Financial Accounting - 2

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A SHG is Planned

Dear friends, welcome back. In this lesson, we shall take a simple example to illustrate financial statements. Let us assume that a group of 10 women from a village panchayat area decide to form a Self-Help Group (SHG), and start a provision store. They are located at the outskirts of a large city, and expect to get fairly good business from the residents of a nearby university campus, as they were working as daily wage earners in that campus, and had a good relationship within the campus. In addition, a new settlement outside the campus was coming up, and there was a good demand for conveniently packed groceries, stationary items, and perishables like milk, fruits and vegetables etc. They were also aware of the potential business advantage, if they could arrange home deliveries.

The SHG is Formed

A faculty member (Mr. Selvaraj) in the Social Work department was known to them, as he used to bring his students for field work in the village. They approached him for help. Mr. Selvaraj, happily agreed, and prepared an initial estimate of Rs. 400,000 for the project. He told that they must put forth 15% of the total cost from their own resources, before any bank could extend them a loan for the remaining amount. That meant, they had to invest Rs. 60,000 in total, and they agreed to share this equally, everyone paying Rs. 6,000 towards the business. So, on October 1st, 2021, they contributed Rs. 6000 each, and opened an account with the local bank in the name of Arathi Provision Stores (APS). Selvaraj explained to them that they were the owners of APS, and each one of them owned 6000 shares each. The value of each share was Re. 1/= only. The bank agreed to extend a loan of Rs. 340,000 on October 5th at an annual interest rate of 12%.

Arathi Provision Stores (APS) Starts

APS was now ready to start their store, and rented a shop on the roadside, and paid Rs. 12,000 in advance, as rental for one year on October 7th. They bought some essential items like storage shelves, weighing scales, a packing machine, a table and chair, a cash register, a tri-cycle for home delivery, etc. costing Rs. 120,000. They also purchased from the wholesale market, all groceries that they expected to sell over a month, at a total cost of Rs. 200,000. The wholesaler accepted a down payment of 50% of the amount, and agreed to extend a credit period of 30 days for the balance. For the sake of simplicity, we shall assume that by the end of the month, APS was able to sell merchandise worth 180,000 at a price of Rs.

240,000, but Rs. 40,000 was sold on credit, and they received cash of Rs. 200,000 for the sales.

During the month, they paid an electricity bill for Rs. 1000. They had engaged a full-time assistant to help them in the stores on a monthly salary of Rs. 7500. Each member took turns in assisting the running of the store, like supervision and training, pre-packing, home delivery, sorting and cleaning etc. They decided to charge the store a monthly remuneration of Rs. 2,500 each for this service. All the salaries, including those charged to themselves for their services were paid at the end of the month.

How did APS perform?

They were rather excited to figure out how did they perform. Suneetha, a member of the group was known for her skill in arithmetic, and they entrusted her the task of doing the calculations. Their leader, Vaishali, suggested that they look at all the money they had received, spent, and had left in the bank. It would also serve as a check that they were accounting for all the money properly. As we are just beginning this type of exercises, we have highlighted all amounts received in yellow and all amounts spent in grey.

Suneetha prepared the following list:

Cash received – 60,000 + 340,000 + 200,000 – Total 600,000

Cash spent – 12,000 + 120,000 + (50% of 200,000) + 1000 + 7,500 + (2,500 X 10) – Total 265,500

Net cash surplus – 334,500.

SHG First Review Meeting

Vaishali called a meeting of all the members next day, and presented the calculations Suneetha had made. There was a great sense of elation as everyone got up from the mat on which they were sitting and started to congratulate each other. After a few minutes, when the excitement had cooled down, several members started asking questions about the correctness of the calculations.

First question: did Suneetha make any mistake in the calculations? Well, this was easy to answer. They checked their balance in the bank account on the mobile, and found the balance to be 334,500. Suneetha had a sigh of relief.

One member asked, we could have done much more business, as we have so much money in the bank. Everybody shouted in chorus ‘Yes, yes!’.

Another member asked, we have sold merchandise worth 40,000 on credit, what about that? Another member countered we have to pay our wholesaler Rs. 100,000, what about that? A third member pointed out that they had paid rent in advance for the full year. A timid lady (Uma) slowly pointed out, all our furniture and equipment would last at least for 5 years, can we consider everything as already spent?

Bala Sir Enters the Scene

Vaishali had a tough time, facing all these questions, and they felt that they do not have all the answers. They decided to approach Mr. Selvaraj, and Mr. Selvaraj referred them to an accounting faculty – Mr. Bala. Mr. Bala gave them an appointment in the evening, but said that he could not deal with all 10 of them at a time, and only 2 or 3 of them should come, who are knowledgeable. But Selvaraj felt that others also should be present, as they also needed to understand the basics. Accordingly, Vaishali, Suneetha, Uma and a few others went to Bala Sir in the evening. Bala Sir started explaining them some basics, as we shall see.

First Lesson Cash Flows

As they had already done some calculations about the cash, Bala decided to begin with cash. He told them that they must separate the cash flows (incoming and outgoing) under three different categories. Chronologically speaking, the SHG had to shell out their own cash, 6000 each, totalling 60,000, before the bank agreed to extend them a loan of 340,000, enabling them to arrange the full amount required for starting their project. These are called **1.financing cash flows**. Once the funds are ready, we need to set up our business. Usually this takes up the form of purchasing some assets that we would use for our business over some years into the future. These could be items like land, buildings, furniture and fixtures etc. These are known as **2.investment cash flows**. Now we are ready to start our business operations and all cash flows arising out of running the business are known as **3.operating cash flows**.

In order to test their understanding of these categories, Bala Sir suggested that they should take five minutes time and discuss within themselves, how to categorise each of the cash flows they had identified earlier, and gave them the following table. Their task was to put a tick mark in the appropriate column for each row item.

Cash Flow Statement			
Transaction	**Operating**	**Investing**	**Financing**
Issue of 60,000 shares of Re. 1 each			
Borrowing Rs. 340,000 from bank			
Buying furniture and fixtures for Rs. 120,000			
Payment of Rs. 12,000 as advance rent for 1 year			
Purchase of merchandise from wholesaler 100,000			
Receipt of Rs. 200,000 from sale of merchandise			
Electricity bill paid			
Payment of salaries of Rs. 7,500			
Payment for self-services rendered Rs. 25,000			

Those of you who are serious about learning these ideas may try to solve this assignment on your own, before reading the solution given below.

After some heated discussions, they presented the following table to Bala Sir:

Cash Flow Statement			
Transaction	**Operating**	**Investing**	**Financing**
Issue of 60,000 shares of Re. 1 each			√
Borrowing Rs. 340,000 from bank			√
Buying furniture and fixtures for Rs. 120,000		√	
Payment of Rs. 12,000 as advance rent for 1 year		√	
Purchase of merchandise from wholesaler 100,000	√		
Receipt of Rs. 200,000 from sale of merchandise	√		
Electricity bill paid	√		
Payment of salaries of Rs. 7,500	√		
Payment for self-services rendered Rs. 25,000	√		

Bala Sir was very happy, but pointed out that payment of advance rent for 12 months is not considered a long term investment, and should be shown as a part of the operating cash flows. He coloured it in red, and then asked them to insert the relevant amounts against each tick mark, and they got a table as under:

Those of you who are serious about learning these ideas may try to solve this assignment on your own, before reading the solution given below.

Cash Flow Statement			
Transaction	**Operating**	**Investing**	**Financing**
Issue of 60,000 shares of Re. 1 each			60000
Borrowing Rs. 340,000 from bank			340000
Buying furniture and fixtures for Rs. 120,000		(120000)	
Payment of Rs. 12,000 as advance rent for 1 year	(12000)		
Purchase of merchandise from wholesaler 100,000	(100000)		
Receipt of Rs. 200,000 from sale of merchandise	200000		
Electricity bill paid	(1000)		
Payment of salaries of Rs. 7,500	(7500)		
Payment for self-services rendered	(25000)		
Total	54,500	(120,000)	400,000
Net surplus in bank – Rs. 334,500.			

They added two rows at the bottom, a row for column totals, and a row showing the net result.

Re-visiting the Cash Flows

Let us go over the statement of cash flows once again, and review the rationale we have used. As you may see, issuing shares and borrowing from the bank are financing activities for the business.

Buying the furniture and fixtures is an investment because we are going to use this asset over the next 5 years at least.

Paying for the rent (in advance) and salaries are expenses required to run the business operations while receipts from sale of merchandise is clearly a result of the business operations. Please also note that we account for only the actual sale receipt of merchandise sold, and exclude the outstanding amount, as we have not yet received the same.

Please also note that we put a bracket around the cash outflows, *to remind us that these are negative figures*. At the second last row, we get the net result under each category. So, we had a net cash inflow of Rs. 400,000 from financing activities, an outflow of 120,000 under investment activities and an inflow of 54,500 under operations group. The net effect is that we have a cash balance of Rs. 334,500; exactly as Suneetha had calculated, but now this is properly structured to give us (and everyone else) greater insights as to where we got the funds and how we spent them.