

# FINANCIAL REPORTING AND ANALYSIS



The image shows a magnifying glass with a gold rim and a dark handle, positioned over a financial statement. The magnifying glass is focused on a table with two columns: the first column lists various equipment and goods, and the second column shows their values. The table is part of a larger document with other text visible in the background.

Power Tools	\$ 31,463
Hand Tools	21,463
Landscaping Equipment	14,309
Electrical Goods	17,170
Residential Construction Equipment	21,463
Commercial Construction Equipment	11,447
Paint Products	25,755
	\$143,090

2002

25,981
18,403
13,494
1,042
15,949
9,815
26,991
\$122,455

2004, 2003, and 2002 were

**SUGGESTIONS**

over the time in Pakistan

2004, 2003, and 2002 were

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DMS IUB

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## FINANCIAL REPORTING & ACCOUNTING PRINCIPLES

### Accounting

Almost every organization and individual maintains accounts and deals with accounting. In simple terms, it can be described as a record of Income and expenditure of a business organization, or budget vs. utilization, in the case of a government non-commercial organization. In the case of the business entity, accounting would deal with measuring, recording and communicating the results of business activities. That is why; Accounting is often called “Language of Business”.

### Purpose of Accounting

Accounting provides decision-makers with sufficient, relevant information to make prudent and intelligent business decisions. This information is provided through accounting reports called financial statements. The whole process is called “financial reporting”

- The purpose of accounting is to organize the financial details of business.
- To identify the financial transactions.
- To organize the financial data into useful information
- To measure the value of these information in terms of money
- To analyze, interpret, and communicate the information to persons or groups, both inside or outside the business.

### Financial Statements Generated by a Business

A business generates four financial statements at the end of its accounting period:-

- Income statement:** shows operational results of business during/over the accounting period.
- Statement of owners' equity:** showing changes in owner's equity through profit/additional investment or through losses/drawl by owner.
- Balance sheet** showing financial position at the end of the accounting period i.e. a picture of what the business owns and what it owes.
- Statement of cash flows** giving a picture of cash inflows (receipts) and cash outflows (payments) over/during the accounting period. It is prepared from the two major financial statements viz Income Statement and Balance Sheet.

### Notes to Financial Statements:

In addition to above, notes containing additional information (financial & non-financial) about the business are also attached to financial statements.

### Accounting Period

Accounting period is the period of time covered by an Income Statement. It is usually one year. It can either be calendar year (Jan to Dec) or financial year (July to June). Financial Statements are prepared at the end of accounting period and are the end product of accounting process/cycle.

### Types of Business

There are usually three types of Business: **service enterprise**, **merchandise** (sale and purchase) enterprise, and **manufacturing enterprises**.

### Types of Business Organizations:

Corresponding to three types of business, there are three types of business organizations viz Sole Proprietorship, Partnership firm and Public Limited Companies or Corporations.

Different combinations of businesses and business organizations can occur. For example, a sole proprietor can have a manufacturing business or a big corporation can indulge in service enterprise.

**GAAP** apply to financial statements of all the three types of business and business organizations.

### Sole Proprietorship:

It is owned by one person (often acting as manager as well). Examples would be small retail stores, farms, service business and professional practices (law, medicine etc). Accounts of business are however separate from personal accounts of the owner. Legally, the business and owner are not separate. It is unincorporated business in which there is personal liability of owner for debts of business. Creditors look to solvency of owner, rather than financial position of business.

Owner is personally liable for all business obligations. If the organization is sued, the proprietor as an individual is sued and has unlimited liability, which means that much of his or her personal property, as well as the assets of the business, may be seized to settle claims. Another problem with a sole proprietorship is the difficulty in raising capital. Because life and success of the business is so dependent on a single individual, a sole proprietorship may not be as attractive to lenders as another form of organization. More over the proprietorship has certain tax disadvantages.. In addition to these drawbacks the proprietorship form makes the transfer of ownership more difficult than does the corporate form. No portion of the enterprise can be transferred to members of the family during the proprietor's lifetime. For these reasons, this form of organization does not afford the flexibility that other forms do.

## Partnership:

It is unincorporated business owned by two or more persons. Owners voluntarily act as partners. Accounts of firm are separate from personal accounts of owners/partners, which mean there is personal liability of owners for debts of firm. Partnership dissolves on the death or retirements of any of its members/partners.

## Disadvantages of a Partnership Firm

The Local Law restricts the number of partners in a partnership firm to twenty. If the firm needs more capital for its business, the partners may not be in a position to invest more money in the business.

Secondly, if the business of the partnership firm is very large and twenty persons can not manage it, they cannot admit new partners in the business. However, there is one exception. The partnership firm of professionals can have more than twenty partners.

At this point, need for forming a COMPANY arises.

## Public Limited Companies/Corporations:

Ownership of public limited companies vests in individuals, Labour unions, banks, universities and other organizations like mutual funds etc. Ownership is through shareholding by shareholders or stockholders.

A corporation is a legal entity having existence separate and distinct from that of its owners. It is an artificial and legal person which can be sued and be sued.

Assets of the company or corporation belong to the company itself, not to owners. Creditors of the company thus have a claim against assets of the company, not against the personal property of stockholders. In other words, there is “limited” liability of shareholders; limited to the extent of their shareholding. This is because stockholders own the company but not its assets, which belong to the company itself. It is the corporation which is responsible for its debts, being a legal person.

## Advantages of A Limited Company

A Limited company enjoys the following benefits:

- It can have more than twenty partners, so problem of extra capital is reduced to minimum.
- The liabilities of the members of a company is limited to the extent of capital invested by them in the company
- There are certain tax benefits to the company, which a partnership firm can not enjoy.
- In Pakistan, affairs of limited companies are controlled by COMPANIES ORDINANCE issued in 1984.
- The formation of a company and other matters related to companies are governed by SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN (SECP).

## Types of Companies

There are two major types of the companies:

- Private limited companies
- Public limited companies

### Private Limited Companies

Following are the main characteristics of private limited companies:

- Number of members in a private limited company ranges from two to fifty.
- Words and parentheses “(Private) Limited” are added at the end of the name of a private limited company. Example: ABC (Private) Limited.
- Private limited company can not offer its shares to general public at large.
- In case a shareholder decides to sell his shares, his shares are first offered to existing shareholders. If all existing shareholders decide not to purchase these shares, only then, an outsider can buy them.
- The shareholders of the private limited company elect two members of the company as Directors.
- These directors form a board of directors to run the affairs of the company.
- The head of board of directors is called “chief executive”.

### Public Limited Company

Following are the main characteristics of public limited companies:

- Minimum number of members in a public limited company is **seven**
- There is no restriction on the maximum number of members in a public limited company.
- Word “Limited” is added at the end of the name of a public limited company. Example: ABC Limited.
- Public limited company can offer its shares to general public at large.
- The shareholders of the public limited company elect seven members of the company as Directors.
- These directors form a board of directors to run the affairs of the company.
- The head of board of directors is called “chief executive”.

There are two types of public limited company:

- Listed Company
- Non Listed Company

#### Listed Company

Listed company is that company whose shares are quoted on stock exchange. i.e. whose shares are traded in stock exchange. It is also called quoted company.

#### Non Listed Company

Non listed company is that company whose shares are not quoted on stock exchange. i.e. whose shares are not traded in stock exchange.



## ACCOUNTING CYCLE/PROCESS

### ACCOUNTING CYCLE/PROCESS

It mainly consists of Recording, Classifying and Summarizing financial transactions over an accounting period.

#### Steps in Accounting Cycle

1. **Analyzing financial transaction.** The purpose is to see which two (or more) Accounts (or sub-Accounts) are affected by a particular financial transaction.
2. **Recording** (chronologically) in journal which is called “book of original entry”. This step is also called journalizing. Its practical illustration is given below.
3. **Posting** in ledger which means transferring debits and credits from journal to Ledger account. This is also called ledgerising or classification.
4. **Preparing trial balance**, this is done to prove the equality of debits and credits in the ledger
5. **Making adjusting Entries**
6. **Adjusted Trail Balance**
7. **Income Statement**
8. **Balance Sheet**

#### Case-1

“Woods & Luxury Pvt. Ptd” is Private Limited Company newly started in 2012 operating in Pakistan with 15 Share holders currently. W&L has Authorized Capital 100,000 Shares of Rs. 10 each. The objective of the business is trading of the wood products. Sale agreement was made with **Ethan Allen Global, Inc. which** is a North American furniture manufacturing chain. HOD of W&L decided to separate the preliminary expenses from financial statements and start the financial treatment from the first day of accounting cycle and follow the Accounting Period of 1-year starting on 01-july however, for first 3 years monthly financial statement ll also be prepared. For accounting treatment accrual base accounting system is adopted and the GAAP is decided to follow where consistency principle is conditional (Approval Taken for 3 Years). Other Policies were decided as follows.

- The ratio of Dividend and Retained earnings is decided as 75:25.
- FIFO ll be used for inventory costing (Situation Dependent)
- 25% declining (Or St. Line) depreciation on fixed asset ll be charged as tax shield (Situation Dependent) and F. Asset ll be recorded at written on WDV.

The Business activities detail is as under:

1. **1-july-12**, Issued capital was invested with 70,000 shares with face value 10 each issued at its original face value.

2. **2-July-12**, W&L opened a bank account and deposit RS. 500,000.
3. **3-July-12** Bank Loan of amount 300,000 is taken.
4. **3-July-12** Paid for furniture Rs. 70,000 through Cheque for office use
5. **7-July-12** Paid for vehicle Rs. 300,000 by Cheque
6. **10-July-12** Bought 500 Units of Product on credit from Ethan Allen Global @ rate 500/- under Transaction Reference # Tr100
7. **13-July-12** Purchased 400 Unit for cash Rs. @ 550/-
8. **15-July-12** Sold 390 Units at Cash 390,000
9. **19-July-12** Purchase 300 Units @ 600/- on cash.
10. **21-July-12** Sold 200 Units on credit to Mr. Wajid amount 200,000.
11. **23-July-12** Half payment Paid to Ethan Allen Global Transaction Reference # Tr100 by Cash.
12. **24-July-12** Salaried expense for the month of July-12 is 60,000/- by Cheque
13. **28-July-12** Electricity Bill of amount 15,000 for the month of July-12 is yet to be paid having last date after the closing date of accounting period.
14. **30-July-12** Pay Interest Expense on Loan Rs. 6,000

Inventory Table			
	Date	Units	Balance
1	<b>10-July-12</b>	500 @ 500	250,000
2	<b>13-July-12</b>	400 @ 550	220,000
3	<b>19-July-12</b>	300 & 600	180,000

- ⇒ For the purpose of maximum profit gaining, inventory costing and depreciation method can be altered. However, depreciated ll be applied to all fixed asset in same manner.
- ⇒ 12<sup>th</sup> portion of depreciated ll be charged in July-12 PnL account (useful life of F. Asset is 3 Years).

Tax Rates are as under:

0-49,999	0
50,000-99,999	8%
100,000-149,999	10%
150,000-199,999	12%
200000-2499,999	18%
more than 250,000	21%

Tax ll be paid in Cash.



## GENERAL JOURNAL AND LEDGERS... RELATED TERMS

### Types of Book Keeping

#### Single Entry Book-keeping

This is the conventional style of keeping records of financial transactions. In single entry book keeping system, as it is clear from the name, only one aspect of the transaction is recorded.

This actually is not a system but is a procedure by which small business concerns, like retailers and small shopkeepers, keep record of their sale / income. In this system, there are usually two to three registers “Khata”. In one register cash received from customers is recorded, whereas the other one is a person-wise record of goods sold on credit “Udhar Khata”. There may or may not be a register of suppliers to whom money is payable. That means, only one aspect of transaction i.e. either cash receipt or the fact that money is receivable from someone is recorded.

#### Double Entry Book-keeping

The concept of double entry is based on the fact that every transaction has two aspects i.e. receiving a benefit and giving a benefit. The accounting system that records both the aspects of transaction in books of accounts is called double entry system.

The account that receives the benefit is debited and the account that provides the benefit is credited. ‘Debit’ and ‘Credit’ are denoted by ‘Dr’ and ‘Cr’ respectively. The ultimate result of the system is that for every Debit (Dr) there is an equal Credit (Cr).

### Cash Accounting and Accrual Accounting

#### Cash Accounting

It is the accounting system in which events are recorded when actual cash / cheque is received or paid.

Let's take the example of utility bills like electricity, telephone etc. The bill of January is received on 15th February and paid on 25th February. If the organization is following cash accounting practice it will record the expense of electricity / telephone on 25th February because the actual payment is made on that day. The same principle applies for income and other transactions as well i.e. income is recorded when cash is actually received instead recording when it is earned.

#### Accrual Accounting

It is the accounting system in which events are recorded as and when they occur.

This means that income is recorded when it is earned and expense is recorded when

incurred i.e. the organization has obtained the benefit from it. Consider the above example. The electricity is utilized in the month of January so the expense should be recorded in the month of January. Similarly the company that is providing the electricity should record the income in the month of January.

## Debit and Credit

Debit and Credit are two Latin words and as such it is difficult to say what do these mean. But we can develop an understanding as to what does these terms stand for.

### Debit

It signifies the receiving of benefit. In simple words it is the left hand side.

### Credit

It signifies the providing of a benefit. In simple words it is the right hand side.

## Dual Aspect of Transactions

For every debit there is an equal credit. This is also called the dual aspect of the transaction i.e. every transaction has two aspects, debit and credit and they are always equal. This means that every transaction should have two-sided effect. For Example: If a business Purchase a Car (Asset) on Cash at Rs. 500,000 then

Car (Asset Account)	500,000 (Dr.)	
Cash		500,000 (Cr.)

## Rules of Debit and Credit

<b>Rules of Debit and Credit for Asset</b> Increase in Asset is Debit Decrease in Asset is Credit	<b>Rules of Debit and Credit for Expenses</b> Increase in Expenditure is Debit Decrease in Expenditure is Credit
<b>Rules of Debit and Credit for Liabilities</b> Increase in Liability is Credit Decrease in Liability is Debit	<b>Rules of Debit and Credit for Income</b> Increase in Income is Credit Decrease in Income is Debit

## TRAIL BALANCE and INCOME STATEMENT

It is prepared in the order of Accounting Equation i.e. balance sheet. It serves as a working paper for accountants. It should however be noted that it gives assurance only as to equality of debit and credit amounts. It does not assure accuracy. For example if a transaction is altogether omitted from accounting records, debits and credits of other transactions so recorded would be equal, but this particular transaction which was omitted altogether, would not be detected by Trial balance.

- At the end of accounting period, a list of all ledger balances is prepared. This list is called trial Balance.

Trial balance is a listing of the accounts in your general ledger and their balances as of a specified date. A trial balance is usually prepared at the end of an accounting period and is used to see if additional adjustments are required to any of the balances. Since the basic accounting system relies on double-entry bookkeeping, a trial balance will have the same total debit amount as it has total credit amounts.

- Both sides of trial balance i.e. Debit side and credit side must be equal. If both sides are not equal, there are some errors in the books of accounts.
- Trial balance shows the mathematical accuracy of the books of accounts.

### Limitations of Trial Balance

1. Trial balance only shows the mathematical accuracy of the accounts.
2. If both sides of trial balance are equal, books of accounts are considered to be correct. But this might not be true in all the cases.

If any transaction is not recorded at all, trial balance can not detect the omitted transaction. • If any transaction is recorded in the wrong head e.g. if an expense is debited to an assets account. Trial balance will not be able to detect that mistake too.

## Illustration

ABC Limited		
Trial balance As on June 30, 2002		
Particulars	Amount Dr. (Rs.)	Amount Cr. (Rs.)
Authorized Share Capital (Face value Rs. 10 each)		1,500,000
Paid up Capital		1,000,000
Share Premium		120,000
General Reserve		48,000
Accumulated profit brought forward		139,750
Opening Stock	336,720	
Sales		4,715,370
Purchases	2,475,910	
Return outward		121,220
Return inward	136,200	
Carriage inward	6,340	
Carriage outward	43,790	
Wages	410,240	
Salesmen Salaries	305,110	
Admin. Wages & salaries	277,190	
Plant And Machinery	610,000	
Motor vehicle hire	84,770	
Provision for Depreciation: Plant & Machinery		216,290
General Selling Expenses	27,130	
General admin. expenses	47,990	
Directors' Remuneration	195,140	
Rent received		37,150
Trade Debtors	1,623,570	
Cash and Bank balances	179,250	
Trade Creditors		304,570
Bills Payable		57,000
<b>Total</b>	<b>6,759,350</b>	<b>6,759,350</b>

### Additional Information

- Closing stock is valued at Rs. 412,780.
- Accrue Auditors' remuneration Rs. 71,000.
- Dividend is proposed @37.5% for the year.
- Depreciate plant & machinery @20% on cost.
- Of the motor hire, Rs. 55,000 is for selling purposes.
- Directors' remuneration has been as follows:

o	Chairman	46,640
o	Managing Director	51,500
o	Finance Director	46,000
o	Marketing Director	51,000
		<b>195,140</b>

**Note:** This Value has already been added to Trail Balance. You just need to Split this Value in Two Different Expenses Heads. **Chairman, Managing Director and Finance Director Remuneration** ll go to **Admin Exp** and **marketing Director** ll go to **Selling Exp.**

## Income Statement

### Solution

#### Profit & Loss Account

ABC Limited			
Profit and Loss Account			
For the Year Ending June 30, 20-2			
Particulars	Note	Amount Rs.	Amount Rs
Sales	1		4,579,170
Less: Cost of Goods Sold	2		(2,695,210)
Gross Profit			1,883,960
Add: other income (rent received)			37,150
Less: Administrative Expenses	3	692,090	
Less: Selling Expenses	4	<u>482,030</u>	<u>(1,174,120)</u>
Profit before tax			746,990
Less: Tax for the year			<u>0</u>
Profit after tax			746,990
Add: Accumulated Profit b/f			<u>139,750</u>
			886,740
Less: Proposed Dividend @ 37.5%	5		375,000
<b>Net Profit Carried Forward</b>			<b>511,740</b>

Notes to the Accounts	
<b>Note # 1</b>	<b>Sale account</b>
Sales	4,715,370
Less: Return in	(136,200)
<b>Net Sales</b>	<b>4,579,170</b>

#### Note # 2 Cost of goods sold

Opening Stock	336,720
Add: Purchases	2,475,910
Wages	410,240

Less: Returns out	(121,220)
Add: Carriage in	6,340
Less: Closing Stock	(412,780)
<b>Total</b>	<b>2,695,210</b>

**Note # 3      Administrative Expenses**

Wages & salaries		277,190
Motor Hire		29,770
General Expenses		47,990
Directors Remuneration: Chairman	46,640	
Managing Director	51,500	
Director Finance	46,000	144,140
Auditors Remuneration		71,000
Depreciation Plant & Machinery	(Note # 3-a)	122,000
<b>Total</b>		<b>692,090</b>

**Note # 3-Fixed Assets**

	Cost	Rate	Opening	Dep	Closing	WDV
Plant & Machinery	610,000	20%	216,290	122,000	338,290	271,710

<b><u>Note # 4</u>      <u>Selling Expenses</u></b>	
Salesmen salaries	305,110
Carriage out	43,790
General Expenses	27,130
Motor Hire	55,000
Marketing Director's Remuneration	51,000
<b>Total</b>	<b>482,030</b>
<b><u>Note # 5 Proposed Dividends</u></b>	<b>375,000</b>



## Income & Expenditure Vs Profit & Loss Account

- Income and Expenditure Account is used for Non-Profit Organizations like Trusts, NGOs while
- Profit and Loss Account is used for Commercial organizations like limited companies.

### Profit & Loss Account

- Profit & Loss account is an account that summarizes the profitability of the organization for a specific accounting period.
- Profit & Loss account has two parts:  
First part is called **Trading account** in which Gross Profit is calculated. Gross profit is the excess of sales over cost of goods sold in an accounting period. In trading concern, cost of goods sold is the cost of goods consumed plus any other charge paid in bringing the goods in salable condition. For example, if business purchased certain items for resale purpose and any expense is paid in respect of carriage or bringing the goods in store (transportation charges). These will also be grouped under the heading of 'cost of goods sold' and will become part of its price. In manufacturing concern, cost of goods sold comprises of purchase of raw material plus wages paid to staff employed for converting this raw material into finished goods plus any other expense in this connection.

2nd part is called **Profit & Loss account** in which Net Profit is calculated. **Net Profit** is what is left of the gross profit after deducting all other expenses of the organization in a specific time period

### How to prepare Profit & Loss Account?

- One way is to write down all the Debit and Credit entries of Income and Expense accounts in the Profit and Loss Account. But it is not sensible to do so.
- The other way is that we calculate the net balance or we can say Closing Balance of each income and expense account. Then we note all the credit balances on the credit side and all the debit balances on the debit of profit and loss account.
- If the net balance of profit and loss is Credit (credit side is greater than debit side) it is Profit and if the net balance is Debit (Debit side is greater than credit side) it is a loss.

### Income, Expenditure, And Profit & Loss

- **Income** is the value of goods and services earned from the operation of the business. It includes both cash & credit. For example, if a business entity deals in garments. What it earns from the sale of garments, is its income. If somebody is rendering services, what he earned from rendering services is his income.
- **Expenses** are the resources and the efforts made to earn the income, translated in monetary terms. It includes both expenses, i.e., paid and to be paid (payable). Consider the above mentioned example, if any sum is spent in running the garments business effectively or in provision of services, is termed as expense.

- **Profit** is the excess of income over expenses in a specified accounting period.

$$\text{Profit} = \text{Income} - \text{expenses}$$

### Classification of Expenses

- **Cost of goods sold (CGS)** is the cost incurred in purchasing or manufacturing the product, which an organization is selling plus any other expense incurred in bringing the product in saleable condition. Cost of goods sold contains the following heads of accounts:
  - o Purchase of raw material/goods
  - o Wages paid to employees for manufacturing of goods
  - o Any tax/freight is paid on purchases
  - o Any expense incurred on carriage/transportation of purchased items.
- **Administrative expenses** are the expenses incurred in running a business effectively. Main components of this group are:
  - o Payment of utility bills
  - o Payment of rent
  - o Salaries of employees
  - o General office expenses
  - o Repair & maintenance of office equipment & vehicles.
- **Selling expenses** are the expenses incurred directly in connection with the sale of goods. This head contains:
  - o Transportation/carriage of goods sold
  - o Tax/freight paid on sale
  - o If the expense head 'salaries' includes salaries of sales staff then it will be excluded from salaries & appear under the heading of 'selling expenses'.
- **Financial expenses** are the interest paid on bank loan & charges deducted by bank on entity's bank accounts. It includes:
  - o Mark up on loan
  - o Bank charges

### A sample of Income Statement

**Name of the Entity**  
**Income statement**  
**For the Period Endin<sup>g</sup> ----**

<b>PARTICULARS</b>	<b>AMOUNT Rs.</b>	<b>AMOUNT Rs</b>
Income/Sales/Revenue		XXXXXXXX
Less: Cost of sales		(XXXX)
<b>Gross profit</b>		<b>Xxxx</b>
Less: Administration expenses	Xxx	
Selling expenses	Xxx	
Financial expenses	xxx	(xxx)
<b>Net profit</b>		<b>xxx</b>

### Detailed Format of Income Statement

<b>PARTICULARS</b>	<b>AMOUNT Rs.</b>	<b>AMOUNT Rs</b>
<b>Net Sale</b> (Sale – Sale Return or Return)		XXXXXXXXXX
<b>Less: Cost of sales</b> (Op. Stock + Purchase + Carriage/Freight In + Wages to Manufacturing –Return Outward – Ending Inventory)	(XXXXXX)	
<b>Gross Profit</b>		<b>XXXXX</b>
Less:		
Admin Expense	(XXXX)	
Selling Expenses	(XXXXX)	
<b>Operating Profit</b>		<b>XXX</b>
Plus:		
Other Revenue		XXXX
<b>EBIT</b>		<b>XXXX</b>
Less:		
Financial Charges	(XXXX)	
Markup on Load	(XXXX)	
<b>EBT</b>		<b>XXXX</b>
Tax	(XXX)	
<b>Net Income</b>		<b>XXXX</b>
<b>For Companies</b>		
Less:		
Dividend		XXXXXX
Retained Earning		XXXX

**Note: The Accounts Used in Income Statements are recognized as Temporary Accounts.**

## Accrual Basis of Revenue & Expense Accounting

Revenue Recording is done on Realization Principle. In this case, the date of rendering services or date of delivery of good sold is considered as the date of earning revenue. For example, if services are rendered in January and actual receipt of revenue/fee takes place in February i.e. after one month as per agreement, still the revenue would be recorded in the month of January since it was “earned” in January.

Expense Recording is done on matching principle. This means that revenues are offset by all expenses incurred in producing those revenues, pertaining to a particular accounting period. It would thus be seen that there is cause-and-effect relationship between revenues and expenses. For example, June salaries are paid in July but these have to be recorded as salaries expense for June. It must also be noted that Revenue & cash Receipts and Expense & cash payments are different. The two can happen before, after or during the accounting period.

## Expenditure Vs Expenses

**Expenditure:** It is the cost benefiting or spreading over two or more accounting periods. **Expense** is the portion of Expenditure for one accounting period only.

## BALANCE SHEET

### Balance Sheet (Continue Illustration)

ABC Limited		
Balance Sheet As At June 30, 2002		
Particulars	Note	
Fixed Assets at WDV	3-a	271,710
<b>Current Assets</b>		
Debtors		1,623,570
Stock in Trade		412,780
Cash & Bank Balance		179,250
		2,215,600
<b>Net Assets Employed</b>		<b>1,679,740</b>
<b>Current Liabilities</b>		
Creditors		304,570
Bills Payable		57,000
Auditors Remuneration Payable		71,000
Proposed Dividend		375,000
		807,570
Working Capital		1,783,030
Financed By:		
Authorized Capital 50,000 Shares of Rs. 10 each		1,500,000
Paid Up Capital		
30,000 Shares of Rs. 10 each		1,000,000
Share Premium		120,000
General Reserve		48,000
Accumulated Profit and Loss Account		511,740
<b>Total</b>		<b>1,679,740</b>

**Assets** are economic resources that are owned by a business and are expected to benefit future operations. In most cases, the benefit to future operations comes in the form of positive future cash flows. The positive future cash flows may come directly as the asset is converted into cash (collection of a receivables) or indirectly as the asset is used in operating the business to create other assets that result in positive future cash flows (building & land used to manufacture a product for sale). Assets may have definite physical form such as building, machinery or stock. On the other hand, some assets exist not in physical or tangible form, but in the form of valuable legal claims or right. Examples are accounts receivables, investment in govt. bonds and patent rights etc.

**Liabilities** are debts and obligations of the business. The person or organization to which the debt is owed is called **creditors**. All businesses have liabilities; even the most successful companies' purchase stocks, supplies and receive services on credit. The liabilities arising from such purchases are called **Accounts payable**.

### Classification of Assets:

There are two types of

assets:

1. **Tangible Assets** which have physical existence and can be seen or touched. It includes Fixed as well as Current assets.
2. **Intangible assets** which have no physical existence like goodwill, patents and copyrights etc.

**Assets Can also be classified as:**

- **Fixed Assets** – Are the assets of permanent nature that a business acquires, such as plant, machinery, building, furniture, vehicles etc. Fixed assets are subject to depreciation.
- **Long Term Assets** –These are the assets of the business that are receivable after twelve months of the balance sheet date. For example, if business has invested some money for two years in any saving scheme or has purchased saving certificates for more than one year, it is a long term asset.
- **Current Assets** – Are the receivables that are expected to be received within one year of the balance sheet date. Debtors, closing stock & all accrued incomes are the examples of Current Assets because these are expected to be received within one accounting period from the balance sheet date.



## Classification of Liabilities

**Capital** – is the funds invested by the owners of the business. Business has a liability to return these funds to the owner. We know that for the purpose of accounting, business is treated separately from its owners. This is known as Separate Entity Concept i.e. Business is a separate entity. Therefore, if the to the business then the business, not only has to return the amount to the owner but it also has to give some return on that money. That is why we treat Capital (Owners Funds) as a Liability.

**Profit & Loss Account** – The net balance of the profit and loss account i.e. either profit or loss also belongs to the owners.

While explaining capital we said that the business has to give return to the owners. Now if the business is managed successfully, then this return would be a Favorable figure (Profit). This return will, therefore, be added to the Owners' investment.

On the other hand, if the business is not managed successfully then this return would be an un-favorable figure (Loss). It will, therefore, be deducted from the Owners' Investment.

- **Long Term Liabilities** – These are the liabilities that will become payable after a period of more than one year of the balance sheet date. For example, if business has taken a loan from bank or any third person and it is payable after ten years, it will be treated as a long term liability for the business.
- **Current Liabilities** – These are the obligations of the business that are payable within twelve months of the balance sheet date. Creditors and all accrued expenses are the examples of current liabilities of the business because business is expected to pay these back within one accounting period.

## Balance Sheet

- It is a position statement that shows the standing of the organization in Monetary Terms at a Specific Time.
- Unlike Profit and Loss that shows the performance of the entity over a period of time, the Balance Sheet shows the Financial State of Affairs of the entity at a given date. Balance sheet is the summarized analysis in a 'T' form of all assets and liabilities of the entity, with liabilities listed on left hand side and assets on right hand side. Asset is any owned physical object (tangible asset) or a right (intangible asset) having economic value to the owner. Liability is an obligation of the business to deliver goods or to provide a benefit in future.

### Format of Balance Sheet (Account Form)

<b>Name of the Entity</b> <b>Balance Sheet</b> <b>As At-----</b>			
<b>Liabilities</b>	<b>Amount Rs.</b>	<b>Assets</b>	<b>Amount Rs.</b>
Capital 100,000	115,000	Fixes Assets	75,000
Add Net Profit 15,000		Long Term Assets	20,000
Long Term Liabilities	50,000	Current assets	80,000
Current liabilities	10,000		
<b>Total</b>	<b>175,000</b>	<b>Total</b>	<b>175,000</b>

### Format of Balance Sheet (Report Form)

<b>Name of the Entity</b> <b>Balance Sheet</b> <b>As At-----</b>		
<b>PARTICULARS</b>	<b>Amount Rs.</b>	<b>Amount Rs.</b>
<b>ASSETS</b>		
Fixes Assets		75,000
Long Term Assets		20,000
Current Assets		80,000
<b>Total</b>		<b>175,000</b>
<b>LIABILITIES</b>		
Capital	100,000	115,000
Add: Net Profit	15,000	
Long Term Liabilities		50,000
Current Liabilities		10,000
<b>Total</b>		<b>175,000</b>

## Illustration # 2

The following Trial Balance has been extracted from the books of Saeed & Co. on 30-06-2002. From this, prepare an Income Statement and Balance Sheet for the year ended 30-06-2002.

Particulars	Dr. (Rs.)	Cr.(Rs.)
Sales		200,000
Purchases	180,000	
purchase return		2,500
Office salaries	3,500	
Furniture & Fixture	16,000	
Office Equipment	11,000	
Rent	5,000	
Accounts Payable(creditors)		28,000
Sales Salaries	3,000	
Freight & custom duty on purchases	6000	
Repair of office equipment	2,000	
Accounts Receivable(debtors)	52,000	
Freight on sales	1,000	
Capital		41,500
Cash in hand	37,000	
Loan from bank(for three years)		50,000
Bank charges	500	
Interest on loan	5,000	
<b>Total</b>	<b>322,000</b>	<b>322,000</b>

### Solution

Saeed & Co.			
Profit & Loss Account for the year ended June 30, 2002.			
	Rs.		Rs.
Purchases	180,000	Sales	200,000
Freight, custom duty on	6,000	Purchase return	2,500
Gross Profit	16,500		
	<b>202,500</b>		<b>202,500</b>
Salaries	3,500	Gross Profit	16,500
Rent	5,000		
Repair of office equipment	2,000		
Sales salaries	3,000		
Freight on sales	1,000		
Interest on loan	5,000		
Bank charges	500		
		Net loss	3,500
<b>Total</b>	<b>20,000</b>		<b>20,000</b>

## Balance Sheet

Saeed & co.			
Balance Sheet As At June 30, 2002			
Liabilities		Assets	
Particulars	Amount Rs.	Particulars	Amount Rs.
Capital Add: Net Profit	41,500 (3,500)	Fixed Assets Furniture & Fixture	16,000
	38,000		
Long Term Liabilities Loan from bank		Current Assets Debtors	52,000
Current Liabilities Creditors	50,000 28,000	Office equipment	11,000
		Cash	37,000
Total	116,000	Total	116,000

## CASH FLOW STATEMENT

### Cash Flow Statement

Cash flow statement shows, how cash was generated and how it was used during the period. These days, it is required by law to include this statement in financial statements, especially in case of financial statements of limited companies.

### **Need For Cash Flow Statement**

For any business, it is important to ensure that:

- Sufficient profits are made to compensate owners for the investment made, efforts put in and the risk taken for the business,
- Sufficient funds are available to meet the obligations of the business as and when required. The information as to profitability is provided by the Profit and Loss Account. The information as to availability of funds or financial health is provided by the balance sheet. But the balance sheet is prepared on a specific date and can provide information of financial position as on that date only. Cash flow, on the other hand provides more detailed information about the movement of funds during the period. With the help of cash flow, we can determine the amount of cash generated from different sources and the areas on which it is utilized.

### **Difference between Profitability and Liquidity**

It is the ability of a business to pay its debts in time. By having good liquidity, we mean that a business has sufficient liquid funds (cash and cash equivalents) so that it can repay liabilities.

### **Cash**

Cash includes cash in hand and demand deposits.

### **Cash Equivalents**

Cash equivalents are those short term investments that can be converted into a known amount of cash at any time. Usually, investments up to three months maturity are included in cash equivalents.

People generally mix up profitability with liquidity. One might think that if a business has earned, say, One Million Rupees of profit then it should have approximately the same amount of cash in it. But mostly this is not the case. Consider the following example:

- A person starts a small business with Rs. 10,000.

- He purchases goods worth Rs. 20,000. Rs. 10,000 is paid in cash and remaining is payable at the end of the month.
- The same day, all the goods are sold on credit of two months for Rs. 30,000.
- Now if we draw a profit and loss account at the end of the month, the business has earned a profit of Rs. 10,000, considering no expenses.
- But at the same time, it is time to pay to the Creditors, whereas payment from debtor is not due yet.
- This means that although the business earned a profit of Rs. 10,000 but it has no cash to pay to its creditors.
- This simple example helps us to understand that liquidity is different from profitability.
- But it is as important as profitability.

### **Components of Cash Flow Statement**

Cash flow statement is divided into three components

- Cash Flow from Operating Activities
- Cash Flow from Investing Activities
- Cash Flow from Financing Activities

### **Cash Flow From Operating Activities**

Cash flow from operating activities is generally derived from the principal revenue producing activities of the business.

Cash Flow from Operating Activities is the indicator of success or failure of a business's operations. If the cash flow from operations is continuously negative, this means that the business revenue is not enough to recover the costs that are incurred to earn it. Therefore, in the long run Cash flow from operations must be positive.

Examples of cash flows from operating activities are:

- Cash receipt from sale of goods and rendering of services.
- Cash receipts from fees, commission and other revenues.
- Cash payments to suppliers for goods and services.
- Cash payments to and on behalf of the employees.
- Cash payments or refunds of income taxes.

### **Cash Flow From Investing Activities**

Cash flow from investing activities includes cash receipts and payments that arise from Fixed and Long Term assets of the organization.

Cash Flows from Investing Activities shows the investment trend of the business. If it is negative (Outflow) this means that the company is investing in long term assets and is expanding. On the other hand if it is positive (Inflow) over the years, this means that the company is selling its long term investments.



Examples of cash flows from investing activities are:

- Cash payments to acquire property plant and equipment. These also include payments made for self-constructed assets.
- Cash receipts from sale of property plant and equipment.
- Cash payments and receipts from acquisition and disposal of other than long term assets e.g. Shares, debentures, TFC, long term loans given etc.

If assets are held for trading purposes or in normal course of business e.g. car / property dealers and loans given by banks, then cash flow from these are included in Operating Cash Flow.

### EXAMPLE

#### Cash Flow from Investing Activities

Add: Disposal of Fixed Asset and Long Term Investments	100,000
Less: Acquisition of Fixed Assets and Long Term Investments	(80,000)
Add: Dividend Received / Returns on Investment Received	-
<b>Net Cash Flow from Investing Activities</b>	<b>20,000</b>

#### Cash Flow From Financing Activities

Cash flow from financing activities includes cash receipts and payments that arise from Owners of the business and other long term liabilities of the organization.

Cash Flows from Financing Activities shows the behavior of investors (both equity capital and debt capital). A positive figure (inflow) shows that funds are being invested in the company and vice versa.

Examples of cash flows from financing activities are:

- Cash received from owners i.e. share issue in case of company and capital invested by sole proprietor or partners.
- Cash payments to owners i.e. dividend, drawings etc.
- Cash receipts and payments for other long term loans and borrowings.

### EXAMPLE

#### Cash Flow from Financing Activities

Add: Shares Issued / Capital Invested	1,000,000
Less: Dividend Paid / Drawings	(400,000)
Add: Increase in Long Term Borrowings	150,000
<b>Net Cash Flow from Financing Activities</b>	<b>750,000</b>

#### Procedure of Preparing Cash Flow

Cash Flow Statement is prepared as follows:

- We start from the Profit / Loss for the period before taxation.
- Adjustments are made for non-cash items that are included in the profit and loss account such as Depreciation, Provisions and other items that relate to investing and financing activities.
- This gives us Operating Profit before Working Capital Changes.
- Then Working Capital Changes, i.e. increase or decrease in items of current assets and liabilities, are added / subtracted (Cash and Cash Equivalents are not included here)
- This gives the Cash Flow from Operations.
- To this figure, we add / subtract cash flows from investing and financing activities.
- This gives us Net Increase / Decrease in Cash and Cash Equivalents.
- To this figure we add Opening Balance of Cash and Cash Equivalents (that we excluded from current assets)
- This gives us the Closing Balance of Cash and Cash Equivalents.

Increase or Decrease is generally taken as difference in opening and closing balances of accounts reported in balance sheets.

#### **Cash Flow from operating activities.**

Inflows in this case are: - cash collections from customers, Interest/dividends collected, and other operating cash receipts e.g. proceeds from litigations.

Outflows would be, cash paid to suppliers & employees, interest & taxes paid and other operating cash payments e.g. payments in litigations.

It should be noted that receipt and payment of interest are classified as operating activities and not investing or financing activities.

Net of the “Inflows” and “Outflows”, gives cash flow from operating activities.

#### **Cash flow from investing activities:**

Inflows in this case are proceed from sales of Certificates/ Securities, proceeds from sales of Plant assets, and collection of loans (principal).

Outflows here would be purchase of Certificates/Securities, purchase of plant assets, and loans made to borrowers.

Net of ‘Inflows’ and ‘Outflows’ gives cash flow from investing activities.

#### **Cash flow from financing activities**

Here, the ‘Inflows’ are proceeds from borrowings, proceeds from issuing “bonds payable”, and proceeds from issuing capital stock.

Outflows correspondingly are payment to settle debts (principal), and payment of dividends.

Net of 'Inflows' and 'Outflows', gives cash provided by financing activities.

Sum of net cash flows from all the three activities viz Operating, Investing and Financing gives overall cash flow during the accounting period.

Analysis of Cash Flow Statement determines firm's ability to generate cash from operations, its capacity to meet cash obligations and its future financing needs. It indicates firm's success in investing activities, and determines the magnitude, fluctuations and causes of the positive or negative operating cash flow.

**Practical exercise:** Consider the following Income Statement of a business.

MOOSA CORPORATION  
INCOME STATEMENT  
FOR THE YEAR ENDED JUNE 30, \_\_\_\_\_

		Rs. _____
Net sales		900,000
Cost of Goods sold		500,000
Gross Profit		400,000
Operating expenses		300,000
(Includes depreciation Rs.40, 000)		
Operating Profit (EBIT)		100,000
<u>Other expenses</u>		
Interest	35,000	
Loss on sale of marketable securities	4,000	39,000
Profit before tax (EBT)		61,000
Income tax expenses		36,000
Profit after tax		25,000
<u>Other Income</u>		
Dividend revenue	3,000	
Interest revenue	6,000	
Gain on sale of plant assets	31,000	40,000
Net Income		65,000

**Additional Information (AI)** obtained from analysis of changes in the balance sheet accounts during the current year:-

Cash & Cash equivalents at beginning of the year	Rs.40, 000
at end of the year	Rs.75, 000

Other additional information classified into the three categories i.e. Operating, Investing and Financing Activities, was as follows:-

**Additional Information relating to Operating Activities**

1. Accounts Receivable increased by Rs.30, 000.
2. Accrued interest i.e. interest receivable decreased by Rs. 1, 000 (Dividend revenue recognized on cash basis & interest revenue on accrual basis).
3. Inventory increased by Rs. 10, 000 and accounts payable by Rs. 15, 000.
4. Short-term prepaid expenses increased by Rs.3, 000.
5. Accrued expenses (payable) decreased by Rs.6, 000.
6. Depreciation for the year Rs.40, 000.
7. Interest payable increased by Rs.7, 000.
8. Income tax payable decreased by Rs.2, 000.

#### **Additional Information relating to Investing Activities**

1. Marketable Securities (not qualifying as cash equivalent) show debit entries of Rs.65,000 and credit entries of Rs.44,000.
2. Notes Receivable Account shows Rs. 17, 000 debit and Rs. 12, 000 credits.
3. Purchase of plant assets for Rs.200,000: Cash Rs. 160,000 and long-term Note Payable Rs.40,000
4. Sale of plant assets with book value Rs.44,000

#### **Additional Information relating to Financing Activities**

1. Borrowed Rs.45, 000 cash by issuing short-term Notes Payable.
2. Repaid Rs.55, 000 on account of principal on Loans & Notes Payable.
3. Issued bonds payable Rs. 100, 000 cash.
4. Issued for cash 1000 shares of Rs. 10 par value at Rs.50 per share.
5. Cash dividend paid Rs.40,000

Re-arranging Income Statement in the two categories of Operating and Investing Activities would give the following picture of the Income Statement:

#### **MOOSA CORPORATION**

##### **Income statement**

For the year ended June 30, \_\_\_\_\_

<u>Sales, other revenue and gains</u>	<u>Rs.</u>
Net sales	900,000
Dividend Revenue	3,000
Interest Revenue	6,000
Gain on sales of plant assets	<u>31,000</u>
Total	940,000
<u>Cost of sales, other expenses and losses</u>	
Cost of goods sold	500,000
Operating expenses	300,000
(Includes Dep of Rs. (40, 000))	
Interest expenses	35,000
Income tax expenses	36,000
Loss on sale of marketable securities	<u>4,000</u>
Total	<u>875,000</u>
Net Income	65,000

### **Cash flow from Operating Activities**

Study computation of net sales, cost of goods sold and interest expense etc. On Income Statement.

Cash received from customers; Cash received from sales on cash = Net Sales; Cash received from sales on credit/on account = Net sales – increase in Accounts Receivable or Net sales + decrease in Accounts Receivable. Increase/decrease in Accounts Receivable is observed from beginning and ending/closing balances, appearing on Balance Sheet.

(A1 No:1): Cash received from customers =  $900,000 - 30,000 =$

Rs.870,000 A1 No:2

Cash dividend received = Dividends Revenue =Rs.3,000: Divided Revenue is based on cash, so whatever Dividend Revenue is being received, that in cash Inflows.

Cash interest received=Interest Revenue + Decrease in Interest Receivable, or Interest Revenue – Increase in Interest Receivable =  $6000 + 1000 = 7000$

Interest & Dividend received =  $3,000 + 7,000 = 10,000$

Cash Inflow from operating activities would be: Cash from customers + interest & dividends receivable =  $870,000 + 10,000 = \text{Rs. } 880,000$

### **Cash flow from Operating Activities**

Study computation of net sales, cost of goods sold and interest expense etc. On Income Statement.

Cash received from customers; Cash received from sales on cash = Net Sales; Cash received from sales on credit/on account = Net sales – increase in Accounts Receivable or Net sales + decrease in Accounts Receivable. Increase/decrease in Accounts Receivable is observed from beginning and ending/closing balances, appearing on Balance Sheet.

(A1 No:1): Cash received from customers =  $900,000 - 30,000 =$

Rs.870,000 A1 No:2

Cash dividend received = Dividends Revenue =Rs.3,000: Divided Revenue is based on cash, so whatever Dividend Revenue is being received, that in cash Inflows.

Cash interest received=Interest Revenue + Decrease in Interest Receivable, or Interest Revenue – Increase in Interest Receivable =  $6000 + 1000 = 7000$

Interest & Dividend received =  $3,000 + 7,000 = 10,000$

Cash Inflow from operating activities would be: Cash from customers + interest &

dividends receivable = 870,000 + 10,000 = Rs. 880,000

### QUESTION # 1

You are given the Balance Sheet of ABC Limited as at June 30, 2001 and June 30, 2002 and its Profit and Loss Account for the year ended June 30 2002.

Required

You are required to prepare Cash Flow Statement for the given period.

ABC Ltd  
Balance Sheet As At June 30 2002

	2002 Rs. Rs. '000	2001 Rs. Rs.
'000		
Building at Cost	181,000	
140,000		
Accumulated Depreciation	<u>36,000</u>	<u>30,000</u>
Written Down Value	<u>145,000</u>	<u>110,000</u>
Plant and Machinery cost	83,000	90,000
Accumulated Depreciation	<u>36,000</u>	<u>35,000</u>
Written Down Value	<u>47,000</u>	<u>55,000</u>



<b>Total Fixed Assets at WDV</b>	<b>192,000</b>	<b>165,000</b>
Long Term Investment	17,000	10,000
<b>Current Assets</b>		
Debtors	30,000	21,000
Stock	25,000	40,000
Short Term Deposits	18,000	15,000
Cash and Bank	30,000	24,000
	<b>103,000</b>	
<b>100,000</b>		
<b>Current Liabilities</b>		
Creditors	15,000	12,000
Proposed Dividend	18,000	16,000
Tax Payable	9,000	8,000
	42,000	36,000
<b>Working Capital</b>	<b>61,000</b>	<b>64,000</b>
<b>Net Assets Employed</b>	<b>270,000</b>	<b>239,000</b>
Financed By		
Share Capital	180,000	160,000
Share Premium Account		17,000
12,000		
General Reserve		23,000
20,000		
Accumulated Profit and Loss	34,000	27,000
<b>Share Holders' Equity</b>	<b>254,000</b>	<b>219,000</b>
Term Finance Certificates	16,000	20,000
<b>Total</b>	<b>270,000</b>	<b>239,000</b>

**ABC Ltd**

**Profit and Loss Account For the Year Ended June 30 2002**

**Rs. '000**

Sales	300,000	
Cost of Sales	(231,000)	
Gross Profit	69,000	
Other Income	4,000	
	73,000	
Less: Administrative Expenses		
Director's Remuneration	4,000	
Depreciation on Building	6,000	
Loss on Sale of Machinery	2,000	
Other Administrative Expenses	12,000	
	24,000	
Less: Selling Expenses	10,000	
Less: Mark up on TFC	2,000	
	36,000	
<b>Profit for the Year Before Tax</b>	<b>37,000</b>	
Provision for tax	9,000	
Profit after tax	28,000	
Acc. Profit Brought Forward	27,000	
	55,000	
Appropriation		
Transfer to Reserve		3,000
Proposed Dividend		18,000
	21,000	
<b>Accumulated Profit Carried Forward</b>		<b>34,000</b>

#### Additional Information

1. Other income include dividend on Long Term Investment
2. Cost of goods sold includes depreciation for the year on machinery Rs. 5,000.
3. Accumulated Depreciation on the machine disposed off amounts to Rs. 4,000.

Arrange

## SOLUTION

### ABC Ltd

#### Cash Flow Statement For the Year Ended June 30 2002

	Note	Rs. '000
Net Profit Before Tax		37,000
Adjustment of Non Cash Items		
Depreciation		11,000
Loss on Sale of Machinery		2,000
Markup on TFC		2,000
		<hr/> 52,000
Less: Other Income		(4,000)
Operating Profit Before Working Capital Changes		<hr/> 48,000
Working Capital Changes		
Reduction in Stock		15,000
Increase in Creditors		3,000
Increase in Debtors		(9,000)
		<hr/> 9,000
Cash Flow from Operations		57,000
Markup on TFC Paid		(2,000)
Tax Paid	1	(8,000)
Net Cash Flow From Operating Activities		<hr/> 47,000
Cash Flow From Investing Activities		
Dividend Received		4,000
Payment to Acquire Investments	2	(7,000)
Purchase of Fixed Assets (Building)	3	(41,000)
Receipt from Sale of Assets	4	1,000
Net Cash Flow From Investing Activities		<hr/> (43,000)
Cash Flow From Financing Activities		
Issue of Ordinary Shares		20,000
Share Premium Account		5,000
Dividend Paid	5	(16,000)
Repayment of TFC	6	(4,000)
Net Cash Flow From Financing Activities		<hr/> 5,000
Net Increase / (Decrease) in Cash and Cash Equivalents During The Year		9,000
O/B of Cash and Cash Equivalents		39,000
<b>C/B of Cash and Cash Equivalents</b>		<hr/> <b>48,000</b> <hr/>

**Note # 1****Tax Paid**

<b>Provision for Tax</b>		<b>Account Code -----</b>	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Cash	8,000	Bal. B/F	8,000
Balance c/f	9,000	For the year	9,000
<b>Total</b>	<b>17,000</b>	<b>Total</b>	<b>17,000</b>

**Note # 2****Payments to Acquire Investments**

<b>Investment</b>		<b>Account Code -----</b>	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Bal. B/F	10,000		
Cash	7,000	Bal. C/F	17,000
<b>Total</b>	<b>17,000</b>	<b>Total</b>	<b>17,000</b>

**Note # 3****Purchase of Fixed Assets**

<b>Building Cost</b>		<b>Account Code -----</b>	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Bal. B/F	140,000		
Cash	41,000	Bal. C/F	181,000
<b>Total</b>	<b>181,000</b>	<b>Total</b>	<b>181,000</b>

**Note # 4****Sale Proceed of Machinery**

<b>Machinery at Cost</b>		<b>Account Code -----</b>	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Bal. B/F	90,000	Disposal A/c	7,000
		Bal. C/F	83,000
<b>Total</b>	<b>90,000</b>	<b>Total</b>	<b>90,000</b>

Disposal of asset		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Cost	7,000	Accumulated Dep. Loss on Sale Sale Proceed	4,000 2,000 1,000
<b>Total</b>	<b>7,000</b>	<b>Total</b>	<b>7,000</b>



#### Note # 5

#### Dividend Payable

Dividend Payable		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Cash	16,000	O/B For the Year	16,000 18,000
C/B	18,000		
<b>Total</b>	<b>34,000</b>	<b>Total</b>	<b>34,000</b>

#### Note # 6

#### Repayment of TFC

TFC Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Cash	4,000	O/B	20,000
C/B	16,000		
<b>Total</b>	<b>20,000</b>	<b>Total</b>	<b>20,000</b>

Cash payment for Merchandise = Cost of Goods Sold + increase in Inventory + Decrease in Accounts Payable, or Cost of Goods sold – Decrease in Inventory – Increase in Accounts Payable.

Keeping in view, A1 No.3; cash payment for merchandise= 500,000 + 10,000 - 15000 =

Rs.495, 000

A1 No.4, 5 & 6

Pre Paid expenses increased by Rs.3, 000, therefore cash payment exceeded the actual expense. Accrued expenses (Payable) decreased by Rs.6000, therefore cash payment exceeded the actual expense (includes employees' expenses). Depreciation of Rs.40, 000 requires no cash payment but it does increase total expenses. It is therefore deducted from operating expenses.

Cash payment for operating expenses = expenses + increase in Pre Paid expenses + decrease in Accrued Expenses – Depreciation=

$$300,000 + 3,000 + 6000 - 40,000 = \text{Rs.}269, 000$$

Cash paid for merchandise and operating expenses= 495,000+269,000 = Rs.764, 000

**Cash payment for interest: (A17)** accrued interest liability (interest payable) increased by Rs.7, 000. It means that not all of the interest expense shown in Income Statement was paid in cash. Interest expenses in Income Statement 35,000. From this, reduce the increase in related accrued liability i.e. 7,000. That means interest paid in cash was Rs. 28,000.

**Cash payment for Income Tax (A1 8)** Tax liability reduced by Rs.2, 000/-. It means that cash payment is greater than expense shown in Income Statement. Tax expenses in Income Statement are Rs.36, 000. Add to this the reduction in tax liability, i.e. Rs. 2,000/-. Therefore Income tax paid in cash comes to Rs.38, 000/-.

**Operating Activities' portion of cash flow statement**

	Rs.____	
Cash received from customers	870,000	
Interest & dividend received	10,000	
Cash inflow		880,000
Cash paid to suppliers (Merchandise) & operating Expenses (including employees)	(764,000)	
Interest paid	(28,000)	
Income tax paid	(38,000)	
Cash (out flow)		(830,000)
Net cash flow from Operating Activities		50,000

Note that net income reported on Income Statement Rs.65, 000 and net cash flow from Operating Activities Rs.50, 000. What are the reasons for difference of Rs. 15, 000? Reasons are: depreciation expense (reduces net income but not cash) and adjustments made to net sales, cost of goods sold and expenses, and non operating gains & losses (these affect cash flow relating to Investing & Financing Activities)

**Cash flow from Investing Activities:** Much information is obtained from changes in related Asset Accounts.

**Purchase & Sale of Marketable Securities** (AI No: 1) Dr in Marketable Securities A/C shows Purchases, and hence cash outflow of Rs.65, 000. Cr of Rs.44, 000 in the A/C shows sale and hence cash inflow. Income Statement shows loss of Rs.4, 000 on these sales. Therefore cash proceeds from sales = Rs.40, 000 i.e. 44,000 – 4,000 (loss).

**Loans made to borrowers** (AI No: 2) Dr in Notes Receivable shows Loans given and hence outflow of Rs. 17, 000. Cr in Notes Receivable shows Loans collected and hence cash inflow of Rs. 12, 000.

It should be re-emphasized that the amount involved here is on account of Principal of loans. Interest, as already stated is credited to Interest Revenue Account and is included in Operating Activities.

**Cash paid to acquire plants** (AI No: 3)

Cash paid to acquire new plants shows cash outflow (160,000); sale of plant assets with book value of Rs.44, 000 shows cash Inflow. Income statement shows gain of Rs.3 1, 000 on this. This means that cash proceeds from sale of plant assets amounted to Rs.75, 000/-.

Investing Activities' portion of cash flow statement would be:-

Purchase of Marketable securities	(65,000)	
Loans made to borrowers	(17,000)	
Purchase of plant assets	(160,000)	
		(242,000)
Proceeds from sale of securities	40,000	
Collection of Loans	12,000	
Proceeds from sale of plant assets	75,000	127,000
Net cash flow from Investing Activities		(115,000)

**Cash flow from financing Activities** (A 1 No.1 to 5)

Proceeds from short-term borrowings in lieu of Notes Payable show cash inflow of Rs.45, 000. Payments to settle debts shows cash outflow of Rs.55, 000/-. Proceeds from issuing bonds show cash inflow of Rs.100,000 and proceeds from issuing capital stock also show cash inflow of Rs.50,000 (1000 shares x Rs.50/share) Dividend paid, of course involves cash outflow of Rs.40,000.

Financing Activities' portion of cash flow statement would be:

Proceeds from short-term borrowings	45,000	
Proceeds from issuing bonds payable	100,000	
Proceeds from issuing capital stock	50,000	195,000
Payment to settle short-term debts	(55,000)	
Dividends paid	(40,000)	(95,000)
Net cash flow from financing activities		100,000

	<u>Rs.</u>
Net cash flow from Operating Activities	50,000
Net cash flow from Investing Activities	(115,000)
Net cash flow from Financing Activities	<u>100,000</u>
Net increase (decrease) in cash	35,000
Cash & Cash equivalent beginning of the year	40,000
Cash & Cash equivalent end of the year	75,000 (tallies with the first item on ===== Additional Information Sheet)

Note that net cash flow from Operating Activities is Rs.50, 000 against net income of Rs.65, 000 shown on Income Statement.



**MOOSA CORPORATION**  
**Statement of Cash Flows**  
**For the Year Ended June 30, \_\_\_\_\_**

Cash Flows from operating activities:		Rs.
Cash received from customers .....	870,000	
Interest and dividends received .....	<u>10,000</u>	
Cash provided by operating activities .....		880,000
Cash paid to suppliers and operating expenses.....	(764,000)	
Interest paid .....	(28,000)	
Income taxes paid .....	<u>(38,000)</u>	
Cash disbursed for operating activities .....		<u>(830,000)</u>
Net cash flow from operating activities .....		50,000
Cash flows from investing activities:		
Purchases of marketable securities	(65,000)	
Proceeds from sales of marketable securities .....	40,000	
Loans made to borrowers .....	(17,000)	
Collections on loans .....	12,000	
Purchases of plants assets .....	(160,000)	
Proceeds from sales of plant assets .....	<u>75,000</u>	
Net cash used by investing activities.....		(115,000)
Cash flows from financing activities:		
Proceeds from short-term borrowing .....	45,000	
Payments to settle short-term debts .....	(55,000)	
Proceeds from issuing bonds payable .....	100,000	
Proceeds from issuing capital stock .....	50,000	
Dividends paid .....	<u>(40,000)</u>	
Net cash provided by financing activities.....		<u>100,000</u>
Net increase (decrease) in cash .....		35,000
Cash and cash equivalents, beginning of year .....		<u>40,000</u>
		75,000



## NOTES TO THE FINANCIAL STATEMENTS

### Valuation of Stock

Any manufacturing organization purchases different material through out the year. The prices of purchases may be different due to inflationary conditions of the economy. The question is, what item should be issued first & what item should be issued later for manufacturing. For this purpose, the organization has to make a policy for issue of stock. All the issues for manufacturing and valuation of stock are recorded according to the policy of the organization. Mostly these three methods are used for the valuation of stock:

- First in first out (FIFO)
- Last in first out (LIFO)
- Weighted average

#### First in first out (FIFO)

The FIFO method is based on the assumption that the first merchandise purchased is the first merchandised issued. The FIFO uses actual purchase cost. Thus, if merchandise has been purchased at several different costs, the inventory (stock) will have several different cost prices. The cost of goods sold for a given sales transaction may involve several different cost prices.

#### Characteristics

- This is widely used method for determining values of cost of goods sold and closing stock.
- In the FIFO method, oldest available purchase costs are transferred to cost of goods sold. That means the cost of goods sold has a lower value and the profitability of the organization becomes higher.
- As the current stock is valued at recent most prices, the current assets of the company have the latest assessed values.

#### Last in first out (LIFO)

As the name suggests, the LIFO method is based on the assumption that the recently purchased merchandise is issued first. The LIFO uses actual purchase cost. Thus, if merchandise has been purchased at several different costs, the inventory (stock) will have several different cost prices. The cost of goods sold for a given sales transaction may involve several different cost prices.

#### Characteristics

- This is alternatively used method for determining values of cost of goods sold and closing stock.
- In the LIFO method recent available purchase costs are transferred to cost of goods sold.

That means the cost of goods sold has a higher value and the profitability of the organization becomes lower.

- As the current stock is valued at oldest prices, the current assets of the company have the oldest assessed values.

### Weighted average method

When weighted average method is in use, the average cost of all units in inventory, is computed after every purchase. This average cost is computed by dividing the total cost of goods available for sale by the number of units in inventory. Under the average cost assumption, all items in inventory are assigned the same per unit cost. Hence, it does not matter which units are sold; the cost of goods sold is always based on current average unit cost.

#### Characteristics

- Under the average cost assumption, all items in inventory are assigned same per unit cost (the average cost). Hence it does not matter which units are sold first. The cost of goods sold is always on the current average unit cost.
- Since all inventories are assigned same cost, this method does not make any effect on the profitability and does not increase/decrease any asset in the financial statements.
- This is the alternatively used method for determining values of cost of goods sold and closing stock.

#### Example

- Receipts:
  - ~ 01 Jan 20--, 10 units @ Rs. 150 per
  - ~ 02 Jan 20--, 15 units @ Rs. 200 per
  - ~ 10 Jan 20--, 20 units @ Rs. 210 per
- Issues
  - ~ 05 Jan 20--, 05 units
  - ~ 06 Jan 20--, 10 units
  - ~ 15 Jan 20--, 15

### FIFO Method of Stock Valuation

Date	Receipts	Issues	Value of Stock
01-01-20--	10 @ Rs. 150		10 x 150 = 1500
02-01-20--	15 @ Rs. 200		10 x 150 = 1500 15 x 200 = 3000 4500
05-01-20--		5 @ 150 = 750      750	5 x 150 = 750 15 x 200 = 3000 3750
06-01-20--		5 @ 150 = 750 5 @ 200 = 1000    1750	0 x 150 = 0 10 x 200 = 2000 2000
10-01-20--	20 @ Rs. 210		10 x 200 = 2000 20 x 210 = 4200 6200
15-01-20--		10 @ 200 = 2000 5 @ 210 = 1050    3050	0 x 200 = 0 15 x 210 = 3150 3150

### Weighted Average Method of Stock Valuation

Date	Receipts	Issues	Value of Stock	Average Cost
01-01-20--	10x150 = 1500		1500	1500/10=150
02-01-20--	15x200 = 3000		1500 + 3000 = 4500	4500/25=180
05-01-20--		5x180 = 900	4500 - 900 = 3600	3600/20=180
06-01-20--		10x180 = 1800	3600 - 1800 = 1800	1800/10=180
10-01-20--	20x210 = 4200		1800 + 4200 = 6000	6000/30=200
15-01-20--		15x200 = 3000	6000 - 3000 = 3000	3000/15=200

### Effects of valuation method on profit

#### FIFO Method

- Cost of Sales = 750 + 1750 + 3050 = 5,550  
Gross Profit = 7500 - 5550 = 1,950

#### Weighted Average Method

- Cost of Sales = 900 + 1800 + 3000 = 5,700  
Gross Profit = 7500 - 5700 = 1,800

## Depreciation Accounting Policies

Depreciation is the expired or used portion of a fixed asset during an accounting period. This is taken into account to achieve the matching principle of matching revenues earned during an accounting period with the expenses incurred during that period. Since plant assets have useful life spreading over a number of accounting periods, the portion used in one accounting period is charged to Income Statement of that accounting period in the form of Depreciation Expense.

Land is recorded at cost, other fixed assets are recorded at Book Value i.e. cost less accumulated depreciation. For this, separate Depreciation Expense and Accumulated Depreciation Accounts for different plant assets are maintained. It must also be noted that depreciation is a process of cost allocation and not a process of valuation as such.

### Computing Depreciation

Different methods are available for computing depreciation of fixed assets. Different methods can be used for different assets. However, comparison among firms with different depreciation methods becomes difficult because of the fact that each firm uses different methods for calculating depreciation, which ultimately affect its net income and balance sheet.

### Methods of Computing Depreciation

1. **Straight-line method:** In this, the depreciation expenses are spread evenly over periods. Assume that a plant asset is acquired for Rs. 17, 000. It is estimated that its useful life is five years and residual value (salvage value) at the end of five years is Rs.2, 000.
2. **Reducing balance method** or Diminishing balance method or written down method  
This method is used a percentage for depreciation. In this method the amount of depreciation decreases as the years passed. Under this method, depreciation is calculated on written down value. In the first year, depreciation is calculated on cost. Afterwards written down value is calculated by deducting accumulated depreciation from the cost of that asset(cost – accumulated depreciation) and depreciation is charged on that value. In this method, the value of asset never becomes zero.

**Residual value** is the cost of the asset after the expiry of its useful life.

### **Useful Life**

- Useful Life or Economic Life is the time period for machine is expected to operate efficiently.
- It is the life for which a machine is estimated to provide more benefit than the cost to run it.

Depreciation is charged on Fixed Asset. Fixed Assets are those assets which are:

- Of long life
- To be used in the business to generate revenue
- Not bought with the main purpose of resale.

Fixed assets are also called “Depreciable Assets”

### Written Down Value

The net amount (after deducting depreciation) is called ‘Written down Value’.

WDV = Original cost of fixed asset – Accumulated Depreciation

Accumulated Depreciation is the depreciation that has been charged on a particular asset from the time of purchase of the asset to the present time. This is the amount that has been charged to profit and loss account from the year of purchase to the present year.

Depreciation accumulated over the years is called **accumulated depreciation**.

### Grouping of Fixed Assets

Major groups of Fixed Assets:

- Land
- Building
- Plant and Machinery
- Furniture and Fixtures
- Office Equipment
- Vehicles

No depreciation is charged for ‘Land’. In case of ‘Leased Asset/Lease Hold Land’ the amount paid for it is charged over the life of the lease and is called **Amortization**.

### Journal entries for recording

**Depreciation Purchase of fixed asset:**

**Debit:** Relevant asset account  
**Credit:** Cash, Bank or Payable Account

For recording of depreciation, following two heads of accounts are used:

- Depreciation Expense Account
- Accumulated Depreciation Account

### Examples of Written Down and St. Line Methods

- Cost of the Asset = Rs.100,000
- Life of the Asset = 5 years
- Annual Depreciation = 20 % of cost or Rs.20,000

#### Written down value method

- Cost of the Asset = Rs. 100,000
- Annual Depreciation = 20%
  - Year 1 Depreciation = 20 % of 100,000 = 20,000
  - Year 1 WDV = 100,000 – 20,000 = 80,000
  - Year 2 Depreciation = 20 % of 80,000 = 16,000
  - Year 2 WDV = 80,000 – 16,000 = 64,000

#### Illustration:

Cost of an asset: Rs. 120,000  
 Residual value: Rs. 20,000  
 Expected life: Rs. 5 years

Calculate depreciation and the written down value of the asset for five years.

#### Solution

##### Straight line method

$$\text{Depreciation} = (120,000 - 20,000) / 5 = \text{Rs. } 20,000$$

Particulars	Depreciation (Rs)	Written Down Value (Rs.)
Depreciable cost		100,000
Dep. Of the 1 <sup>st</sup> year	(20,000)	80,000
Dep. Of the 2 <sup>nd</sup> year	(20,000)	60,000
Dep. Of the 3 <sup>rd</sup> year	(20,000)	40,000
Dep. Of the 4 <sup>th</sup> year	(20,000)	20,000
Dep. Of the 5 <sup>th</sup> year	(20,000)	0

#### Same Example with Written Down Value Method:

Cost of an asset Rs.100,000  
 Expected life Rs. 5 years  
 Depreciation rate 20%

### Solution

Particulars	Depreciation (Rs)	Accumulated Depreciation (Rs.)	Written Down Value (Rs.)
Depreciable cost			100,000
Dep. Of the 1 <sup>st</sup> year 100,000 x 20%	20,000	20,000	80,000
Dep. Of the 2 <sup>nd</sup> year 80,000 x 20%	16,000	36,000	64,000
Dep. Of the 3 <sup>rd</sup> year 64,000 x 20%	12,800	48,800	51,200
Dep. Of the 4 <sup>th</sup> year 51,200 x 20%	10,240	59,040	40,960
Dep. Of the 5 <sup>th</sup> year 40,960 x 20%	8,192	67,232	32,768

You see, at the end of five years, WDV of the asset is Rs. 32,768, not zero. But in case of straight line method, the WDV, after five years was zero. So, in the opinion of some people, reducing balance method is better than that of straight line method, but both methods are effective. It is the management that has to decide, which method is best suited to their business. Once an asset has been fully depreciated, no more depreciation should be recorded on it, even though the property may be in good condition and may be in use. The objective of depreciation is to spread the cost of an asset over the periods of its usefulness; in no case can depreciation be greater than the amount paid for the asset. When a fully depreciated asset is in use beyond the original estimate of useful life, the asset account and the accumulated depreciation account should remain in the accounting records without further entries until the asset is retired.

In this method, depreciation is calculated on written down value. In the first year, depreciation is calculated on cost. Afterwards written down value is calculated by deducting accumulated depreciation from the cost of that asset (cost – accumulated depreciation) and depreciation is charged on that value.

**Cost of Asset – Price at which the asset was initially recorded**

**Written Down Value / Book Value – Cost minus Accumulated Depreciation.**

In reducing balance method, a formula is used for calculation the depreciation rate i.e.

### Reducing Balance Method Special Case

Sometimes, the ingredients are provided which look like the Straight Line Method requirement but actually the Declining Methods required there. In such Cases, % of depreciation is not provided in the question. So, In such cases, The formula is used to calculate the % of depreciation as under:

In reducing balance method, a formula is used for calculation the depreciation rate i.e.

$$\text{Rate} = 1 - \sqrt[n]{RV / C}$$

Where:

“RV” = Residual Value

“C” = Cost

“n” = Life of Asset

**Calculate the rate if:**

Cost	= 100,000
Residual Value (RV)	= 20,000
Life	= 3 years

$$\text{Rate} = 1 - \sqrt[3]{20000/100000}$$

= 42%



**Year 1**

Cost	100,000
Depreciation 100,000 x 42%	<u>(42,000)</u>
WDV (Closing Balance)	58,000

**Year 2**

WDV (Opening Balance)	58,000
Depreciation 58,000 x 42%	<u>(24,360)</u>
WDV (Closing Balance)	33,640

**Year 3**

WDV (Opening Balance)	33,640
Depreciation 33,640 x 42%	<u>(14,128)</u>
WDV (Closing Balance)	19,511

**Disposal of Asset**

Arrange



Cost of Asset	= 100,000
Life of the Asset	= 5 Years
Depreciation Method	= Straight Line
Residual Value	= Rs.10000
Sale Price after Five Years	= Rs.15000

$$\text{Depreciation per year} = (100000 - 10000) / 5$$

$$= \text{Rs.}5000 \text{ per year}$$

$$\text{Total Depreciation in Five Years} = 18,000 \times 5$$

$$= 90,000$$

$$\text{Book Value after Five Years} = 100,000 - 90,000$$

$$= 10,000$$

$$\text{Profit on Disposal} = 15,000 - 10,000$$

$$= \text{Rs.}5000$$

### **Policies of Charging Depreciation**

#### **1) On the Basis of Use**

This is the method in which we calculate the depreciation for the period on which the asset is being used. Calculation may go to the monthly calculation level as well.

#### **2) Full Year Depreciation Method**

In this method, we charge complete depreciation in the year of purchase and no depreciation is charged in the year of sale.

## Illustration # 2

Following information of machinery account is available in Year 2004:

- Machine # 1 is purchased on September 1, 2000 for Rs. 100,000
- Machine # 2 is purchased on January 31, 2002 for Rs. 200,000
- Machine # 3 is purchased on July 1, 2003 for Rs. 50,000
- Machine # 1 is disposed on March 31, 2004


Depreciation is charged @ 25% reducing balance method. Financial year is closed on June 30 every year.

Show the calculation of depreciation on machinery for four years using the following policies:

- Depreciation is charged on the basis of use
- Full depreciation is charged in the year of purchase and no depreciation is charged in the year of disposal.

### Solution

#### Depreciation on the basis of use



Date	Purchase of machine (Rs.)	Depreciation (Rs.)	Accumulated depreciation (Rs.)	Total Accum. Dep.	Written Down Value (Rs.)	Total Written Down Value (Rs.)
01-09-2000	100,000	Machine # 1 $100,000 \times 25\% \times 10/12 = 20,833$	Machine # 1 20,833	20,833	Machine # 1 79,167	79,167
2001-2002		Machine # 1 $79,167 \times 25\% = 19,792$	Machine # 1 40,625	61,458	Machine # 1 59,375	238,542
31-01-2002	200,000	Machine # 2	Machine # 2		Machine # 2	

Arranged

		200,000x25%x5 /12= <b>20,833</b>	20,833		179,167	
2002-2003		Machine # 1 59,375x25% = <b>14,844</b> Machine # 2 179,167x25% = <b>44,792</b>	Machine # 1 55,469  Machine # 2 65,625	121,094	Machine # 1 44,531  Machine # 2 134,375	178,906
2003-2004		Machine # 1 44,531x25%x 9/12= <b>8,350</b> Machine # 2 134,375x25% = <b>33,594</b> Machine # 3 50,000x25% = <b>12,500</b>	Machine # 1 63,819  Machine # 2 99,219  Machine # 3 12,500	175,538	Machine # 1 <b>(36,181)</b> <b>(sold)</b> Machine # 2 100,781  Machine # 3 37,500	138,281
01-07-2003	50,000					

**Full year depreciation in the year of purchase and no depreciation in the year of sale:**

Date	Purchase of machine (Rs.)	Depreciation (Rs.)	Accumulated depreciation (Rs.)	Total Accum. Dep.	Written Down Value (Rs.)	Total Written Down Value (Rs.)
01-09-2000	100,000	Machine # 1 100,000 x 25% = <b>25,000</b>	Machine # 1 25,000	25,000	Machine # 1 75,000	75,000
2001-2002		Machine # 1 75,000x25% = <b>18,750</b> Machine # 2 200,000x25% = <b>50,000</b>	Machine # 1 43,750  Machine # 2 50,000	93,750	Machine # 1 56,250  Machine # 2 150,000	206,250
31-01-2002	200,000					
2002-2003		Machine # 1 56,250x25% = <b>14,063</b> Machine # 2 150,000x25% = <b>37,500</b>	Machine # 1 57,813  Machine # 2 87,500	145,313	Machine # 1 42,187  Machine # 2 112,500	154,687

2003-2004		Machine # 1 0	Machine # 1 57,813	185,935	Machine # 1 42,187	121,875
		Machine sold Machine # 2 $112,500 \times 25\%$ <b>= 28,125</b>	(sold) Machine # 2 115,625		(sold) Machine # 2 84,375	
01-07-2003	50,000	Machine # 3 $50,000 \times 25\%$ <b>= 12,500</b>	Machine # 3 12,500		Machine # 3 37,500	

## Illustration # 2

Following information of machinery account is available in Year 2004:

- Machine # 1 is purchased on August 1, 2000 for Rs. 50,000
- Machine # 2 is purchased on April 1, 2002 for Rs. 100,000
- Machine # 3 is purchased on March 1, 2004 for Rs. 150,000
- Machine # 1 is disposed on May 31, 2004

Depreciation is charged @ 20% reducing balance method. Financial year is closed on June 30 every year.

Show the calculation of depreciation on machinery for four years using the following policies:

- Depreciation is charged on the basis of use
- Full depreciation is charged in the year of purchase and no depreciation is charged in the year of disposal,

## Solution

### Depreciation on the basis of use

Date	Purchase of machine (Rs.)	Depreciation (Rs.)	Accumulated depreciation (Rs.)	Total Accum. Dep.	Written Down Value (Rs.)	Total Written Down Value (Rs.)
01-08-2000	50,000	Machine # 1 $50,000 \times 20\% \times 11/12 = \mathbf{9,167}$	Machine # 1 9,167	9,167	Machine # 1 9,167	40,833
2001-2002 01-04-2002	100,000	Machine # 1 $40,833 \times 20\% = \mathbf{8,167}$ Machine # 2 $100,000 \times 20\% \times 3/12 = \mathbf{5,000}$	Machine # 1 17,334 Machine # 2 5,000	22,334	Machine # 1 32,666 Machine # 2 95,000	127,666
2002-2003		Machine # 1 $32,666 \times 20\% = \mathbf{6,533}$	Machine # 1 23,867	47,867	Machine # 1 26,133	102,133

		Machine # 2 95,000x20% = <b>19,000</b>	Machine # 2 24,000		Machine # 2 76,000	
2003-2004		Machine # 1 26,133x20% x 11/12= <b>4,791</b>	Machine # 1 28,658	77,858	Machine # 1 (21,342) (sold)	200,800
01-03-2004	150,000	Machine # 2 76,000x20% = <b>15,200</b>	Machine # 2 39,200		Machine # 2 60,800	
		Machine # 3 150,000x20% x 4/12= <b>10,000</b>	Machine # 3 10,000		Machine # 3 140,000	

**Full year depreciation in the year of purchase and no depreciation in the year of sale:**

Date	Purchase of machine (Rs.)	Depreciation (Rs.)	Accumulated depreciation (Rs.)	Total Accum. Dep.	Written Down Value (Rs.)	Total Written Down Value (Rs.)
01-08-2000	50,000	Machine # 1 50,000 x 20% = <b>10,000</b>	Machine # 1 10,000	10,000	Machine # 1 40,000	40,000
2001-2002		Machine # 1 40,000x20% = <b>8,000</b>	Machine # 1 18,000	38,000	Machine # 1 32,000	112,000
01-04-2002	100,000	Machine # 2 100,000x20% = <b>20,000</b>	Machine # 2 20,000		Machine # 2 80,000	
2002-2003		Machine # 1 32,000x20% = <b>6,400</b>	Machine # 1 24,400	60,400	Machine # 1 25,600	89,600
		Machine # 2 80,000x20% = <b>16,000</b>	Machine # 2 36,000		Machine # 2 64,000	
2003-2004		Machine # 1 0	Machine # 1 24,400	103,200	Machine # 1 (25,600) (sold)	171,200
01-03-2004	150,000	Machine sold Machine # 2 64,000x20% = <b>12,800</b>	Machine # 2 48,800		Machine # 2 51,200	
		Machine # 3 150,000x20% = <b>30,000</b>	Machine # 3 30,000		Machine # 3 120,000	