Financial Accounting - 3

By
Dr.Sanjay Banerji
Founder Director/Dean of Amrita School of Business

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 in the last lesson.

At the end, please recall that Uma requested Bala Sir to explain, why it was necessary to separate the cash flows in this manner. Bala Sir smiled, and said, "A very good question. As you would soon learn, while running a business, we have to be very careful. In fact, what you see in the Cash Flow table is only one part of the story. Do you recall the questions that were asked? What about

1. Money that we have not received,
2. Money we have not paid,
3. Money that we have paid in advance; and as Uma said earlier -
4. Money that we have paid, but the benefits of those expenses are going to be realised over the next 5 years. Finally, though no one has pointed this out,
5. What about our loan from the bank, when and how do we pay it back; and
6. Did we make any real profit?

Second Lesson Income and Expenditure

In this lesson we shall try answering some of these questions. The rest would be covered in the next lesson. Let us take up the last question **(#6)** first, "Did we make any real profit, and if so, how much?" In order to answer this question, we have to prepare another statement of income and expenditure, focusing upon all operating income and expenditure both apparent and not so apparent. Essentially, this is known as 'Accounting income' which is different from cash flows. We shall show you in the following paragraphs, how accounting income and expenditure are different from cash flows.

Credit Sales

Consider the fact that APS did sell merchandise worth 40,000 on credit, and they can definitely expect to be paid this amount very soon. Therefore, we should be able to consider this as an income, ***to be realized in near future.***

Investments

APS purchased furniture and fixtures for Rs. 120,000. As of now, the entire amount was not spent for running the business. APS did use some part of the useful life of these assets, but certainly not the entire amount.

Non-cash Asset

APS paid advance rent for 1 year, but had used the facilities for one month only so far. Therefore, APS has 11 months of entitlement left to use the rented premises. This is known as a non-cash asset.

Interest Expense

APS had taken a loan of 340,000 at 12% interest rate. Now one month has elapsed, and therefore, interest for 1 month has already become due. This must be considered as a necessary expenditure for running our business, even though; APS has not paid the bank any interest so far.

Cash Flow and Accounting Income are Different

The above examples show that accounting income is not the same as cash flows. We shall try to record all business income and expenditure appropriately, in order to arrive at an answer to our question, *'Did APS make any profit during the last month, and if so, how much?'*.

The Recognition Principle

So, let us start recording all the incomes and expenditures incurred. In order to do so, we would follow a general principle in accounting - we ***recognize*** all income and expenditure as best as possible, that we have incurred during a period, ***irrespective of*** whether actual money transfer has taken place or not. The actual money transfer (cash flow) may be full or part or nil, but for accounting purposes we record them as respective income or expenditure for the period. This is also known as the ***Recognition Principle.***

For the sake of convenience, we are reproducing all the operating transactions below:

> "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.
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> "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".

We shall now take up every single transaction, and try to figure out if it should be recognised as an income / expenditure for the period, and if so, what should be the amount to be recognised. Here we go.

Please remember always, that we are trying to figure out our accounting income and expenditure for the month of October 2021.

1. APS rented a shop on the roadside, and paid Rs. 12,000 in advance, as rental for one year on October $7^{th.}$

    This looks like expenditure, as we are paying rent for the shop. How much have we spent? This requires a little calculation. APS paid an advance of 12,000 as advance for 1 year, which amounts to Rs. 1000 per month. Now we are standing at the end of October, and so, we have already used one month's value of the advance we have paid, and 11 month's value (our entitlement to use the premises) is still with us. Therefore, we can book or record an expenditure of 1000 as rent expenses <u>at the end of the month</u>.

2. APS bought some essential items … costing Rs. 120,000.

    This also looks like an expenditure, but as Uma had pointed out, we have not really spent all the amount of Rs. 120,000. How much have we used? In order to answer this question, we need to do a little more calculations. The real issue here is that these are all essential items required for running the business, therefore they do qualify to be recognised as an expenditure, but how much of it have we really used up during the month of October? Well, to answer this question, we must first answer another question, what is the reasonable estimate of the useful life of all these furniture and fixtures? We are advised that 5 years is a reasonable estimate, generally acceptable to all parties. Therefore, on a pro-rata basis, the annual cost of using all these assets would be Rs. 24,000 (120,000 / 5). The monthly cost would amount to Rs. 2000. In accounting parlance, this is known as **depreciation** expenses. We may book Rs. 2000 as **depreciation** expenses for the month of October. (Did we hear Uma having a sigh of relief?). This addresses the question **(#4)** in part only.

3. APS purchased groceries worth Rs. 200,000, with a down payment of 50% of the amount, the balance to be paid in 30 days.

    This looks like an expense an expense, but is it really so? If so, how much?
    We shall deal with the second question later. First let us examine the first question, did APS actually spend this amount or did APS simply exchanged one type of asset (cash) for another type of asset – merchandise inventory? The logical conclusion is the latter, and therefore, we do not record this transaction as an expenditure. We shall see later, how we account for such transactions. The second question becomes redundant, after this understanding. This transaction is in a way similar to buying furniture and fixtures, but with a difference. Our aim is to use them up as soon as possible. As and when we use them up, we shall book a corresponding expenditure.

4. APS sold merchandise worth 180,000 at a price of Rs. 240,000, but Rs. 40,000 was sold on credit.

This is an income, but how much? Again, we apply the recognition principle and record an income of Rs. 240,000. This addresses the question **(#1).** We must not forget to record the associated expenditure. Remember, we received this revenue through the sale of merchandise worth Rs. 180,000. We must record an expenditure named **'Cost of Goods Sold - COGS'** amounting to Rs. 180,000. This was a typical example in business where, we record the revenue at the value we did the sales, and record expenses (COGS) at the value we incurred for the goods / services we sold. If our costs are lower than the sale proceeds, we have a positive margin on sales.

5. During the month, they paid an electricity bill for Rs. 1000. This is clearly expenditure for the month.

6. APS paid the full-time assistant the monthly salary of Rs. 7500. This is also expenditure for the month.

7. APS made payment for self-services renderedan amount of Rs. 2,500 each.
   This also should be recorded as an expenditure for the month, totalling Rs. 25,000.

8. We have now covered all the explicit operational transactions. Now it is time to ask ourselves, is there any hidden income or expenditure that we have not recorded?

   Radha hesitantly raised her hand, willing to answer this question. Bala Sir was very happy and encouraged Radha to give her answer. Radha said, what about the loan we have taken from the bank? Some interest has already accumulated now. Should we consider this to be an expenditure? Bala Sir had a wide grin on his face, as he congratulated Radha. Urmila, another member now raised her hand, and Bala Sir told Urmila to hold on, I shall come back to you soon. But, before that, let us complete this question of interest payable on the loan. Please recall that APS had taken a loan of Rs, 340,000 at an annual interest rate of 12%. One month has passed. Therefore, an interest of Rs. 3,400 has fallen due. So, APS must record an expenditure **'Interest expense'** of Rs. 3400. This is an example of question **(#2).**

9. Bala Sir now asked Urmila to give her point. Urmila said, we have so much money in our bank account. Have we not earned any interest on that amount? Bala Sir replied, this is an excellent point. However, for the purpose of doing business, firms open an account known as Current Accounts, and these accounts do not earn any interest.

We shall now consolidate all these operating transactions into one Table named APS Income and Expenditure Statement for October 2021.

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
		Excess of Income over expenses	**20,100**
Total	240,000	Total	240,000

Bala Sir finished this session here, and said that he would take up preparation of the Balance Sheet in the next lesson.

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 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%.

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 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.

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.