
2) Depreciation on Plant and Machinery at 10% and on Fixtures at 5%.
3) Preliminary expenses to be written off by 20%.
4) Rs. 25,000 were to be transferred to General Reserve.
5) The provision for bad debts to be maintained at 5% on sundry debtors.

You are required to prepare the Trading and Profit and Loss Account and Profit and Loss Appropriation Account for the year ended 31st March 2004 and the Balance Sheet as on that date.

Solution

Trading and Profit and Loss Account of the Bengal Manufacturing Co. Ltd.
for the year ending 31st March, 2004

		Rs.		*Rs.*
To Opening Stock (1-4-2004)		1,87,500	By Sales	10,37,500
” Purchases		4,62,500	” Closing Stock (31-3-2004)	2,52,000
” Freight and Duty		32,750		2,52,000
” Wages		2,12,000		
” Gross Profit c/d		3,94,750		
		12,89,500		12,89,500
To Salaries		36,250	By Gross Profit b/d	3,94,750
” Commission		18,000		
” Rent		12,000		
” General Expenses		12,250		
” Directors' Fees	Rs.	14,350		
” Debenture Interest	12,500			
Add. Outstanding Interest	32,500			
To Bad Debts	5,275			
Add: Provision for Bad Debts Required @ 5% on Debtors Rs. 2,17,500	10,875			
	16,150			
Less: Old Provision for Doubtful Dets	8,750			
		7,400		
” Depreciation on: Plant & Machinery @ 10%	90,000			
Fixtures @ 5%	900			
		90,9000		
“ Preliminary Expenses (20%)		2,500		
” Provision for Taxation		62,500		
” Net Profit transferred to Profit and Loss Appropriation A/c		93,000		
		3,94,750		3,94,750

Calculation of Outstanding Interest

	Rs.
Interest on Rs. 7,50,000 debentures @ 6% for one year	45,000
Less: Debenture interest paid	12,500
Outstanding interest	32,500

Profit and Loss Appropriation Account
for the ending 31st March, 2004

	Rs.		Rs.
To Interim Dividend	18,750	By Balance b/d (1-4-2003)	36,250
” Proposed Final Dividend @ 5% on Rs. 11,31,250 (i.e. Rs. 11,50,000 called) up capital—Rs. 18,750 calls-in-arrears)	56,562	” Net Profit for the year	93,600
” General Reserve	25,000		
Balance c/d	29,538		
	1,29,850		1,29,850

Balance Sheet of the Bangalore Manufacturing Co. Ltd.
as at 31st March, 2004

Liabilities		*Rs.*	*Assets*		*Rs.*
Share Capital:	Rs.		**Fixed Assets:**		
Authorsed Capital: 15,000 equity shares of Rs. 100 each		15,00,000	Goodwill		62,500
			Buildings	Rs.	7,50,000
			Plant & Machinery	9,00,000	
Called up and Paid up Capital:			*Less:* Depreciation	90,000	
11,500 shares of Rs. 100 each					8,10,000
fully calld up	11,50,000		Fixtures	18,000	
Less: Calls-in-arrears	18,750		*Less:* Depreciation	900	
		11,31,250			17,100
Reserves and Surplus:			***Investments:***		
General Reserve	62,500		4% Government Securities		1,50,000
Add: Transferred during the year	25,000		***Current Assets, Loans and Advances:***		
		87,500	A. ***Current Assets:***		
Profit and Loss Account		29,538	Stock		2,52,000
Secured Loans			Sundry Debtors	2,17,500	
6% Debentures		7,50,000	*Less:* Provision for		
Debenture Interest Outsanding		32,500	Bad Debts @ 5%	10,875	
Unsecured Loans		Nil			2,06,625
Current Liabilities & Provisions:			Cash in hand		5,875
A. ***Current Liabilities:***			Cash at Bank		95,750
Bills Payable		95,000	B. Loans and Advances		Nil
Sundry Creditors		1,15,000	***Miscellaneous Expenditure:***		
B. ***Provisions:***			(to the extent not written		
Provision for Taxation		62,500	off or adjusted)		
Proposed Dividends		56,562	Preliminary Expenses		10,000
		23,59,850			23,59,850

Illustration 12

Spik and Span Ltd. was registered with an authorised capial or Rs. 3 lakh divided into 30,000 equity shares of Rs. 10 each. The company offered 15,000 shares for public subscription of which Rs. 7.50 pen share was called up.

The following trral balance was drawn from the book of accounts as on March 31, 2004. You are required to prepare a Profit & Loss Appropriation Account for the year ending on March 31, 2004 and Balance Sheet as on that date.

	Debit Rs.	Credit Rs.
Land	23,800	
Buildings	52,900	
Calls in Arrear	5,000	
Brokerage on Shares	8000	
Stores and Spare parts	18,000	
Preliminary Expenses	7,600	
Unexpired Insurance	640	
Live Stock	900	
Plant & Machinery	1,03,600	
Loose Tools	24,000	
Stock in trade at cost	50,000	
Cash at Office	12,480	
Cash Bank	25,000	
Sundry Debtors	26,000	
Share Capital		1,12,500
Sundry Creditors		1,24,600
Capital Reserve		30,800
Wages Outstanding		1,820
Godown Rent due		700
General Reserve		16,800
Employee's Benefit Fund		3,000
Salaries Outstanding		1,000
Reserve for Doubtful Debts		1,300
Unpaid Dividends		700
Profit & Loss Accoaunt		57,500
Total	3,50,720	3,50,720

Out of the creditors of, Rs. 1,24,600 Rs. 84,600 were due to bank for a loan secured by mortage on buildings and machinery, and Rs. 22,000 were due on account of loan from subsidiary company.

The company earned a profit of Rs. 61,200 during the year. The balance of profit brought forward from the previous year was Rs. 38,600 out of which it was decided that Rs. 15,000 be paid as final dividend, Rs. 16,800 the carried to General Reserve, Rs. 3,000 to Employees Benefit Fund. It was further resolved that Rs. 7,500 be paid by way of interim dividend for the first half of the current year.

Solution

Spik and Span Ltd.

Profit and Loss Appropriation A/c for the year ended March 31, 2004

	Rs.		*Rs.*
To Interim Dividend	7,500	Balance as per P & L A/c for the	
To Balance of Profit	57,500	year ending March 31, 2003	38,600
To Dividend	15,000		
To General Reserve	16,800		
To Employee's Benefit Fund	3,00	Profit as per P & L A/c	61,200
	99,800		99,800

Spik & Span Ltd.
Balance Sheet as on March 31, 2004

Liabilities	*Rs.*	*Assets*		*Rs.*
Share Capital:		**Fixed Assets:**		
Authorised		(Net Block)	Rs.	
30,000 Equity Shares of		Land	23,800	
Rs. 10 each	3,00,000	Buildings	52,900	
Issued & Subscribed Capital:				
15,000 Equity Shares of		Plant &		
Rs. 10 each Rs. 750 per		Machinery	103,600	
Share called up Rs. 1,12,500		Live Stock	900	1,81,200
Less Calls in Arrear Rs. 5,000		**Current Assets:**		
	1,07,500	Stock in trade at cost		50,000
		Stores & Spares		18,000
Reserves and Surplus:				
Capital Reserve	30,800	Loose Tools		24,000
General Reserve	16,800	Sundry Debtors	26,000	
		Less Reserve		
Profit & Loss Account	57,500	for D'ful Debts	1,300	24,700
Empioyees Benefit Fund	3,000	Cash & Bank Balances		37,480
Secured Loans:		**Loans and Advances:**		
From Bank (Secured by		Unexpired Insurance		640
mortgage on buildings machinery)	84,600			
Unsecured Loans:		**Miscellaneous Expenditure**		
From Subsidiary	22,000	**& Losses:**		
Current Liabilities and		Preliminary Expenses		7,600
Provisions:		Brokerage on Shares		800
Sundry Creditors	18,000			
Unpaid Dividends	700			
Outstanding Wages	1,820			
Outstanding Salary	1,000			
Godown Rent due	700			
	3,44,420			3,44,420

Adjustment: (1) Stock on 31st March 2003 was valued at Rs. 3,42,000

(2) Depreciate:

Plant and Machinery	15%
Computers	10%
patents & Trade Marks	5%

(3) Provision for Bad & doubtful debts is required at Rs. 2,040

(4) Provide for–

Rent o/s	Rs.	3,200
Salaries o/s	Rs.	3,600
Proposed Dividend	15%	

Provision for Income Tax 50% & Corporate Dividend tax 12.5%

Ans:

Net Profit after Tax	Rs.	1,03,900
Corporate dividend	Rs.	12,000
Balance Sheet Total	Rs.	8,32,800

Corporate Tax = Rs. 6000 + Rs. 3600 = Rs. 9600
Rs. 96000 × 12.5% = Rs. 12000

2. The following balances appeared in the books of ABC Co. Ltd. as on December 31, 2004.

Particulars	*Rs.*	*Rs.*
Paid up Capital		6,00,000
60,000 Equity Shares of Rs. 10 each		2,50,000
General Reserve		6,526
Unclaimed Dividend		36,858
Trade Creditors		
Buildings at Cost	1,50,000	
Purchases	5,00,903	
Sales		10,83,947
Manufacturing Expenses	3,59,000	
Establishment Charges	26,814	
General Charges	31,078	
Machinery at Cost	2,00,000	
Motor Vehicle at Cost	30,000	
Furniture at Cost	5,000	
Opening stock	1,72,058	
Book Debts	2,23,380	
Investments	2,88,950	
Depreciation Reserve		71,000
Advance Payment of Income Tax	50,000	
Cash Balnce	72,240	
Directors Fees	1,800	
Investment's Interest		8,544
Profit and Loos Account		
(January 1,2004)		16,848
Staff Providend Fund		37,500
	21,11,223	21,11,223

From these balances and the following information prepare the Company's Balance Sheet as on December 31, December 31, 2004 and its Profit and Loss Accout for the year ended on that date.

a) The stock on December 31, 2004 was Rs. 1,48,680.

b) Provide Rs. 10,000 for depreciation on fixed assets, Rs. 6,500 for Managing Director's Commission and Rs. 1,500 for the Company's contribution to the Staff Providend Fund.

c) Interest accrued on Investment amounted to Rs. 2,750.

d) A Provision of Rs. 60,000 for taxes in respect of the profit for 2004 is considered necessary.

e) The directors propose a final dividend at 4% after transfering Rs. 50,000 to general Reserve.

f) A claim of Rs. 2,500 for workmen's compensation is being disputed by the company.

g) The Market value of investment as on 31.12 2004 amounts to Rs. 3,02,500.

(Ans: Net Profit after tax Rs. 74,268, P and L Appn. A/c Rs. 17,116, Balancer Sheet Rs. 10,90,000).

3) An inexperienced accountant has prepared the balance sheet of ABC Ltd. as follows:

Balance Sheet of A B C Limited

Liabilities	*Rs*	*Assets*		*Rs*
Trade Creditors	80,900	Stock:		
Advances from Customers	42,260	In hand		3,60,480
Share Capital	8,00,000	With Agents		24,300
Profit & Loss A/c	45,630	Cash in hand		23,540
Provision for Taxes	95,000	Investments		20,000
Proposed Dividend	59,000	Fixed Assets:		
Loan to Managing Director	5,000	Land		1,80,000
General Reserve	75,000	Plant & Machinery		
Dev. Rebate Reserve	30,000	(W.D.V.)		4,10,000
Provision for Contingencies	23,000	Debtors	2,15,450	
Share Premium A/c	22,000	Less: Provision		
Forfeited Shares	3,000	For B/D	9,300	
				2,06,150
		Bills Receiveable		5,000
		Amount due from Agents		51,320
	12,80,790			12,80,790

Redraft the above Balance Sheet in the form prescribed by Indian Companies Act, 1956 giving necessary details yourself.

4) The following balances have been extracted from AB Ltd. as on September 30, 2004:

	Rs.	*Rs.*
Share Capital (Authorised and issued):		
Equity (1,50,000 shares)		15,00,000
8% Redeemable Preference (400 shares)		40,000
Share Premiium		25,000
Preference share Redemption	48,000	
General Reserve		1,00,000
Land (Cost)	3,00,000	
Buildings (Cost less Depreciation)	7,00,000	
Furniture (Cost Less Depreciation)	20,000	
Motor Vehicle (Cost less Dep.)	35,000	
Trading Account–gross Profit		9,00,000
Establishment Charges	2,50,000	
Rates, Taxes and Insurance	12,000	
Commission	4,000	
Commission		5,000
Discount received		8,000
Directors' Fees	2,000	
Depreciation	60,000	
Sundry Office Expenses	60,000	
Payment to Auditors	4,000	
Sundry Debtors and Creditors	1,06,600	25,600

Profit and Loss Account		
(as on 30.9.2003)		10,000
Unpaid Dividend		2,000
Cash in hand	12,000	
Cash at Bank in Current Account	1,95,000	
Security Deposit	10,000	
Outstanding Expenses		6,000
Investment in G.P. Notes	2,00,000	
Stock-in-trade (at or below cost)	3,53,000	
Provision for taxation (y/e 30.9.03)		70,000
Income tax paid under dispute (y/e 30.9.03)	1,00,000	
Advanced payment of income-tax	2,20,000	
Total	26,91,600	26,91,600

The following further details are available:

1) The Preference shares were redeemed on 1st October, 2003 at a premium of 20% but no entries were passed for giving effect thereto, except payment standing to the debit of Preference Share Redemption A/c.

2) Depreciation provided up to 30th September, 2004 is as follows:

   a) Buildings 2,10,000

   b) Furniture 20,000

   c) Moter Vehicles 60,000

3) Establishment charges include Rs. 18,000 paid to Managing Director as minimum remuneration in terms of agreement which provides for a remuneration of 5% of annual net profits subject to the above minimum in the case of absence or inadequacy of profitsw in the year.

4) Payment to Auditors includes Rs. 1,000 for taxation work in addition to audit fees.

5) Market value of investments on 30th September 2004 Rs. 1,80,000

6) Sundry Debtors include Rs. 40,000 due for a period exceeding six months.

7) All receivables and deposits are considered good for realisation.

8) Income-tax demand for the year ended 30.9.2003 Rs. 1,00,000 has not been provided for against which an appeal is pending.

9) Income-tax to be provided@ 55%.

10) Directors decide to transfer Rs. 25,000 to the General Reserve and to recommend payment of dividend on equity shares at the rate of 5%.

11) Ignore previous year's figures.

You are required to prepare the Profit and Loss Account for the year ended 30th September, 2004 and the Balance Sheet as at that date.

(**Ans:** Net profit after tax and commission Rs. 2,30,422,

Balance of P/L Appn. A/c Rs. 1,40,422

Balance Sheet Total Rs. 22,51,600).

Hint: 5% Remeneration Rs. 26950

5) The following balances have ben extracted for the books of XYZ Company Ltd. as on March 31, 2004.

	Rs.		*Rs.*
Freehold Land	23,000	Income from Investments	1,200
Building	7,500	Provisions for doubtful debt	
Furniture	2,000	(1st April 2003)	200
Debtors	5,000	Creditors	2,000
Stock (31 March 2004)	4,000	Provision for Depreciation	
Cash at Bank	500	(1st April, 2003)	500
Cash in hand	100	Buildings	
Cost of Goods sold	30,000	Furniture	
Salaries and Wages	1,500	Suspense A/c	
Misc. Expenses	800	Equity Share Capital	36,750
Investment in Shares	18,000	6% Cumulative Pref.	
Interest	300	Share Capital	8,000
Bad Debts	100	Share Premium	1,000
Repairs and Maintenance	150	Bank Overdraft	5,000
Advance payment of		Sales	38,000
Income-tax	600	Profit and Loss A/c	
		(1st April, 2003)	250
	93,550		93,550

The following further particulars are available:

1) The land was revalued on 1st january, 2004 at Rs. 30,000 by an expert valuer but no effect has been given in the books although the Directors have decided to adjust the relavant amount.

2) Provision for doubtful debt is to be adjusted to 5% on the amount of debtors.

3) Equity Share Capital is composed of Rs. 10 Shares, 3640 shares were fully paid and 50 on which a call of Rs. 3 remains unpaid.

4) Suspense A/c represents money received from the new allottee for re-issue of 50 shares shares forfeited during the year for non-payment of the final call, but no entry for adjustment thereof has been passed.

5) Provision for taxation is to be made at 45%

6) Market value of investments was Rs. 18,500 on 31st March 2004

7) The company is managed by the Directors who are entitled to a remuneration of 3% on the annual net profits.

8) Depreciation is to be charged on written down value of:

   Building at 2%

   Furniture at 10%

9) The land and buildings of the company are mortgaged in favour of the bank as security for overdraft sanctioned up to a limit of Rs. 25,000.

10) Dividend on Cumulative preference shares were in arrears for 5 years upto March 31, 2004. The Directors have recommended payment of dividend for two years.

Prepare Profit and Loss Account for the year ended March 31, 2004 and Balance Sheet on that date.

(**Answer:** Profit Rs. 5,999, Balance Sheet total Rs. 60,491)

6) Ajax Co. Ltd. had an authorised capital of 5,000 equity shares of Rs. 100 each. As on December 31, 2003, 3000 shares were fully called up, and the following balances were extracted from the company's ledger accounts.

	Rs.		*Rs.*
Salary	4,85,000	Printing and Stationery	2,300
Purchases	3,20,000	Advertishing Expenses	7,300
Stock	75,000	Sundry Debtors	52,700
Manufacturing wages	70,000	Sundry Creditors	34,200
Insurance upto 31-3-2004	6,720	Plant & Machinery	83,500
Rent	6,000	General Reserve	60,700
Salaries	18,500	Furniture	27,100
Discount Allowed	1,050	Building	84,580
General Expenses	9,050	Cash at Bank	1,24,000
Calls in Arrear	4,800	Loans from Managing Director	3,700
Profit and Loss A/c (Cr.)	21600	Bad Debts	12,600

The following further information is given: (i) Depreciation to be charged on Machinery and Furniture at 15% and 10% respectively; (ii) Provision for Taxation to be made Rs. 19,000; (iii) Closing Stock Rs. 1,21,000; (iv) Outstanding liabilities: Wages, Rs. 7,000; Salaries Rs. 8,200; Rent, Rs. 1,600; (v) Dividend at 5% on paid-up capital to be provided; (vi) Rs. 10,000 to be transferred to General Reserve.

Prepare Profit and loss Account for the year ended December 31, 2003 and Balance Sheet (in proper form) as on that date.

(**Answer:** Profit for the year Rs. 28125, total of Balance Sheet Rs. 4,79,325).

7) The following balances are extracted from the books of ABC Ltd., as on 31 March, 2003.

Share Capital	40,00,000
Cash in hand	62,000
Repairs and Maintenance	86,000
Raw Materials at cost	26,70,000
Furniture	1,22,000
Sundry Creditors	34,00,000
Directors' Fees	4,000
Plant and Machinery	43,00,000
Miscellaneous Expenses	6.10,000
General Reserve	30,00,000
Land	3,00,000
Finished Goods at cost	31,00,000
Sales	4,33,00,000
Buildings	7,41,000
Cash at Bank	80,000
Provision for Taxation	21,00,000
Sundry Debtors	14,00,000
Raw Materials Consumption	2,86,00,000

Staff Advance	53,000
Advance from customers	5,00,000
Salaries, Wages and Bonus	1,16,00,000
Cash credit from Bank	1,25,000
Power	88,000
Prepaid expenses	46,000
Rent	53,000
Travelling and Conveyance	41,000
Auditors' Fees	15,000
Miscellaneous Income	5,46,000
Income Tax Advance	30,00,000

The following further information is also given:

1) The authorised share capital of the company is 80,000. Equity Shares of Rs. 100 each which has been issued and subscribed to the extent of 50%.
2) Tax provision @ 6% is to be made on current year's profits.
3) 15% dividend on the paid-up share capial is recommended by the Directors.
4) The closing stock of finished goods at cost is Rs. 56,00,000.
5) Depreciation on assets amounting to Rs. 4,30,000 on Furiture and Rs. 33,000 on Building has been debited to miscellanceous expenditure.
6) The surplus in profit and loss account is to be transferred to General Reserve Account.

Prepare Profit and Loss Account and Balance Sheet as on 31.3.2003.

(**Answer:** Net Profit before tax Rs. 25,79,000
Total of Balance Sheet Rs. 1,57,04,000)

8) An inexperienced accountant has prepared the balance sheet ABC Ltd. as follows:

Balance Sheet of A B C Limited

Liabilities	*Rs*	*Assets*		*Rs*
Trade Creditors	80,900	Stock:		
Adances from Customers	42,260	In hand		3,60,480
Share Capital	8,00,000	With Agents		24,300
Profit and Loss A/c	45,630	Cash in hand		23,540
Provision for Taxes	95,000	Investments		20,000
Proposed Dividend	59,000	Fixed Assets:		
Loan to Managing Director	5,000	Land		1,80,000
General Reserve	75,000	Plant and Machinery		
Dev. Rebate Reserve	30,000	(W.D.V.)		4,10,000
Provision for Contingencies	23,000	Debtors	2,15,450	
Share Premium A/c	22,000	Less: Provision		
Forfeited Shares	3,000	For B/D	9,300	
				2,06,150
		Bills Receiveable		5,000
		Amount Due from Agents		51,320
	12,80,790			12,80,790

3.11 LET US SUM UP

Financial statements are prepared by all forms of business organisations to ascertain the operating results of the business and to know the financial position on a particular date. Before preparing financial statements one must gain clarity about the nature of certain items and their treatment in the final accounts. It is obligatory on the part of companies to maintain and prepare financial statements by the end of each accounting period. Manufacturing account is prepared to know the cost of goods produced while Trading account is prepared to know the results of trading operations. Profit and loss account is prepared to ascertain the net profit earned or net loss incurred by the business concern during an accounting period. The operating and non-operating expenses are charged to profit and loss account. The distribution or appropriation of profit is shown under Profit and Loss Appropriation Account, which is also called 'Below the Line'.

Balance Sheet is a statement of assets and liabilities to ascertain the financial position of a concern at a particular date. The assets and liabilities are presented either on the basis of liquidity or performance. Under 'liquidity order' assets are shown on the basis of 'most liquid', 'liquid' and 'least liquid' assets. Liabilities are shown in the order of payment. Under 'order of performance' the assets are arranged on the basis of their useful life whereas liabilities are shown on the besis of long term, medium term, short term and current liabilities.

It is important to distinguish between capital and revenue to ascertain correct profit or loss amount and fair view of the affairs of the business. There are certain rules which guide us to determine whether a particular expenditure or receipt is of a capital nature or of a revenue nature.

Revenue recognition is concerned with the timing of recognition revenue in the statement of profit and loss. 'Realisation Concept' recognises the revenue at the point of sale or service rendered. Operating and non-operating revenues should be shown separately while preparing Profit and Loss Account. There are some established practices as per the Accounting Standards to recognise certain items as revenues. The Accounting Standards have some established practices to recognise revenue in cases of sale of goods, rendering services and financial services. But there are also certain exception to this general rule.

The financial statements of non-corporate entities may be presented either in conventional format or vertical format. Under vertical form various items of incomes and expenses, assets and liabilities arranged vertically to get some additional information about the operating efficiency and financial position of the business enterprise. The sole traders and partnership forms hardly adopt vertical form of financial statements. As regards preparation of Balance Sheet of a company, the nature of details shown with respect to the liabilities and assets and the order of arrangement of the items are prescribed in Schedule VI, Part I of the Companies Act. There are two alternate proformas given in Schedule VI for the preparation of Company Balance Sheets: (i) horizonal and (ii) vertical. Any of these forms may be adopted for the Balance Sheet of a Company. Both the prescribed forms may require that the figures of the previous year should be shown in a separate column along side the figures of the current year.

3.12 KEY WORDS

Capital Expenditure: An expenditure which results in the acquisition of fixed asset or addition to fixed asset, or an improvement in the earning capacity of the business.

Capital Receipt: Receipt in the form of additions to capital, liabilities or sale proceeds of a fixed asset.

Revenue Expenditure: An expenditure the benefit of which is limited to one year.

Revenue Receipt: Receipts on account of goods sold or services provided.

Deferred Revenue Expenditure: A revenue expenditure which involves a heavy amount and the benefit of which is likely to spread over the years.

Appropriation: Distribution of profits.

Balance Sheet: Statement of assets and liabilities depicting the financial position at the end of the financial year.

Below the line: Part of the Profit and Loss Account which shows the appropriation of profits.

Above the line: Profit and loss account which shows the profit or loss before appropriation of profits.

Contingent Liability: Liability which depends upon the happening of a certain event

Preliminary Exenses: Expenses incurred in connection with the formation and registration of a company.

Profit and Loss Account: Income statement disclosing the results of operation (profit or loss) for the financial year.

Dividend: Part of profits distributed to the equity shareholders.

Final Dividend: Dividend declared in the annual general meeting.

Provision for Taxation: The amount appropriated from profit for the liability arising on account of payment of taxes.

Financial Statements: Annual statements of assets and liabilities (Balance Sheet) and of income and expenditure (Profit and Loss Account).

3.13 TERMINAL QUESTIONS

1) Following is the Trial Balance of V.N. Ltd. as on 31st March 2003. Prepare Trading and Profit and Loss Account and Balance Sheet after taking into account the adjustments.

	Rs.	Rs.
Opening Stock	3,00,000	
Purchases/Sales	9,80,000	13,60,000
Bills Receivable/Bills Payable	20,000	28,000
Patents and Trade Marks	19,200	
General Reserve		62,000
Cash at Bank	1,84,800	
Plant and Machinery	1,16,000	
Debtors and Creditors	1,10,000	70,000
Share Capital		4,00,000
Dividend paid for 2001-2002	36,000	
Profit and Loss A/c (1.4.2002)		94200
Sundry Expenses	28,200	
Rent	16,000	
Salaries	30,000	
Computers	68,000	
Carriage–Inward	38,000	
Discount Received		12,000
Wages	1,20,000	
Return outwards		40,000
	20,66,200	20,66,200