



## Financial Accounting - 4



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Dear Friends, welcome back to the study of Financial Accounting. Please recall that we are using a fictitious case study for this purpose. We have reproduced the case study at the end, for ease of reference. We had explained how to prepare a formal Cash Flow Statement and the Income and Expenditure Statement in the last two lessons. This is the third and the last lesson in this series, as we shall discuss the preparation of the Balance Sheet. We reproduce the Income and Expenditure Statement from the previous session for ease of reference.



APS Income and Expenditure Statement for October 2021			
Income		Expenditure	
Sale of merchandise	240,000	Shop Rent expenses	1,000
		Depreciation expenses	2,000
		Cost of Goods Sold (COGS)	180,000
		Electricity Bill	1,000
		Salaries expenses	7,500
		Self-service expenses	25,000
		Interest expense	3,400
		Sub-total	219,900
		<b>Excess of Income over expenses</b>	<b>20,100</b>
Total	240,000	Total	240,000

### Vaishali Feels Sad

Vaishali was a little sad. Bala Sir noticed this and asked her why? She said that she made a quick calculation, and arrived at their individual gains as Rs. 4500 approximately, compared to 7,500 earned by their employee. Bala Sir asked Vaishali to explain how she got this figure of 4500. Vaishali said, we got Rs. 2500 each for our self-service expenses. In addition, we have had a surplus income of 20,100. If divided equally among the ten of us, we get Rs. 2010 each. The total works out to Rs. 7510. Bala Sir, was happy to see that intuitively, Vaishali made a right calculation, and tried to console her, saying that this was just the beginning. As time passes, they would be able to make more business and earn higher profits. In addition, he pointed out that they owned the business, and it has so many assets. He decided to explain to them, how to prepare the balance sheet.

### The Third Lesson: Balance Sheet

The balance sheet tells us **the financial position of the company – its assets and liabilities**. The assets and the liabilities must always be equal. Why? Suneetha asked. Bala Sir explained

that the company is considered to be a separate legal entity. Everything is done **on behalf of this entity**. As this is a virtual entity, all the assets it holds **actually belong to some others**. So this separate entity has the obligation or liability to acknowledge these obligations completely. In order to be complete, we must account for all the assets, and therefore we get the most fundamental accounting equation or relationship:

$$\text{Assets} = \text{Liabilities}$$

### APS Company's Balance Sheet

Bala Sir wanted Vaishali and team to understand that the immediate profit was not everything. They had the entire Store to themselves. One way to get a sense of its value is to know the APS company's balance sheet. First assets. What are the assets of APS **as on October 31<sup>st</sup> 2021**? He told them to remember, a balance sheet is a **snapshot**. It tells us the financial position of the company at a particular point of time. As we have seen just now, this means all its assets and liabilities on that date. Bala Sir cautioned Vaishali that they have to be careful, and count the assets as on October 31<sup>st</sup> 2021. He asked Vaishali and others to try to list the assets APS has on October 31<sup>st</sup> 2021.

#### Assets - Cash

Suneetha quickly pointed out the cash balance they had in the bank (Rs. 334,500) and asked if this could be counted as an asset. Bala Sir, agreed and congratulated Suneetha.

#### Assets – Furniture and Fixture

Uma mentioned the furniture and fixtures, and again Bala Sir agreed, but returned back a question to her, “What should be the value of these furniture and fixtures? Uma was little uncertain, but Vaishali said, it must be less than the original purchase value, as APS had used them for one month. Bala Sir again congratulated Vaishali, and said, “You are right!”.

#### Other Assets

Are there any other assets? Bala Sir asked. One lady from the back asked, we paid advance rent for 12 months and we have used the shop for one month. Is this an asset? Another lady asked, we still have merchandise worth 20,000 in our stock, is this an asset? Another lady excitedly said, ‘Don't forget the 40,000 due from our customers. This must be our asset. Everybody clapped their hands. They quickly made the following list of APS company's assets.

Cash	334,500
Furniture and Fixtures	118,000
Prepaid rent	11,000
Merchandise inventory	20,000
Accounts receivable	40,000
Total	523,500

#### Liabilities – Bank Loan

Next, Bala Sir asked them to list all the liabilities of APS as on October 31<sup>st</sup>, 2021. Everybody shouted in chorus, our bank loan of 340,000; ‘**and** the outstanding interest of Rs. 3400’ pointed out Uma.

### Liabilities – Credit Purchase

Vaishali had made the purchase on 50% credit from the wholesaler, and she pointed out that APS owed the remaining Rs. 100,000 to the wholesaler.

### Liabilities - Shareholders equity

Bala Sir was happy, but felt that he should explain to them that their own contributions to APS as shares, amounting Rs. 60,000 is also a liability of APS.

### Liabilities – Retained Earning

He also explained that the surplus of Rs. 20,100 that APS earned during the month, actually belongs to the shareholders, and it is also a liability, called Retained Earnings.

### APS Liabilities

They made a quick list.

Bank loan	340,000
Interest payable	3,400
Accounts payable	100,000
Shareholders equity	60,000
Retained Earnings	20,100
Total	523,500

Bala Sir was very happy that the women had a fair understanding of the basic concepts, even though, he was sure that they would require many more tutorials. He asked them to combine the two lists into a standard balance sheet format as under:

APS Balance Sheet (As on October 31, 2021)			
Assets	Amount	Liabilities	Amount
Cash	334,500	Bank loan	340,000
Furniture and Fixtures	118,000	Interest payable	3,400
Prepaid rent	11,000	Accounts payable	100,000
Merchandise inventory	20,000	Shareholders' equity	60,000
Accounts receivable	40,000	Retained Earnings	20,100
Total	523,500	Total	523,500

### Vanijye Vasate Lakshmi

Vaishali asked Bala Sir to explain how, their business has grown over a single month from a total value of Rs. 400,000 they started with (own contribution – 60,000 and bank loan 340,000) to the present total value of Rs. 523,500, as evident from the balance sheet. Bala Sir was surprised and happy at this insightful question from Vaishali. He explained to them that

this is the basic principle behind all business. Instead of keeping money locked up in private accounts, if we invest the money into profitable business activities, money tends to grow with time, and all the participants get a share of the benefits. Some get employment, some get their daily requirements conveniently, and some others get more business as they sell their goods and services. Banks get interest on loans extended. If done well and honestly, this is a win – win situation for all. Vanijye Vasate Lakshmi as the saying goes.

### **A Gentle Reminder**

Bala Sir also told them that it is not customary to prepare these statements on a monthly basis. He did so just to explain the concepts. It is mandatory to prepare these statements annually. The women were very eager to learn more, and Bala Sir agreed to conduct tutorial classes for them on all weekends between 5:30 p.m. and 7 p.m.

We reproduce the case study below for ease of reference.

### **Arathi Provision Stores**

This is a fictitious case study, developed with the sole purpose of explaining the principles of Financial Accounting.

#### **An Idea is Born**

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.



#### **An Initial Estimate**

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.

#### **The Initial Investment**

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 1<sup>st</sup>, 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 5<sup>th</sup> at an annual interest rate of 12%.

### Ready to Start

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 7<sup>th</sup>. 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.



### The First Month

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 are we Doing?

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.

### Image link:

[www.Livemint.com](http://www.Livemint.com)

[www.Dreamstime.com](http://www.Dreamstime.com)

