

Each chapter is specifically designed to make journey of understanding comfortable, interesting and innovative for the reader. Following is the quick overview of sequence followed to explain topic in each chapter:

Learning Objectives

Each chapter opens with a set of learning objectives, summarizing what one should learn from each chapter.

Introduction to Financial Accounting

1

Learning Objectives

After studying this chapter, you will be able to

- ◊ Define accounting and realise its importance
- ◊ Distinguish between financial, cost and management accounting
- ◊ Relate finance function and accounting
- ◊ Understand accounting as an academic discipline and as a profession
- ◊ Get an overview of auditing and internal control
- ◊ Know ethical issues in accounting
- ◊ Relate accounting and corporate governance

LET US SET THE STAGE . . .

Mr Mayank started a general store in Mumbai on 1st April 2012. He invested Rs 1,00,000 in his business and borrowed a sum of Rs 2,00,000 from bank. He purchased furniture worth Rs 80,000. The premise which he was using was on rental basis, requiring him to pay refundable deposit of Rs 70,000 and rent of Rs 10,000 pm. He also purchased a refrigerator for Rs 30,000. After making these arrangements, he acquired stock of grocery items, cold drinks and ice cream from Mr Raghu and paid him Rs 1,00,000 out of which he paid Rs 30,000 in cash. He recorded all these transactions carefully on the same day in a simple diary. He started recording all his daily transactions in the same diary on different dates. After a month he thought of calculating profit from his new business. When he opened his diary he got confused looking at the various transactions. He approached his accountant friend Mr. Jain with this diary. Mr. Jain told him to follow a proper process of maintaining accounts with double entry system to avoid such confusions in future.

- What is an accounting process? What is double entry system?
- How can one maintain systematic records to determine his financial position?

All such questions can be answered by studying this chapter.

(This case is continued in Business Cases provided at the end of the chapter.)

INTRODUCTION

We have seen the structure of financial statements in earlier chapters. A balance sheet discloses various assets and liabilities while an income statement shows incomes and expenses. The balance sheet equation is as follows:

Owner's Fund + External Liabilities = Assets

or

Owner's Fund = Assets – External Liabilities

It shows that total assets are equal to total liabilities. This equality arises due to the specific process of maintaining books of accounts to record various transactions. We shall discuss the entire process of recording various transactions in a systematic manner to arrive at financial statements.

CLASSIFICATION OF ACCOUNTS

An account is a statement which shows all transactions related to a particular party, asset, liability, income or expense. The types of accounts are personal, real and nominal (Figure 5.1).

Objective 1
To understand classification of accounts

Introductory Case [Let us set the stage.....]

Each chapter opens with an introductory case which sets the scene and introduces the issues that will be addressed in the chapter. It brings out how learning this chapter is important for overall understanding of the business.

LET US SET THE STAGE . . .

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Introduction

It provides brief discussion on the main theme of the chapter and gives an overview of the chapter.

Illustrations

Each chapter provides a number of solved problems/cases helping you to apply theory to accounting practice.

Diminishing/Reducing Balance Method or Written Down Value Method (RBM)

Under this method, the depreciation is charged at a fixed annual rate on the reducing balance, i.e. cost less depreciation. The amount of depreciation charged in each year is not fixed but it goes on decreasing gradually every year. Thus, the amount of depreciation is higher in earlier periods and lower in subsequent periods when repairs and maintenance cost of the asset increases. The formula for calculating the rate of depreciation under diminishing balance method is as follows:

$$\text{Rate of Depreciation} = 1 - n \sqrt[n]{\frac{\text{Net Residual Value}}{\text{Cost of Acquisition}}}$$

If residual value is zero, assume as 1.

Here, n = life of the asset (in year)

ILLUSTRATION 6.3

The cost of the asset is Rs 20,000, residual value is Rs 2,000 and the life of the asset is 3 years. Compute the annual rate of depreciation.

Solution:

The rate of depreciation would be calculated as follows:

$$\begin{aligned} \text{Rate of Depreciation} &= 1 - 3 \sqrt[3]{\frac{2,000}{20,000}} \\ &= 53.6\% \end{aligned}$$

ILLUSTRATION 6.4

A company buys equipment at a cost of Rs 10,000. It decides to depreciate the asset at the cost of 20% per annum based on the reducing balance method (RBM). Calculate the amount of depreciation and WDV for 5 years. Show how equipment will appear in the balance sheet at the end of years 1, 2 and 3.

Solution:

Year	Cost	Depreciation = Cost * 20%	WDV = Cost - Depreciation	Accumulated Depreciation
1 st	10,000	2,000	8,000	2,000
2 nd	8,000	1,600	6,400	3,600
3 rd	6,400	1,280	5,120	4,880
4 th	5,120	1,024	4,096	5,904
5 th	4,096	819.2	3,276.8	6,723.2

EXHIBIT 5.1 Bank Reconciliation Statement (Starting with Cash Book Balance)

	Rs	Rs
Bank Balance as per Cash Book		XXXX
Add: Cheques Issued but not Presented for Payment		
Direct Collections by Bank	XXXX	
Direct Deposits by Debtors/Collection Agents	XXXX	
Interest Credited by Bank	XXXX	XXXX
Less: Cheques Deposited but not Cleared	XXXX	
Direct Payment by Bank	XXXX	
Dishonoured Cheques and Related Charges	XXXX	
Interest and Bank Charges	XXXX	XXXX
Balance as per Pass Book		XXXX

BRS can also be prepared starting with pass book balance as per the following exhibit:

Bank Balance as per Current Account Statement	Rs	Rs
Fixed Assets and Depreciation Accounting	159	
Equipment will appear in balance sheet as under:		
Fixed Assets	Year 1	Year 2
Equipment	XXXX	XXXX
—Gross Block	10,000	10,000
—Less: Accumulated Depreciation	2,000	3,600
—Net Block	8,000	6,400

- Merits:**
- (a) The charge for depreciation reduces every year, while maintenance cost is likely to rise thus total cost of use of asset will remain more or less constant.
 - (b) Valuation of asset as shown in WDV is likely to represent its fair value.
 - (c) This method reduces the impact of tax on profit during the earlier years of the life of the asset by charging higher amount of depreciation.
 - (d) This method is approved by the income tax authorities.

- Demerits:**
- (a) The amount of depreciation keeps on changing each year.
 - (b) The value of the asset cannot be reduced to zero and some balance will always be left at the end of useful life of an asset.

Table 6.2 compares SLM and RBM.

TABLE 6.2 Comparison between SLM and RBM

Basis	Straight Line Method	Reducing Balance Method
Depreciation	It remains the same throughout the life of the asset.	It goes on decreasing every year.
Book Value	The book value of the asset can be reduced to zero.	The book value of the asset cannot be reduced to zero.
Income Tax Law	This method is not acceptable.	This method is acceptable.

Under the Companies Act, a company is free to choose either of the two methods: SLM or RBM. However, rates of depreciation are prescribed in Table 6.3 as per the Companies Act and 6.4 as per the Income Tax Act.

TABLE 6.3 Rates of depreciation as per Companies Act

Provisions of Companies Act (Schedule XIV)	Rate of Depreciation	
Assets	WDV	SLM
Factory Buildings	10%	3.34%
Furniture	18.1%	6.33%
Plant and Machinery (Single Shift)	13.91%	4.75%
Computers	40%	16.21%
Vehicles	25.89%	9.5%

Tables, Exhibits

Sufficient tables and exhibits have been inserted to make the text easier to grasp and to depict information.

Cash and Cash Equivalents	Opening Balance	Closing Balance
Cash	15,000	5,000
Bank	5,800	9,050
Short-Term Investments	30,000	15,000
	50,800	29,050

Workings

Fixed Asset A/c			
Particulars	Rs	Rs	
Balance B/d	6,00,000	Bank A/c (Sale Value)	1,50,000
Purchase of Fixed Assets*	1,75,000	Loss on Sale of Fixed Assets	50,000
		Depreciation	75,000
		Balance C/d	5,00,000
	7,75,000		7,75,000

SUMMARY

- ▶ The purpose of a statement of cash flows is to provide information about the cash receipts and cash payments of the entity and how they relate to the entity's operating, investing and financing activities. Readers of financial statements use this information to assess the solvency of a business and to evaluate its ability to generate positive cash flows in future periods, pay dividends and finance growth.
- ▶ Cash flows are classified as operating, investing and financing activities. Receipts and payments of interest are classified as operating activities.
- ▶ The major operating cash flows are cash received from customers, cash paid to suppliers and employees, interest and dividends received, interest paid and income taxes paid. These cash flows are computed by converting the income statement amounts for revenue, cost of goods sold and expenses from the accrual basis to the cash basis. This is done by adjusting the income statement amounts for changes occurring over the period in related balance sheet accounts.
- ▶ The direct and indirect methods are alternative formats for reporting net cash flows from operating activities. The direct method shows the specific cash inflows and outflows comprising the operating activities of the business. Under the indirect method, the computation begins with accrual-based net income and then shows adjustments necessary to arrive at net cash flows from operating activities. Both methods result in the same amount of net cash flows from operating activities.

Summary

This briefly reviews and reinforces the main topics one has covered in each chapter. This would ensure that one has acquired an understanding of the key topics.

WALKTHROUGH

Exercises

Exercises encourage you to review and apply the knowledge you have acquired from each chapter and can be undertaken to test your understanding. Exercises are divided into following categories:

MULTIPLE CHOICE QUESTIONS*

- Accounting concepts refer to
 - The basic assumptions
 - Rules and regulations
 - Procedures
 - None of the above
- The business entity concept assumes that, for accounting purposes,
 - The business enterprise and its owner are two separate independent entities
 - The business enterprise and its owner are same entities
 - Business is continued forever
 - None of the above
- This money measurement concept assumes that
 - All business transactions should be expressed in non-monetary terms
 - All business transactions should be expressed in non-monetary terms
 - Either in monetary or non-monetary terms
 - None of the above
- In accordance with which of the following basic accounting concepts, during the lifetime of an entity, financial statements are prepared periodically?
 - Conservation
 - Matching
 - Accounting period
 - None of the above
- When information about two different entities has been prepared and presented in a similar manner the information shows the characteristic of
 - Verifiability
 - Relevance
 - Reliability
 - None of the above
- A concept that a business organisation will not be closed down in the near future is known as
 - Going concern
 - Economic entity
 - Monetary
 - None of the above
- The primary qualities that make accounting information useful for decision-making are
 - Relevance and freedom from bias

*Answers to Multiple Choice Questions are provided on the website of the book, www.mhhe.com/bupat-raithatha.

Multiple Choice Questions

These questions are conceptual questions with four alternative choices given. It helps for quick revision of the concepts explained in the chapter.

THEORY QUESTIONS

- The proprietor of a firm withdrew Rs 56,000 for his personal use. This was shown as an expense of the firm. Profits were reduced to pay a lower tax. Is this right from accounting point of view? Justify your answer.
- The CEO of a company is killed in a plane crash. To the extent "an organisation is the lengthened shadow of a man", the real value of the company will change immediately and this will be reflected in the market price of the company shares. Will this have any effect as far as the accounts of the company are concerned? Give appropriate reasons.
- A company revalues its buildings, which were purchased at a cost of Rs 10,00,000 in 1995 to Rs 90,00,000 in 2010, and records the difference of Rs 80,00,000 as profit for the year 2003. Is this practice right? Give reasons.
- The accounting year of a firm closes on 31st December each year. The rent for business premises of Rs 45,000 for the last quarter could not be paid to the owner on account of his being away in a foreign country. Should the rent payable be taken into account for computing the firm's profit for the accounting year? Give reasons.
- A government contractor supplies stationery to various government offices. Some bills amounting to Rs 10,000 were still pending with various offices at the close of the accounting year on 31st March. Should the businessman take the revenue of Rs 10,000 into account for computing the net profit of the period?
- A company had been charging depreciation on a machine at Rs 10,000 per year for the first three years. Then it began charging Rs 9,000 for the fourth year and Rs 7,800 for the fifth year and so on. Is this practice justified? Give reasons for your answer.
- Indicate which of the following transactions relate to Mr Keshav's business as news agent and which are his personal transactions:
 - Rs 50,000 won from a lottery ticket
 - Rs 10,000 for placing advertisement on a local cricket ground regarding his up to date news service
 - Sale of unsold newspaper to local stationary shop
 - Payment to newspaper wholesaler Rs 20,000
 - Purchase of new car for family use although it was used in each morning to collect newspapers from suppliers
- At the end of the year 2012, an organisation had a factory on a piece of land measuring 10 acres, office building containing 50 rooms, 50 personal computers, 50 office chairs and tables, 100 kg of raw materials. All these assets were disclosed as mentioned above in the balance sheet. Using accounting concepts, you are required to comment on this approach.

Theory Questions

These are conceptual questions which involve recollecting and theoretically narrating the issue. It includes short notes, 'distinguish between' and essay-type questions.

Practical problems

Practical problems are divided into 3 layers i.e. Easy, Standard and Expert.

Level 1 – Easy

These are simple problems to understand the basic calculations of relevant concepts of the chapter.

Level 2 – Standard

These are problems that require deep understanding of concepts and issues.

Level 3 – Expert

These are practical problem at higher level which aims at testing the grasping power of the reader and thorough understanding of the chapter.

- Distinguish between SLM and RBM.
- What is an asset impairment? Why is it necessary to provide for the same?

PRACTICAL PROBLEMS

Level 1: Easy

- Amteck Ltd. bought a machine on 1.1.2012 costing Rs 5,00,000 with a useful life of 10 years. It is expected to have a scrap value of Rs 20,000 at the end of its useful life. The rate of depreciation applicable to RBM is 10%. You are required to calculate depreciation for the year 2013 and 2014 and also WDV as on 31.12.2013 and 31.12.2014 as per SLM and RBM and offer your comments.
- Mr Omprakash purchased machinery costing Rs 1,80,000 on 1st April, 2012 having a useful life of 15 years, with no salvage value at the end. He decides to provide depreciation @ 10% pa as per RBM. You are required to pass necessary journal entries using provision for depreciation method for 3 years.
- Complete the following fixed assets schedule: Rs in lacs

Particulars	Gross Block		Depreciation			Net Block		
	Cost as on 1/4/2011	Additions	Cost as on 31/3/2012	Accumulated as on 1/4/2011	Current Year	Accumulated as on 31/3/2012	As on 1/4/2011	As on 31/3/2012
Goodwill	50,000	—		—				
Land and Building	1,80,000	5,000		50,000				
Plant and Machinery	4,50,000	15,000		60,000				
Furniture	1,55,000	5,000		10,000				

You are informed that:

- Rate of depreciation for land and building is 10%, plant and machinery is 15% and furniture is 20%
 - Full depreciation is provided on assets purchased during the year
 - WDV is used for providing depreciation
4. The following information is available for Bharat Ceramic Ltd:

Particulars	
Cost of the Machine (Rs)	26,00,000
Useful Life (Years)	5
Scrap Value (Rs)	1,30,000

You are required to:

- determine annual depreciation for first 3 years and rate of depreciation as per SLM
 - determine accumulated depreciation at the end of third year
 - show disclosure of machine in balance sheet at the end of third year
5. Omkar Silk Ltd. purchased machinery, the details of which are as under. Using the given information you are required to calculate cost of the machine.

Particulars	Amount	Amount
Invoice Price:		
List Price	25,00,000	
Less: Trade Discount	50,000	
Balance	24,50,000	
Add: Sales Tax and Excise Duty	3,00,000	27,50,000
Transportation Charges to Factory Site		12,500
Installation Charges		37,500
Travelling Charges for Manager for Monthly Visit		40,000
Scrap Value		20,000

6. Aparna Pharmaceuticals Ltd purchased on 1.1.1997, a divisible plant for Rs 20,00,000. The plant had estimated useful life of 5 years. It was depreciated as per SLM. A major extension was carried out for Rs 4,00,000 which was operational from 1.1.1999. Prepare the machinery account for all the years assuming:

- the extension will last only till the life of the existing asset
- the extension is capable of being used independently of existing plant and is expected to last 5 years from its installation

Level 2: Standard

7. Complete the following fixed assets schedule:

Rs in lakhs

Particulars	Gross Block		Depreciation			Net Block		
	Cost as on 1/4/2011	Additions	Cost as on 31/3/2012	Accumulated as on 1/4/2011	Current Year	Accumulated as on 31/3/2012	As on 1/4/2011	As on 31/3/2012
Land and Building	3,50,000			25,000				
Plant and Machinery	1,85,000			24,000				
Furniture	1,20,000			16,500				
Computer	2,25,000			59,000				

Level 3: Expert

11. Suman Ltd purchased the following assets during the year 2012.

Asset	Cost	Residual Value	Useful Life
Plant	24,00,000	1,60,000	10
Building	30,00,000	1,80,000	20

Company used SLM for providing depreciation from the year of purchase. However from year 5, company decided to change depreciation method to WDV and decided to apply rate of 10%.

Assuming company earning a profit of Rs 6,50,000 before depreciation which grows @ 10% pa, you are required to:

- Compute profit after depreciation for 5 years. Show the impact of change in method of depreciation in year 5 (assuming it is done retrospectively from year 1).

12. Carriage Transport Company purchased 5 trucks at the cost of Rs 2,00,000 each on 1 April 2001. The company writes off depreciation @ 20% p a on the original cost and closes its books on 31 December, every year. On 1st October, 2003, one of the trucks is involved in an accident and is completely destroyed. Insurance company has agreed to pay Rs 70,000 in full settlement of the claim. On the same date the company purchased a second hand truck for Rs 1,00,000 and spent Rs 20,000 on its overhauling. Prepare a truck account and provision for depreciation account for the three years ended on 31 December 2003. Also give truck account if truck disposal account is prepared.
13. The following is the schedule of fixed assets of Amtech Ltd for 2011–12:

Particulars	Gross Block		Depreciation/Amortisation/ Impairment			Net Block		
	As on 31/3/2011	Additions	As on 31/3/2012	As on 31/3/2011	Additions	As on 31/3/2012	As on 31/3/2011	As on 31/3/2012
Building	4,00,000	—	4,00,000	1,00,000	30,000	—	1,30,000	3,00,000
Plant and Machinery	5,00,000	—	5,00,000	2,50,000	50,000	—	3,00,000	2,50,000
Furniture and Fixtures	2,00,000	—	2,00,000	1,00,000	30,000	—	1,30,000	1,00,000
Computer Systems	1,55,000	—	1,55,000	77,500	15,500	—	93,000	77,500
Vehicles	3,00,000	—	3,00,000	1,50,000	60,000	—	2,10,000	1,50,000
Total	15,55,000	—	15,55,000	6,77,500	1,85,500	—	8,63,000	8,77,500
							6,92,000	

BUSINESS CASE

India's largest power company, NTPC was set up in 1975 to accelerate power development in India. NTPC is emerging as a diversified power major with presence in the entire value chain of the power generation business. Apart from power generation, which is the mainstay of the company, NTPC has already ventured into consultancy, power trading, ash utilisation and coal mining. NTPC ranked 341st in the '2010, Forbes Global 2000' ranking of the world's biggest companies. NTPC became a *Maharatna* company in May 2010, one of the only four companies to be awarded this status.

The total installed capacity of the company is 36,014 MW (including JVs) with 15 coal based and 7 gas based stations, located across the country. In addition under JVs, 5 stations are coal based and another station uses naphtha/LNG as fuel. The company has set a target to have an installed power generating capacity of 1,28,000 MW by the year 2032. The capacity will have a diversified fuel mix comprising 56% coal, 16% gas, 11% nuclear and 17% renewable energy sources (RES), including hydro. By 2032, non-fossil fuel-based generation capacity shall make up nearly 28% of NTPC's portfolio.

NTPC has been operating its plants at high efficiency levels. Although the company has 17.75% of the total national capacity, it contributes 27.40% of the total power generation due to its focus on high efficiency.

The following information is available regarding its incomes and expenses in Rs Cr for the years ending 31st March 2010 and 2011.

Particulars	March 2011	March 2010
Sales Turnover	55,216.69	46,623.60
Excise Duty	278.01	245.9
Other Income	2,525.48	2,872.80
Raw Materials	31.33	31.1
Power and Fuel Cost	35,796.37	29,689.10
Employee Cost	3,395.27	2,946.80
Other Manufacturing Expenses	1,273.14	1,096.60
Selling and Admin Expenses	2,264.01	578.5
Miscellaneous Expenses	525.63	436.4
Interest	2,027.21	1,861.90
Depreciation	2,485.69	2,650.10
Tax	2,630.54	2,682.70
Preference Dividend	0	0
Equity Dividend	3,133.26	3,133.20

You are required to prepare income statement and calculate profit at various levels.

Business Cases

Business cases are designed in such a way that reader can understand real business scenarios. Cases are developed with interesting situations and real life data. Application of knowledge will be the key requirement of solving the cases.

Research Assignments

Each chapter ends with research assignments which are given as guidelines to collect and analyse specific information. They are home assignments to serve the purpose of self-study and improve research skills.

Interpreting Financial Reports

Financial reports published by corporates are an important source of data for the company information. It provides financial statements and/or a specific corporate issue to be analysed and interpreted.

Using the following information you are required to prepare fixed assets schedule for 2012-13.

- Company follows RBM to provide depreciation
- On 1st July, 2012 company acquired new vehicle worth Rs 50,000 and sold old vehicle for Rs 50,000 (WDV Rs 50,000 and cost Rs 1,00,000)
- On 1st September, 2012 company acquired new building worth Rs 1,00,000
- On 1st January, 2012 company acquired furniture worth Rs 40,000

14. A company provides depreciation on plant and machinery at 20% per annum on diminishing balance method. On 1 April 2013, the balance in the plant and machinery account was Rs 10,00,000. It was discovered during 2013-14 that:

(a) Rs 50,000 being ordinary repairs to machinery incurred on 30 June 2011 had been wrongly capitalised.

(b) Rs 1,00,000 being the cost of a generator purchased on 1 October 2010 had been wrongly treated as revenue expenditure and written off to stores.

A plant which cost Rs 80,000 on 30 September 2012 was scrapped and replaced with a more sophisticated one on 31 December 2013 by spending Rs 1,20,000. Scrap worth Rs 20,000 was released.

Prepare the plant and machinery account as would appear on 31 March 2014 after providing depreciation for that year. Also show the detailed working notes making all the calculation.

RESEARCH ASSIGNMENTS

1. Study annual report of Coal India Ltd, TCS Ltd and Infosys Ltd for 3 years and answer the following questions:
 - (a) Compare depreciation method followed by companies.
 - (b) Find out if assets are revalued and how revaluation effect has been reflected in the financial statements.
 - (c) Suppose company wants to charge depreciation on revalued amount, explain how it would affect the profit.
 - (d) Analyse intangible assets shown in financial statements of the company and comment on accounting policies adopted for the valuation.
 - (e) Comment on assets impairment policy of the company and reflect whether it has affected companies profit or not.

INTERPRETING FINANCIAL REPORTS

1. Following details have been extracted from the Annual Report of Reliance Industries Limited, for the year 2010-11.