UNIT 4 CONSTRUCTION AND ANALYSIS OF BALANCE SHEET

Objectives

After having studied this unit, you should be able to:

- understand and explain the terms used in a balance sheet
- classify the different assets, liabilities and capital accounts as they would appear on a balance sheet.
- apply simple principles of valuation of assets
- understand the idea of balance sheet equation.

Structure

4.1 INTRODUCTION

One of the basic objectives of accounting is to convey information. This is achieved by different accounting reports prepared by an entity. One of the most important reports is the Balance Sheet.

Balance sheet is concerned with reporting the financial position of an **entity** at a particular point in time. This position is conveyed in terms of listing all the **things of value** owned by the entity as also the claims against these things of value. The position as represented by the balance sheet is valid only until another transaction is carried out by the entity.

4.2 CONCEPTUAL BASIS OF A BALANCE SHEET

The above concept can be elaborated by an example.

I want to purchase a car costing Rs. 8,00,000. To do so, I have to borrow. A bank agrees to finance me if I can invest Rs. 3,00,000 on my own.

Now let us follow the sequence of events when I approach the bank with the proposal. Granting my ability to repay the loan, the banker will ask two specific questions:

1. What are the things of value you own?

2. How much do you owe, and to whom?

In other words, the banker would like to know what I am worth in material terms. My replies to the questions could be tabulated as follows:

Things of value owned by me		**Amount owned by me**	
	Rs.		Rs.
Balance with bank	3,50,000	Personal loan from friend	1,00,000
Fixed deposits	1,50,000		
Other personal belonging	5,00,000		
	10,00,000		1,00,000

This implies I own Rs. 10,00,000 worth things of value, Rs. 3,50,000 of this could be withdrawn at any time in cash. We say I have Rs. 3,50,000 in liquid form. Another Rs. 1,50,000 is in monetary investment and the remaining Rs. 5,00,000 is in non-monetary property. Further, I owe Rs. '1,00,000 to friend of mine. In other words, he has got a claim against the things of value owned by me to the extent of Rs. 1,00,000. In brief, we can say I am worth Rs. 10,00,000, claim against my worth is Rs. 1,00,000 and hence my **net worth** is Rs. 9,00,000. This implies Rs. 9,00,000 is my own claims against the things of value owned by me or my net worth.

Now I can present my financial position in the following form:

Financial Position Statement 1

Things of value owned		**Claims against things of value**	
	Rs.		**Rs.**
Balance with bank	3,50,000	Personal loan from friend	1,00,000
Fixed deposits	1,50,000	Own claim or net worth	9,00,000
Other personal belongings	5,00,000		
	10,00,000		10,00,000

Now that the bank grants me the loan of Rs. 5,00,000 and I buy the car for Rs.8,00,000. After purchase of the car my financial position statement will change as follows:

Financial Position Statement 2

Things of value owned		**Claims against things of value**	
	Rs.		**Rs.**
Balance with bank	50,000	Personal loan from friend	1,00,000
Fixed deposit	1,50,000	Mortgage loan from bank.	5,00,000
Car	8,00,000	Own claim or net worth	9,00,000
Other personal belongings	5,00,000		
	15,00,000		15,00,000

Now, as a result of this transaction my worth has increased from Rs. 10,00,000 to Rs. 15,00,000. However, since there is also an equal increase in claims against my worth in the form of mortgage loan from the bank, my net worth remains the same.

Things of monetary value possessed by an entity are referred to as assets. Accountants use the term **assets** to describe things of value measurable in monetary terms.

The amount owed by an entity or individual which represent claims against it or his assets by outsiders are liabilities. It is the claims of outsiders which are legally enforceable claims against an individual or entity that are referred to as liabilities.

The assets owned by the entity, less liabilities or outsider's claims, is the net worth. Since the net worth represents the claims of owner(s) in case of an **entity,** it is referred to as owner's equity.

Now we can understand that the position statement is a summary of the assets, liabilities and net worth as of a specific point in time.

A comparison of the two position statements before and after purchase of the car will help to clarify some of these ideas better.

Comparative Financial Position Statement

Assets	**Before I**	**After II**	**Liabilities and Net Worth**	**Before I**	**After II**
Balance with Banks	3,50,000	50,000	Personal loan from friend	1,00,000	1,00,000
Fixed Deposits	1,50,000	1,50,000	Mortgage loan from bank	-	5,00,000
Car	-	8,00,000			
Other personal belonging	5,00,000	5,00,000	Net Worth	9,00,000	9,00,000
	10,00,000	1,50,000		10,00,000	15,00,000

The following points may be noted from the above example:

1. Even after purchasing the car, my net worth remains the same. This is due to the fact that increase in assets of Rs. 5,00,000 was balanced by increase in liability of Rs. 5,00,000. However, it could be noticed that the Rs.3,00,000 spent from my savings amount to only a transformation of my assets from bank deposit to motor car.
2. Outsiders' claim has priority over the owners' claim on the assets and hence net worth or owner's equity is a residual claim against assets. It follows from this that at any point in time, owners equity and liabilities for any accounting entity will be equal to assets owned by that entity. This idea is fundamental to accounting and could be expressed as the following equalities:

$$\text{ASSETS} = \text{LIABILITIES} + \text{OWNERS EQUITY} \qquad (1)$$

$$\text{OWNERS EQUITY} = \text{ASSETS} - \text{LIABILITIES} \qquad (2)$$

It could easily be visualised that the position statements we prepared are nothing but the equality (I). In simple terms, a position statement which shows the balance between assets owned by an entity and its liabilities and owner's equity is referred to as a balance sheet. Our position statements were based on a personal situation and a single transaction. In a business situation there can be scores of such transactions. However, these impacts could be reflected on the fundamental equality in the same way. This equation represents the corner-stone on which the accounting edifice is built. It shows the **duality** represented by `benefit-sacrifice' from the point of view of an entity. In other words, assets of an entity, are always equal to the claims of the outsiders and owners. This equality enables us to reduce impact of all transactions in term of the following possibilities:

1. An increase in assets is followed by an increase in liabilities and/or equity and **vice versa.**
2. A decrease in assets is followed by a decrease in liabilities and/or equity and **vice versa.**
3. An increase in an asset is followed by a decrease in another asset and **vice versa.**
4. An increase in a liability is followed by a decrease in another liability and **vice versa.**

Activity 4.1

Please answer by completeing the blanks.

1. An increase in assets in a position statement is possible:
   a)…………………………………………………………………………
   b)…………………………………………………………………………
   c)…………………………………………………………………………
2. An increase in liability could result in:
   a)…………………………………………………………………………
   b)…………………………………………………………………………
   c)…………………………………………………………………………
3. Outsiders claim against assets of an entity is called:

………………………………………………………………………………………
………………………………………………………………………………………
……………………………………………………………………………………..

4. Things of value to the entity are called by accountants as:

………………………………………………………………………………………
………………………………………………………………………………………
……………………………………………………………………………………..

Activity 4.2

Mark whether the following statements are `True' or `False' by circling T or F opposite each statement.

1. An increase in asset always results in increase in owner's equity	T/F
2. Assets = liabilities + owner's equity is always true	T/F
3. Outsiders claim against business is a residual claim	T/F'
4. An increase in assets could be equalled by increase in liabilities	T/F
5. Losses result in increase in owner's equity	T/F
6. All assets in the balance sheet are valued at their realisable value	T/F

Activity 4.3

Answer the following questions by filling in the boxes with figures or words.

1. The fundamental accounting equation could be written as:

1.	$\boxed{\quad}$	=	$\boxed{\quad}$	+	$\boxed{\quad}$
2.	$\boxed{\quad}$ Assets	=	$\boxed{10,000}$ Owner's equity	+	$\boxed{15,000}$ Liabilities
3.	$\boxed{\quad}$ Owner's equity	=	$\boxed{1,00,000}$ Assets	–	$\boxed{75,000}$ Liabilities
4.	$\boxed{\quad}$ Liabilities	=	$\boxed{1,00,000}$ Assets	–	$\boxed{30,000}$ Owner's equity

4.3 CONSTRUCTING A BALANCE SHEET

Now, let us examine how the ideas we have learned so far could be used in a business situation. Please recall that based on the entity principle we shall be dealing with the `business' as distinct and separate from the owners. We shall demonstrate this by means of an illustration:

Ram starts a store on January 1, 2003 with an investment of Rs.2,00,000 from his personal savings. He decides to call his venture **Ramstore.**

Suppose now, we want to prepare the balance sheet of Ramstore on January 1, 2003. How do we proceed? Based on the equality we have studied, we have to answer the following questions:

1 What are the assets of Ramstore on that date?

2. What are the liabilities of Ramstore on that date?

If we have answers to these questions it also follows that assets minus liabilities is Ram's equity and this information would complete the equality and hence the balance sheet. Answer to the first question is that the only asset of Ramstore on January 1, 2003 is Rs.2,00,000 in cash. Answer to the second question is that Ramstore has no liability on that date or, in other words, it does not owe anything to outsiders. Thus it follows that the only claim on the assets in that of Ram. This could be represented as the balance sheet below:

RAMSTORE

Balance Sheet as on January 1, 2003

Assets		**Liabilities and Owner's Equity**	
Cash	Rs. 2,00,000	Owner's equity	Rs. 2,00,000

On January 2 the Store purchases a shop for Rs.5,00,000 paying Rs.1,00,000 cash and signing a mortgage for Rs.4,00,000. This transaction changes the balance sheet as on January 2 as follows:

1. Cash is reduced by Rs.1,00,000 on account of payment for the shop premises. hence cash balance is Rs.1,00,000.

2. A new asset, shop, is acquired worth Rs.5,00,000.

3. A new liability, mortgage on the shop, is contracted in the amount of Rs.4,00,000.

4. Owner's equity = Total asset - liabilities

= Rs.6,00,000 - Rs.4,00,000 = Rs.2,00,000.

That is, there is no change in the owner's equity since increase in an asset is followed by an increase in liability. Thus the new balance sheet will be as follows:

RAMSTORE
Balance Sheet as on January 2, 2003

Assets		**Liabilities & Owner's Equity**	
	Rs.		Rs.
Cash	1,00,000	Mortgage on shop	4,00,000
Shop premises	5,00,000	Owner's equity	2,00,000
	6,00,000		6,00,000

On January 3, the store purchased Rs.50,000 worth of merchandise paying cash and Rs.1,50,000 worth of merchandise on credit from Mr. Vanik. The impact of these transactions is that the assets in the form of merchandise increase by Rs.2,00,000. These assets are intended for resale and hence have a short life span. However, part of this increase is accounted by decrease in another asset, cash. The other Rs.1,50,000 increase is accounted by the liability owed to Vanik. The amounts payable on account of purchases of merchandise are called **accounts payable or sundry creditors.** Usually these are short duration liabilities to be paid at the end of the normal credit period. The balance sheet on January 3, 2003 reflects the position of the business after these transaction.

RAMSTORE

Balance Sheet as of January 3, 2003

Assets		Liabilities & **Owner's Equity**	
	Rs.		Rs.
Cash	50,000	Accounts payable	1,50,000
Merchandise inventory	2,00,000	Mortgage on shop	4,00,000
Shop premises	5,00,000	Owner's equity	2,00,000
	7,50,000		7,50,000

On January 4, he sells half the merchandise inventory (that is Rs. 1,00,000 worth inventory) for Rs.1,50,000 cash. Apparently, this transaction shows the transformation of an asset into another asset at higher monetary value. This is yet another basis of economic transaction where business profits are earned in the process of exchange of utility differential for a monetary differential. The balance sheet after this transaction will clarify some of the conceptual issues arising out of this transaction.

RAMSTORE
Balance Sheet as of January 4, 2003

Assets		Liabilities & **Owner's Equity**	
	Rs.		Rs.
Cash	2,00,000	Accounts payable	1,50,000
Merchandise inventory	1,00,000	Mortgage on shop	4,00,000
Shop premises	5,00,000 •	Owner's equity	2,50,000
	8,00,000		8,00,000

Please note the change in owner's equity figure. For the first time since we started following the transactions of Ramstore, the owner's equity figure has changed. How did this come about? The answer is simple. We followed the equality of "Assets - liabilities = Owner's equity". Thus the increase in owner's equity is the result of increase in assets arising out of exchange of merchandise inventory for cash at a higher monetary value. Thus we find that the owner's equity increases to the extent of revenue earned over the cost of earning that revenue. In this case the revenue earned is Rs.1,50,000 (the amount realised from sales of merchandise is usually referred to as sales revenue). The direct cost of earning that revenue was the merchandise inventory parted within the amount of Rs.1,00,000. We refer to this as **cost of goods sold.**

Another important fact should also be noted in this context. All along we represented the assets on the balance sheet at the original cost. The unsold inventory is still valued at the original cost. This is yet another concept we follow in the preparation of balance sheet. As a general principle all assets are valued at their original cost.

The increase in the owner's equity is equal to the profit earned out of trading. Normally, it is profitable operation which increases the owner's equity. Thus owner's equity could be understood as comprising of two parts, namely, contributed capital and retained earnings. Retained earnings is the profits earned and not withdrawn by the owners. This relationship could be expressed by yet another equality:

OWNER's EQUITY = CONTRIBUTED CAPITAL + RETAINED EARNINGS(3)

The above illustration would enable us to evaluate the balance sheet in the context of accounting concepts.

- The **dual aspect principle** has particular relevance to balance sheet. This is shown by the **equality of assets to liabilities and owner's equity.**
- All the figures are expressed in **monetary units** irrespective of its nature. In our example we had cash, merchandise inventory and shop premises all expressed in **monetary quantities.**
- **A**ll the transactions we reflected were in respect of only the **business entity,** Ramstore' rather the methodology was applied to the specific entity.
- All the valuations were based on the assumption of a **going concern,** and not based on break up value.
- All the assets were based on **cost** as the basis of valuation.

Activity 4.4

Complete the following blanks:

1. Balance sheet is prepared at the end of a specified period. This period in accounting is variously referred to as:

   a) ____________________________ ______________________________

   b) ____________________________ ______________________________

   c) ____________________________ ______________________________

2. Balance sheet prepared at the end of an year summarises the balances in **:**

   a) ____________________Accounts b) _________________Accounts

   c) __________________Accounts.

3. Assets on a balance sheet are usually grouped together as:

   a) ____________________assets b) _________________assets

   c) __________________assets.

4. Claims against the assets on the balance sheet are summarized as:

   a) _________________ liabilities b_________________liabilities

   c) _________________equity.

4.4 BALANCE SHEET CONTENTS

Having examined the conceptual basis of the balance sheet we now try to study the balance sheet itself. We have seen that every transaction affects the financial position. Since it is not feasible to draw up a balance sheet after every transaction, it is prepared at the end of a specified period, usually, an year. This period is referred to as **accounting** period or fiscal year or **financial** year. This period as a convention has become one calendar year, though, there is no accounting justification for it.

The balance sheet as prepared at the end of the accounting period shows the year end status of each of the assets of the firm and the various claims on these assets. We could also say that the balance sheet shows the **year end balance** in the asset, liability and capital accounts.

Read the following illustration carefully. It is a typical summarised balance sheet. We shall follow this balance sheet for subsequent discussions. It shall be useful if you could copy it on a sheet of paper for ready reference. It may be clarified that there are two conventions of preparing the Balance sheet- the American and the English. According to the American convention, assets are shown on the left hand side and the liabilities and the owner's equity on the right hand side. The English convention is just the opposite. i.e., assets are shown on the right hand side of the Balance Sheet and the liabilities and the owner's equity on the left hand side. In India, generally the English conventions is followed. However, in all our illustrations and working here in this booklet, we shall be using the American pattern because it appears to be more logical as it is in tune with the way the transactions are recorded in the books of account and the balances are taken out.

Illustration

Table 4.1: RAMSONS LTD.
Balance Sheet as on December 31, 2003

(Rupees in thousands)

Assets			**Liabilities and Owner's Equity**		
Current Assets			**Current Liabilities**		
Cash		500	Notes Payable		600
Marketable Securities		200	Accounts Payable	1,200	
Notes/Bills Receivable		300	Accrued Liabilities		800
Accounts Receivable	1,000		Income Tax Payable		400
Less: Estimated Loss on collection	100	900	Total Current Liabilities		3,000
			Long term Liabilities		
Merchandise Inventory		1,100	10% Debentures	1,000	
Prepaid Expense		500	Secured Long-term loan from IFCI		2,000
Total Current Assets		3,500	Total Liabilities		6,000
Property, Plant & Equipment			**Shareholders' equity**		
Land		2,000	9% Cumulative Preference Shares of Rs.100 each		500
Buildings, Plant	3,000				
Less: Accumulated			Ordinary Shares of Rs. 10 each		2,000
Depreciation	1,000	2,000	Capital Reserves		500
			Reserves & Surplus		1,000
Other Assets		1,500			
Deferred Expenditure		1,000	Total Liabilities and		
Total Assets		10,000	Shareholder's equity		10,000

4.5 FORM AND CLASSIFICATION OF ITEMS

The balance sheet lists assets, liabilities and capital separately. It is an accepted convention that the assets and liabilities are shown into sub-groups and listed in the order of their **liquidity.** Liquidity implies the length of time required to convert them into cash. Assets which are likely to be converted into cash in the near future are grouped as **current assets.** Similarly, liabilities which are due for payment in the short run are classified as **current liabilities.**

The balance sheet in our example is presented in the I account form. That is the assets are listed on one side and liabilities and owners' equity on the other. Another commonly used way of presentation is the **report form** where liabilities and capital are listed below the assets. However, the presentation matters very little since the balance sheet represents the equality between assets, liabilities and capital.

Current Assets

Current assets are assets which will normally be converted into cash within a year or within the **operating cycle.** The operating cycle is the duration in time taken by a unit of cash to circulate through the business operations. For example, in a simple trading operation, we use cash to buy merchandise and sell it to recover cash. The operating cycle in such a situation will consist of the period for which cash, merchandise inventory, and receivable are held. The cycle starts with cash and ends with the collection of cash.

The items comprising current assets are listed in the order of their **relative liquidity** and hence, cash is listed first.

Cash

Cash is usually taken to include currency (legal tender), cheques or any other document that circulates as cash. Cash is usually classified as a current asset when it is available for a firm's day-to-day operations. It includes cash kept in the cash chest as also deposits on call on current accounts with banks. If cash is specifically ear-marked for any purpose and not available for transactions it is better classified as **other assets.**

Temporary Investments

Whenever firms have short-term excess cash it may be invested in readily marketable securities. These securities may include shares, debentures and Government securities. These assets are readily marketable and could be sold whenever cash is required. They are classified as current assets only when these investments are held with the objective of realisation within a year.

These securities are usually recorded at cost at which they are acquired. Since they are only held for short duration and should reflect their cash value, the principle of accounts receivable to their estimated realisable value. For instance: lower than the original cost, they are valued at their market price or realisable value.

Apparently, the valuation rule `lower of cost or market price' may look contradictory. Why should one not value the securities at higher than cost? This distinction is made, based on the **generally accepted accounting principles.** We do not anticipate gains but only losses. Gains are recognised in accounting only when outside transaction takes place. This is the essence of **conservatism** in accounting.

When the firm values its securities at cost or market price, whichever is lower, we say the firm is conservative. That is, whenever presented with two alternatives the firm chooses the one which shows the lower valuation of assets or higher valuation of liabilities.

Accounts Receivable

Accounts receivable are amounts owed to the company by **debtors**. This is the reason why we also use the term **sundry debtors** to denote the amounts owed to the firm. This represents amounts usually arising out of normal commercial transactions. In other words, `accounts receivable' or sundry debtors represent unpaid customer accounts. In the balance sheet illustration these represent amounts owed to the firm by customers on the balance sheet date. These are also known as trade receivables, since they arise out of normal trading transactions. Trade receivables arise directly from credit sales and as such provide an important information for management and outsiders. In most situations these accounts are unsecured and have only the personal security of the customer.

It is normal that some of these accounts default and become uncollectable. These collection losses are called **bad debts.** It is not possible for the management to know exactly which accounts and what amount will not be collected. However, based on past experience , it is possible for the management to estimate the loss on the receivable or sundry debtors as a whole. Such estimates reduce the gross value of accounts receivable to their estimated realisable value. For instance:

Accounts Receivable	7,50,000
Less: Estimated collection loss at 10%	75,000
Net realisable value of accounts receivable	6,75,000

The estimated collection loss is variously referred to as reserve for doubtful debts, reserve for bad debts or reserve for collection losses. It is a common practice to refer to this as a provision instead of reserve.

It is a usual practice for debts to be evidenced by formal written promises to pay or acceptance of an order to pay. These formal documentary debts represent **promissory Notes Receivable** or **Bills Receivable.** These instruments used in trade are negotiable instruments and hence enable the trader to assign any of his receivables to another party or a bank for realizing immediate liquidity.

It is also usual for accounts receivables to be pledged or assigned mostly to banks against short-term credits in the form of **cash credits** or **overdrafts.**

Inventory

In a trading firm inventory is merchandise held for sale to customers in the ordinary course of business. In case of manufacturing firms inventory would mainly consist of materials required to manufacture the products, namely, raw materials, materials remaining with the factory at various stages of completion i.e., work in process and goods ready for sale or finished goods. Apart from these there may be inventory of stores and supplies. Thus we have raw material inventory, work in process inventory, finished goods inventory and stores and supplies inventory.

It is common to refer to inventory as stock-in-trade and thus we could come across stock of raw materials, stock of work in process and stock of finished goods.. Inventory is usually valued on the basis of "lower of cost or market price". Market price is taken to mean the cost of replacement either by purchase or by reproduction of the material in question. As a general principle, inventory is valued on cost at situation. It implies that all normal costs incurred to make the goods available at the place where it can be sold or used are treated as costs of inventory.

In trading firms, inventory costs include freight-in, transit insurance costs, import or entry levies as also the invoice cost. Warehouse costs, handling costs, insurance costs in storage and interest costs are not included as costs. They are treated as expenses of a period of the firm.

In case of manufacturing units, valuation of inventory costs is more complex and involved. As a general rule all costs of materials, labour and plant facilities used for manufacturing the goods are included in the valuation of inventory.

In valuing inventory at lower of cost or market price, care should be taken to see that the valuation does not exceed the realisable value or selling price in the ordinary course of business.

Prepaid Expenses

In many situations, as a custom, some of the item of expenses are usually paid in advance such as rent, taxes, subscriptions and insurance. The rationale of including these prepayments as current assets is that if these prepayments were not made they would require use of cash during the period.

Fixed Assets

Fixed assets are tangible, relatively long lived items owned by the business. The benefit of these assets are available not only in the accounting period in which the cost is incurred but over several accounting periods. Current assets provide benefits to the organisation by their exchange into cash. In the case of fixed assets. value addition arises by facilitating the process of production or trade. In other words, benefits from fixed assets are indirect rather than direct.

All man made things have limited life. In accounting we are concerned with useful life of the assets. Useful life is the period for which a fixed asset could be economically used. This implies that the benefits from the fixed assets will flow to the organisation throughout its useful life. Another aspect of this is that the cost incurred in the period of purchase of the asset will be providing benefits over the useful life of the asset.

Valuation of the fixed assets is usually made on the basis of original cost. However, since the assets have limited life the cost will be expiring with the expiration of the life. Thus, valuation of the asset is reduced proportionate to the expired life of the asset. Such expired cost is referred to as depreciation in accounting. We shall discuss this idea in more detail in a subsequent unit. The conceptual basis could be clarified with an example.

Suppose a trader buys a delivery van at a cost of Rs. 10,00,000. Assume that the van will have to be discarded as junk at the end of five years. At the time of purchase:

Delivery van at cost	Rs. 10,00,000

At the end of first year it will be represented as:

Delivery van at cost	Rs. 10,00,000
Less: Depreciation to date	2,00,000
Net Value	Rs. 8,00,000

At the end of second year it will be:

Delivery van at cost	Rs. 10,00,000
Less: Depreciation to date	4,00,000
Net Value	Rs. 6,00,000

The process of providing depreciation for each year will continue. At the end of five years the valuation of the asset will be zero. The value of the assets at cost is usually referred to as **gross fixed assets** and the amount of depreciation to date as **accumulated depreciation.** Net value of the asset is usually referred to as **net fixed assets.**

Please note that we reckoned the amount of depreciation by equally distributing the cost of asset over its useful life. This is the simplest method of determining the annual depreciation of the assets. Thus, we can say that the annual depreciation over the useful life of the asset shall not exceed its net cost. We say net cost because the actual cost of the asset to be depreciated is its purchase cost less any salvage value at the end of its useful life. Hence depreciable cost of the asset is net cost which is equal to original cost minus salvage value. The relationship between cost and depreciation could be visualised as follows:

Year 1 Depreciation	Year 2 Depreciation	Year 3 Depreciation	Year 4 Depreciation	Year 5 Depreciation
Rs. 2,00,000	Rs.2,00,000	Rs., 2,00,000	Rs. 2,00,000	Rs. 2,00,000

Cost of the asset : Rs. 10,00,000

Depreciation represents the cost of earning revenue in an accounting period on account of use of fixed assets. Fixed assets are valued on the basis of cost making the asset available and ready for use. Thus cost includes the price as well as charges for delivery, assembly and erection.

Fixed assets normally include assets such as land, building, plant, machinery and motor vehicles. All these items, with the exception of land, are depreciated. Land is not subject to depreciation and hence shown separately from other fixed assets.

Intangible and Other Assets

Intangible assets are assets or things of value without physical dimensions. They cannot be touched, they are incorporeal, representing intrinsic value without material being. One of the most common of these assets is **goodwill.** Goodwill reflects the ability of a firm to earn profits in excess of normal return. Almost all firms may have some goodwill. However, they appear in the books and balance sheet only when it has been purchased. Usually, when a going concern is purchased, the purchase price paid in excess of the fair value of the assets is considered goodwill. The amount is classified as another asset `goodwill' on the balance sheet.

Many intangible assets have limited life too. Examples are patent rights, copy rights, franchise rights, incorporation costs and so on. Since they have limited useful life, the cost of acquiring such assets have to become expired costs over such useful life. This process of expiration of the cost of intangible assets is called **amortisation.** Even those intangible assets which have almost infinite life are amortised over a limited period. In reality the material effect of **amortisation** and **depreciation** is almost the same.

The category "Other Assets" is used to classify assets which are not normally classified as current, fixed and intangible.

Current Liabilities

We have studied that **liabilities** are claims of outsiders against the business. In other words, these are amounts owed by the business to people who have lent money or provided goods or services on credit. If these liabilities are due within an accounting period or the operating cycle of the business, they are classified as current liabilities. Most of such liabilities are incurred in the acquisition of materials or services forming part of the current assets. As was the case with current assets, current liabilities are . also listed in the order of their relative liquidity.

Acceptances and Promissory Notes Payable

Acceptances are **bills of exchange** accepted by the firm usually for goods purchased. Similarly, **promissory notes** are written promises to pay the debts at specified future dates. Both these liabilities specify the amount payable on due date and any other conditions of payment. If such notes or bills payable are for longer duration than one year, then the portion which is due for payment during the current period alone is treated as current liability. Long-term bills may be used for purchase of machinery.

Accounts Payable

Accounts Payable or sundry creditors are usually unsecured debts owed by the firm. These are also referred to as payables on open accounts. They are not evidenced by any formal written acceptance or promise to pay. They represent credit purchase of goods or services for which payment has not been made as on the date of the statement.

Accrued Liabilities

Accrued liabilities represent expenses or obligations incurred, in the previous accounting period but the payment for the same will be made in the next period. In many cases where payments are made periodically, such as wages, rent and similar items, the last month's payment may appear as accrued liabilities (especially if the practice is to pay the same on the first working day of a month). This obligation shown on the balance sheet indicates that the firm owed the said amount on the balance sheet date.

Provisions or Estimated Liabilities

Where the liabilities are known but the amounts cannot be precisely determined, we estimate the liability and provide for it as a liability. A common example is **income tax payable.** Unless the tax liability is determined the amount payable cannot be accurately determined. There could be other examples too, such as product warranty expenses to be met and so on. The common practice is to estimate these liabilities based on past experience.

Contingent Liabilities

Contingent liabilities should be distinguished from estimated liabilities. Estimated liabilities are known liabilities where the amount is uncertain. Contingent liabilities on the other hand are no liabilities as of now. They become liabilities only on the happening of a certain event. In other words, both the amount and the liability (or obligation) are uncertain till the specified event occurs in future. These may include items like a claim against the company **contested** in a court. Only if the court gives an unfavourable verdict, it becomes a liability. They are not listed as liabilities in the body of the balance sheet. However, in order to give a fair view of all known facts about the affairs of the firm, contingent liabilities are disclosed as **foot-notes** to the balance sheet. They are not mentioned in the balance sheet as the firm is not liable as on that date; they are mentioned as notes because all those who are concerned may know that there is possibility that the events might occur.

Long-term Liabilities

Long-term liabilities are usually for more than one year. They cover almost all the liabilities not included in the **current liabilities** and **provisions.** These liabilities may be unsecured or secured. Security for long-term loans, are usually the fixed assets owned by the firm assigned to the lender by a pledge or mortgage. All details such as interest rate, repayment commitment and nature of security are disclosed in the balance sheet. Usually, such long-term liabilities include debentures and bonds, borrowings from financial institutions and banks.

Activity 4.5

Fill in the blanks:

1. As a convention, items appearing on the balance sheet are listed in the order of their relative………………
2. Balance sheet could be presented either in
   a) …………………………………from, or
   b) …………………………………………………………
3. Operating cycle is the duration…………………………………………..
4. Temporary investments are valued in the balance sheet by applying the principle of……………………………………………
5. Accounts receivable are also referred to as…………………………………..
6. Expired cost with respect to a fixed asset is referred to as………………………… expense.
7. Expiration of cost of intangible assets is referred to as………………………...
8. Sundry creditors are also referred to as……………… , ………………………

Activity 4.6

1. We judge an item as a current asset if it is converted into cash during and…………………………………………
2. Liquidity refers to nearness of an item to………………………………
3. Items classified as current assets are usually listed in the order of their relative……………………………………………………………..
4 The basis of valuation as applied to temporary investment is………………
5. Asset losses expected out of non-collection of receivables are called…………………………………
6. Formal written/documented debts refer to………………………………….
7. Items commonly referred to as inventory include (i) ………, (ii)……….and (iii)……………………
8. Inventory is usually valued on the basis of………………………………

Capital

We have seen earlier in this unit that the fundamental accounting equality states: **assets** = **liabilities** + **owners equity.** From the example of balance sheet we can easily establish this. See Rainsons balance sheet:

Total assets	Rs. 1,00,00,000
Total liabilities	Rs. 60,00,000
Owner's equity	Rs. 40,00,000

We also know that the owner's equity consists of the contributed capital and the retained earnings of the firm. If Ramsons were an individual proprietorship business, the owner's equity will be reflected directly as:

Capital	Rs 40,00,000

If 'Ramsons' were a partnership firm with four partners W, X, Y and Z all sharing equally, the capital would be represented as:

Capital-	Partner W	Rs. 10,00,000
	Partner X	Rs. 10,00,000
	Partner Y	Rs. 10,00,000
	Partner Z	Rs. 10,00,000
	Total	Rs. 40,00,000

In our example the balance sheet was titled `Ramsons Ltd.', implying that it was an incorporated limited company. We did not provide the detailed balance sheet incorporating all the legal requirements in order to avoid confusion. According to the company law the capital has to be disclosed in greater detail. This requirement could be related to the corporate legislation's need for ensuring maintenance of capital or keeping the firm's assets intact. This is ensured by insisting that the distribution by way of dividends to shareholders is made only out of accumulated earnings.

According to the legal requirements, the owner's equity section of the company balance sheet is divided into two parts: (1) the share capital representing contributed capital and (2) reserves and surplus representing retained earnings. The contributed capital is the amount paid by shareholders. Share capital is the **joint stock** predetermined by the company at the time of registration. It may consist of either ordinary share capital or preference share capital (having preferential right to fixed dividend and repayment of capital at the time of liquidation), or both. This share capital stock is divided into units or shares. Thus if the company decides to have a share capital it could be either ordinary shares alone or ordinary and preference shares.

A company has an authorised share capital of Rs. 2,00,000 divided into 15,000 ordinary shares of Rs. 10 each and 500 10% cumulative preference shares of Rs. 100 each.

This will be represented as:

Authorised capital:

15,000 ordinary shares of Rs. 10 each	Rs. 1,50,000
500 10% cumulative preference shares of Rs. 100 each	Rs. 50,000
Total	Rs. 2,00,000

The company need not raise the entire amount of-the predetermined or authorised capital. That portion of the authorised capital which has been issued for subscription is referred to as **issued capital.**

Suppose the company offered to the public 7500 ordinary shares and 500 preference shares for cash which were fully subscribed and paid up.

The share capital of the company in summary will be:

Authorised Capital:		
15,000 ordinary shares of Rs. 10 each	Rs.1,50,000	
500 10% cumulative preference shares of Rs. 100 each	50,000	Rs. 2,00,000
Issued Capital		
7,500 ordinary shares of Rs. 10 each	75,000	
500 10% cumulative preference shares of R§. 100 each	Rs. 50,000	Rs. 1,25,000
Subscribed, called up and paid up		
7,500 ordinary shares of Rs. 10 each	75,000	
500 10% cumulative preference shares of Rs. 100 each	50,000	Rs, 1,25,000

In the above example, even though the company was authorised to issue 15,000 ordinary shares, it needed only part of the capital and hence choose to issue only one half of the total authorised ordinary shares. The implication of authorised capital is that it is the maximum amount of capital a company may raise without altering the registration deed.

Ordinary and Preference Shares

Preference shares are so called because they have some preferences over the ordinary shares. These preferences relate to repayment of capital and payment of dividend. In the event of liquidation of the company the assets that remain after payments to creditors are first distributed to preference shareholders. Similarly, whenever the company earns profits and decides to distribute dividends the preference shareholders are first paid their pre-fixed dividend in preference to ordinary shareholders. Preference shares could be made redeemable after a specified period. Similarly, the preference shares could be granted the right to cumulate unpaid dividends. It is also possible to provide to preference shareholders the opportunity to share the excess profits (i.e. over and above their fixed dividends). Under the company law it is not necessary that a company should have preference shares.

Ordinary shares have no preferential or fixed rights with respect to either repayment of capital or distribution of profits. They have the residual claims against assets after the claims of creditors and preference shareholders have been met.

We have hinted earlier that even if the company earns profit, shareholders, including preference shareholders, have no right to dividend unless the company decides to distribute it. However, in case of **cumulative** preferences sareholders such unpaid dividends will accumulate and will have to be paid before any dividend can be paid to ordinary shareholders.

Reserves and Surplus

Reserves and surplus or **retained earnings** normally arise out of profitable operations. It is a surplus not distributed by the firm as dividends. In other words, these are profits decided to be retained within the business. When a firm starts its operations it has no retained earnings. If in the first year it earns say Rs. 10,000 profit and decides to distribute Rs. 5,000 as dividends, the reserves and surplus at the end of the year will be Rs. 5,000. During its second year of operation if the firm makes a loss of Rs. 3,000 then the retained earnings at the end of the year will be Rs. 2,000. Retained earnings (or reserves and surplus) are in the nature of **earned capital** for the firm. We have seen earlier that the dividends are limited to retained earnings. This implies that at no point in item the original capital of the firm is depleted. In other words, the capital originally contributed is maintained intact.

It is possible to allocate the profits earned and accumulated as reserves or retained earnings to be earmarked for specific purposes. The earmarked reserves are not distributed. Only non-earmarked or **free reserves** are available for distribution as dividends.

Activity 4.7

Fill in the blanks with the correct word(s)

1. Balance sheet is a statement of………………………………………………
2. …………………..............represents the owners' claim against assets of a business.
3. ……………………………………………are claims of outsiders against the business.
4. ……………………………………………………………..increase owners' equity.
5. Amounts owed by a business on account of purchase of inventory are usually called………………………..or……………………………………
6. Amounts receivable by a firm against credit sales are usually called……….

7. As a general rule all assets are valued at their …………………to the business.

8. Owner's equity could be understood as comprising two parts:…………………and………………………

9. The dual aspect principle has special relevance to………………………

10. All valuations in a balance sheet are based on the assumption about the entity as a…………………………………………………………………………….

4.6 SUMMARY

Balance Sheet as we have seen is one of the most important financial statements. It is a periodic summary of the position of the business. It is the statement of assets, liabilities and owners' capital as of a particular point in time. This statement in itself does not reveal anything about the details of operations of the business. However, a comparison of two balance sheets could reveal the changes in business position. A realistic understanding of the operations of the business would require two other statements - Profit and Loss Account and Funds Flow Statement. We shall take them up in subsequent units.

4.7 KEY WORDS

Asset: Anything, tangible or intangible, of monetary value to a business entity.

Liability: Any amount owed by one person (the debtor) to another (the creditor). In a balance sheet all those claims against the assets of the entity, other than those of the owners.

Current Assets: All of the assets held by a firm with the objective of conversion to cash within the operating cycle or within one year whichever is longer. Current Assets include items such as cash, receivables, inventory and prepayments.

Current Liabilities: All those claims against the assets of the firm to be met out of cash or other current assets within one year or within the operating cycle, whichever is longer. Usually include items such as accounts payable, tax or other claims payable, and accrued expenses.

Intangible Assets: Any long-term assets useful to the business and having no physical characteristics. Include items such as goodwill, patents, franchises, formation expenses and copyrights.

Contingent Liability: A liability which has not been recognised as such by the entity. It becomes a liability only on the happening of a certain future event. An example could be the liability which may arise out of a pending law suit.

Fixed Asset: Tangible long-lived asset. Usually having a life of more than one year. Includes items such as land building, plant, machinery, motor vehicles, furniture and fixtures.

Owner's Equity: It is the owner's claim against the assets of a business entity. It could be expressed as total assets of an entity less claims of outsiders or liabilities, includes both contributed capital and retained earnings.

4.8 SELF-ASSESSMENT QUESTIONS/EXERCISES

l. Explain the following terms giving examples;

Accounts Receivable

Inventory

Current Liabilities

Reserves and Surplus

Contingent Liabilities

2. By definition , a balance sheet `balances'. Can you think of any advantages that flow from accountants' adherence to this convention?

3. "Financial statements are most useful if they report only the value of assets that are tangible". Do you agree?

4. "Current assets are producing assets. The most profitable firm will practically have few assets which are current compared to other assets". Evaluate fully.

5. For a company, the excess of assets over liability is commonly represented by several items. What are they? What is the caption placed over them?

6. "Fixed assets are physical assets that provide operating capacity for a number of accounting periods". Explain with the help of suitable examples. Are all fixed assets depreciable assets?

7. Peninsular Transport Company began trucking operations on January 1, 2003. The company's bank account showed a balance of Rs. 90,000 on December 31, 2003, which was in agreement with the bank statement received on the same date. The company had Rs. 6,000 cash in the office and Rs. 4,000 worth cheques received from customers.

On December 31, receivables outstanding amounted to Rs. 3,00,000. Company also had Rs. 30,000 worth promissory notes signed by their customers. Employees had drawn festival advance, which was outstanding in the amount of Rs. 6,000. Peninsular owed Rs. 3,60,000 to Southern Service Station as on December 31, 2003.

During the year Peninsular purchased stationery and office supplies costing Rs. 11,000 from Ramlinga lyer & Sons. The use of stationery and supplies during the year was estimated at Rs. 8,000.

Peninsular purchased eight trucks during the year, each costing Rs. 4,00,000. They owed Rs. 20,00,000 to Southern Sales and Finance at the end of the year on account of trucks bought. The obligation was supported by hire purchase agreement for payment at the rate of Rs. 50,000 per month. Depreciation was Rs. 80,000 per truck for the year. Spare parts and tyres inventory amounted to Rs. 13,000.

Company had rented a garage on a 30 year lease, office space and parking space at Rs. 1,00,000 a year on the NH 47 within the city limits. Because of the real estate boom, Peninsular could easily sublet the premises for Rs. 1,50,000 a year. On January 1, 2003 when Peninsular started operations they had paid first two years' rent in advance.

On December 31, 2003 Peninsular purchased an airconditioned car for office use costing Rs. 1,00,000. Insurance and registration cost amounted to Rs. 8,000.

The company had a bulk storage tank for diesel needed for its trucks. The tank was filled on 4 occasions with 50,000 litres each. On December 31 the meter reading indicated that 1,80,000 litres had been used during the year. Average cost per litre of diesel was Rs. 3.00.

Peninsular paid employees' salary on the last day of each month. Bonus for the employees was due in the amount of Rs. 2,12,000 relating to 2003 and will be paid along with first salary in 2004.

The owners of Peninsular originally invested Rs. 6,00,000. Net income for 2003 was Rs. 2,08,000. Drawings by the owners during the year amounted to Rs. 1,00,000.

Prepare the balance sheet as on December 31, 2003 for Peninsular Transport Company in the blank proforma provided as Table 4.2.

Table 4.2
Peninsular Transport Company
Balance Sheet as on 31st December, 2003

Assets			Liabilities and Capital	
Current Assets			**Current Liabilities**	
Cash		______	Hire purchase payment due in one year	______
Cash at Bank		______	Accounts payable	______
Promissory Notes		______	Bonus payable	______
Accounts receivable		______		
Advances to employees		______	**Long Term Liabilities**	
Office supplies inventory		______	Hire purchase payable	______
Prepaid insurance and license		______	**Capital**	
Prepaid rent		______	Owners' Capital	______
Inventory of diesel		______	Net income for the year	______
Spare parts inventory		______	Less: Owner's drawings	______
		______		
Plant and equipment		______		
Trucks	______			
Less: Accumulated Depreciation	______	______		
Motor Car				
Total Assets		______	Total Liabilities and Capital	______

8. The following Balance were extracted from the books of account of Punjab Ceramics Limited, on 30th June, 2003 after the income statement for that year had been prepared and all the relevant adjustments had been made.

Balance as on 30th June 2003

	Rs.
Freehold land and building at cost	32,000
Bank overdraft	27,200
Cash in hand	1,680
Inventory	74,400
Creditors	18,560
10% Debentures	34,000
Dividends Proposed - 8% Preference shares	1,600
Ordinary shares	6,000
Accrued expenses	2,400
General reserves (at 1 July 2002: Rs. 8,000)	20,000
Share capital: 200 8% Preference share of Rs. 100 each	20,000
6,000 Ordinary shares of Rs. 10 each	60,000
Investments at cost	14,800
Motor vehicles at cost	37,200
Provision for depreciation on 30 June 2003	9,600
Plant and machinery at cost	84,960
Provision for depreciation on 30 June 2003	24,160
Retained income (At 1 July 2002, Rs. 28,000)	32,800
Share premium	14,240
Accounts Receivable	25,520

The authorised share capital consists of 400 8% preference shares of 100 each and 1,200 ordinary shares of Rs. 10 each.

Prepare the Balance Sheet of Punjab Ceramics Limited as on 30th June, 2003. Also ascertain the net income for the year.

Answers to Activities

Activity 4.1

1 a) By a decrease in another asset. b) by an increase in liability . c) by an increase in owner's equity.

2 a) an increase in asset. b) decrease in another liability. c) decrease in owner's equity.

3 Liability

4 Assets.

Activity 4.2

1 F. 2 T. 3 F. 4 T. 5 F. 6 F.

Activity 4.3

1 Assets = liabilities + owner's equity

2 Rs. 25,000

3 Rs, 25,000= Rs. 1,00,000 - Rs. 75,000

4 Rs. 70,000 = Rs. 1,00,000 - Rs 30,000

Activity 4.4

1 (a) Accounting period (b) fiscal year (c) financial year

2 (a) asset (b) liability (c) capital

3 (a) current (b) property, plant (c) other

4 (a) current (b) long-term (c) shareholders.

Activity 4.5

1 Liquidity

2 a) T account form

b) Report

3 In time taken by a unit of cash to circulate through the business.

4 Lower of cost or market price

5 Sundry debtors

6 Depreciation

7 Amortisation

8 Accounts payable

Activity 4.6

1 Operating cycle

2 Cash

3 Liquidity

4 "Lower of cost or market price".

5 Bad debts.

6 Promissory Notes receivable *or* bills receivable.

7 Raw material (ii) Work-in-Process (iii) Finished goods.

8 Lower of cost or market price if Ramsons were an individual proprietorship business, the owners equity will be reflected directly as:

Activity 4.7

1 Assets, Liabilities and capital

2 Owners equity

3 Liabilities

4 Profits

5 Accounts payable or sundry creditors

6 Accounts receivable or sundry debtor

7 Original cost

8 Contributed capital and retained earnings

9 Balance sheet

10 Going concern.

Answers to Self-assessment Questions/Exercises

7. Solutions:

Peninsular Transport Company
Balance Sheet as on 31st December, 2003

Assets			**Liabilities and Capital**		
Current Assets			**Current Liabilities**		
Cash		10,000	Hire purchase payment due in one year		6,00,000
Cash at Bank		90,000			
Promissory Notes		30,000	Accounts payable		3,60,000
Accounts receivable		3,00,000	Bonus payable		2,12,000
Advances to employees		6,000			
Office supplies inventory		3,000	**Long Term Liabilities**		11,72,000
Prepaid insurance and license		8,000	Hire purchase payable		14,00,000
Prepaid rent		1,00,000	**Capital**		
Inventory of diesel		60,000	Owners' Capital		6,00,000
Spare parts inventory		13,000	Net income for the year	2,08,000	
			Less: Owner's drawings	1,00,000	1,08,000
Plant and equipment					
Trucks	32,000				
Less: Accumulated Depreciation		25,60,000			
64,000		1,00,000			
Motor Car					
		32,80,000			
Total Assets			Total Liabilities and Capital		32,80,000

4.9 FURTHER READINGS

Horngren C.T. and Harrison, 01/23/2003, *Financial Accounting,* Prentice Hall : New Delhi (Chapter 1)

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