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MASTER OF BUSINESS ADMINISTRATION (HRM)

MBAH 104 : FINANCIAL ACCOUNTING

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CENTRE FOR DISTANCE AND ONLINE EDUCATION

UNIVERSITY OF SCIENCE & TECHNOLOGY MEGHALAYA

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Techno City, 9th Mile, Baridua, Ri-Bhoi, Meghalaya, 793101

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MBAH 104
FINANCIAL ACCOUNTING

CONTENTS

UNIT-I: INTRODUCTION TO ACCOUNTING

1.0 INTRODUCTION

Business is an economic activity undertaken with the motive of earning profits and to maximize the wealth for the owners. Business cannot run in isolation. Largely, the business activity is carried out by people coming together with a purpose to serve a common cause. This team is often referred to as an organization, which could be in different forms such as sole proprietorship, partnership, body corporate etc. The rules of business are based on general principles of trade, social values, and statutory framework encompassing national or international boundaries. While these variables could be different for different businesses, different countries etc., the basic purpose is to add value to a product or service to satisfy customer demand.

The business activities require resources (which are limited & have multiple uses) primarily in terms of material, labour, machineries, factories and other services. The success of business depends on how efficiently and effectively these resources are managed. Therefore, there is a need to ensure that the businessman tracks the use of these resources. The resources are not free and thus one must be careful to keep an eye on cost of acquiring them as well.

Evolution of Accounting: Accounting is as old as money itself. It has evolved, as have medicine, law and most other fields of human activity in response to the social and economic needs of society. People in all civilizations have maintained various types of records of business activities. The oldest known are clay tablet records of the payment of wages in babylonia around 600 b.c. accounting was practiced in india twenty-four centuries ago as is clear from kautilya's book ?arthshastra' which clearly indicates the existence and need of proper accounting and audit.

For the most part, early accounting dealt only with limited aspects of the financial operations of private or governmental enterprises. Complete accounting system for an enterprise which came to be called as ‘double entry system’ was developed in Italy in the 15th century. The first known description of the system was published there in 1494 by a Franciscan monk by the name Luca Pacioli.

The expanded business operations initiated by the industrial revolution required increasingly large amounts of money which in turn resulted in the development of the corporation form of organizations. As corporations became larger, an increasing number of individuals and institutions looked to accountants to provide economic information about these enterprises. For e.g. Prospective investors and creditors sought information about a corporation's financial status.

Government agencies required financial information for purposes of taxation and regulation. Thus, accounting began to expand its function of meeting the needs of relatively few owners to a public role of meeting the needs of a variety of interested parties

Definitions

In order to understand the subject matter with clarity, let us study some of the definitions which depict the scope, content and purpose of Accounting. The field of accounting is generally sub-divided into:

(a) Book-keeping

(b) Financial Accounting

(c) Cost Accounting and

(d) Management Accounting

Let us understand each of these concepts.

(a) Book-keeping

The most common definition of book-keeping as given by J. R. Batliboi is "Book-keeping is an art of recording business transactions in a set of books."

As can be seen, it is basically a record keeping function. One must understand that not all dealings are, however, recorded. Only transactions expressed in terms of money will find place in books of accounts. These are the transactions which will ultimately result in transfer of economic value from one person to the other. Book- keeping is a continuous activity, the records being maintained as transactions are entered into. This being a routine and repetitive work, in today's world, it is taken over by the computer systems. Many accounting packages are available to suit different business organizations.

It is also referred to as a set of primary records. These records form the basis for accounting. It is an art because, the record is to be kept in such a manner that it will facilitate further processing and reporting of financial information which will be useful to all stakeholders of the business.

(b) Financial Accounting

It is commonly termed as Accounting. The American Institute of Certified Public Accountants defines Accounting as "an art of recoding, classifying and summarizing in a significant manner and in terms of money, transactions and events which are in part at least of a financial character, and interpreting the results thereof."

The first step in the cycle of accounting is to identify transactions that will find place in books of accounts. Transactions having financial impact only are to be recorded. E.g. if a businessman

negotiates with the customer regarding supply of products, this will not be recorded. The negotiation is a deal which will potentially create a transaction and will have exchange of money or money's worth. But unless this transaction is finally entered into, it will not be recorded in the books of accounts.

Secondly, the recording of the business transactions is done based on the Golden Rules of accounting (which are explained later) in a systematic manner. Transaction of similar nature are grouped together and recorded accordingly. e.g. Sales Transactions, Purchase Transactions, Cash Transactions etc. One has to interpret the transaction and then apply the relevant Golden Rule to make a correct entry thereof.

Thirdly, as the transactions increase in number, it will be difficult to understand the combined effect of the same by referring to individual records. Hence, the art of accounting also involves the step of summarizing them. With the aid of computers, this task is simplified in today's accounting world. The summarization will help users of the business information to understand and interpret business results.

Lastly, the accounting process provides the users with statements which will describe what has happened to the business. Remember the two basic questions we talked about, one to know whether business has made profit or loss and the other to know the position of resources that are used by the business.

(c) Cost Accounting

According to the Chartered Institute of Management Accountants (CIMA), Cost Accountancy is defined as "application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability as well as the presentation of information for the purpose of managerial decision-making."

It is a branch of accounting dealing with the classification, recording, allocation, summarization and reporting of current and prospective costs and analyzing their behaviors. Cost Accounting is frequently used to facilitate internal decision making and provides tools with which management can appraise performance and control costs of doing business. It primarily involves relating the costs to the different products produced and sold or services rendered by the business. While Financial Accounting deals with business transactions at a broader level, Cost Accounting aims at further breaking it up to the last possible level to identify costs with products and services. It uses the same Financial Accounting documents and records. Modern computerized accounting packages like ERP systems provide for processing Financial as well as Cost Accounting records simultaneously.

This branch of accounting deals with the process of ascertainment of costs. The concept of cost is always applied with reference to a context. Knowledge of cost concepts and their application provide a very sound platform for decision making. Cost Accounting aims at equipping management with information that can be used for control on business activities.

(d) Management Accounting

Management Accounting is concerned with the use of Financial and Cost Accounting information to managers within organizations, to provide them with the basis in making informed business decisions that would allow them to be better equipped in their management and control functions. Unlike Financial Accounting information (which, for public companies, is public information), Management Accounting information is used within an organization (typically for decision-making) and is usually confidential and its access available only to a selected few.

According to the Chartered Institute of Management Accountants (CIMA), Management Accounting is "the process of identification, measurement, accumulation, analysis, preparation, interpretation and communication of information used by management to plan, evaluate and control within an entity and to assure appropriate use of and accountability for its resources. Management Accounting also comprises the preparation of financial reports for non management groups such as shareholders, creditors, regulatory authorities and tax authorities".

Basically, Management Accounting aims to facilitate management in formulating strategies, planning and constructing business activities, making decisions, optimal use of resources, and safeguarding assets of business.

These branches of accounting have evolved over years of research and are basically synchronized with the requirements of business organizations and all entities associated with them. We will now see what are they and how accounting satisfies various needs of different stakeholders.

Difference between Book-keeping and Accountancy:

The Significant difference between Book-keeping and Accountancy are:

Financial Statements: Financial statement can now be easily prepared which will exhibit the true financial position and operating results.

1.1 OBJECTIVES OF ACCOUNTING

The main objective of Accounting is to provide financial information to stakeholders. This financial information is normally given via financial statements, which are prepared on the basis of Generally Accepted Accounting Principles (GAAP). There are various accounting standards developed by professional accounting bodies all over the world. In India, these are governed by The Institute of Chartered Accountants of India, (ICAI). In the US, the American Institute of Certified Public Accountants (AICPA) is responsible to lay down the standards. The Financial Accounting Standards Board (FASB) is the body that sets up the International Accounting Standards. These standards basically deal with accounting treatment of business transactions and disclosing the same in financial statements.

The following objectives of accounting will explain the width of the application of this knowledge stream:

(a) To ascertain the amount of profit or loss made by the business

i.e. to compare the income earned versus the expenses incurred and the net result thereof.

(b) To know the financial position of the business i.e. to assess what the business owns and what it owes.

(c) To provide a record for compliance with statutes and laws applicable.

(d) To enable the readers to assess progress made by the business over a period of time.

(e) To disclose information needed by different stakeholders.

Let us now see which are different stakeholders of the business and what do they seek from the accounting information. This is shown in the following table.

1.2 BASIC ACCOUNTING TERMS

In order to understand the subject matter clearly, one must grasp the following common expressions always used in business accounting.

The aim here is to enable the student to understand with these often used concepts before we embark on accounting procedures and rules. You may note that these terms can be applied to any business activity with the same connotation.

(i) Transaction: It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person

e.g. purchase of goods would involve receiving material and making payment or creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction. In credit transaction, the payment is settled at a future date as per agreement between the parties.

(ii) Goods/Services : These are tangible article or commodity in which a business deals. These articles or commodities are either bought and sold or produced and sold. At times, what may be classified as 'goods' to one business firm may not be 'goods' to the other firm. e.g. for a machine manufacturing company, the machines are 'goods' as they are frequently made and sold. But for the buying firm, it is not 'goods' as the intention is to use it as a long term resource and not sell it. Services are intangible in nature which are rendered with or without the object of earning profits.

(iii) Profit: The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.

(iv) Loss: The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.

(v) Asset: Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be Tangible and Intangible. Tangible Assets are the Capital assets which have some physical existence. They can, therefore, be seen, touched and felt, e.g. Plant and Machinery, Furniture and Fittings, Land and Buildings, Books, Computers, Vehicles, etc. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as intangible Assets. They cannot be seen or felt although they help to generate revenue in future,

e.g. Goodwill, Patents, Trade-marks, Copyrights, Brand Equity, Designs, Intellectual Property, etc. Assets can also be classified into Current Assets and Non-Current Assets.

Current Assets - An asset shall be classified as Current when it satisfies any of the following :

(a) It is expected to be realised in, or is intended for sale or consumption in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded ,

(c) It is due to be realized within 12 months after the Reporting Date, or

(d) It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date, term etc.

(vi) Liability: It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. E.g. when goods are bought on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date or when a loan is taken from bank, an obligation to pay interest and principal amount is created. Depending upon the period of holding, these obligations could be further classified into Long Term on non-current liabilities and Short Term or current liabilities.

Current Liabilities - A liability shall be classified as Current when it satisfies any of the following :

(a) It is expected to be settled in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded,

(c) It is due to be settled within 12 months after the Reporting Date, or

(d) The Company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Non-Current Liabilities - All other Liabilities shall be classified as

Non-Current Liabilities. E.g. Loan taken for 5 years, Debentures issued etc.

(vii) Internal Liability : These represent proprietor's equity, i.e. all those amount which are entitled to the proprietor, e.g., Capital, Reserves, Undistributed Profits, etc.

(viii) Working Capital : In order to maintain flows of revenue from operation, every firm needs certain amount of current assets. For example, cash is required either to pay for expenses or to meet obligation for service received or goods purchased, etc. by a firm. On identical reason, inventories are required to provide the link between production and sale. Similarly, Accounts Receivable generate when goods are sold on credit. Cash, Bank, Debtors, Bills Receivable, Closing Stock, Prepayments etc. represent current assets of firm. The whole of these current assets form the working capital of a firm which is termed as Gross Working Capital.

Gross Working Capital = Total Current Assets

= Long term internal liabilities plus long term debts plus the current liabilities minus the amount blocked in the fixed assets.

There is another concept of working capital. Working capital is the excess of current assets over current liabilities. That is the amount of current assets that remain in a firm if all its current liabilities are paid. This concept of working capital is known as Net Working Capital which is a more realistic concept.

Working Capital (Net) = Current Assets - Currents Liabilities.

(ix) Contingent Liability : It represents a potential obligation that could be created depending on the outcome of an event. E.g. if supplier of the business files a legal suit, it will not be treated as a liability because no obligation is created immediately. If the verdict of the case is given in favour of the supplier then only the obligation is created. Till that it is treated as a contingent liability. Please note that contingent liability is not recorded in books of account, but disclosed by way of a note to the financial statements.

(x) Capital : It is amount invested in the business by its owners. It may be in the form of cash, goods, or any other asset which the proprietor or partners of business invest in the business activity. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer o f the business. Hence, it is not classified as a normal liability. For corporate bodies, capital is normally represented as share capital.

(xi) Drawings : It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use. e.g. if the life insurance premium of proprietor or a partner of business is paid from the business cash, it is called drawings. Drawings will result in reduction in the owners' capital. The concept of drawing is not applicable to the corporate bodies like limited companies.

(xii) Net worth : It represents excess of total assets over total liabilities of the business. Technically, this amount is available to be distributed to owners in the event of closure of the business after payment of all liabilities.

(xiii) Non-current Investments : Non-current Investments are investments which are held beyond the current period as to sale or disposal. e. g. Fixed Deposit for 5 years.

(xiv) Current Investments : Current investments are investments that are by their nature readily realizable and are intended to be held for not more than one year from the date on which such investment is made. e. g. 11 months Commercial Paper.

(xv) Debtor : The sum total or aggregate of the amounts which the customer owe to the business for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Receivable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or service rendered on credit. These debtors may again be classified as under:

(i) Good debts : The debts which are sure to be realized are called good debts.

(ii) Doubtful Debts : The debts which may or may not be realized

are called doubtful debts.

(iii) Bad debts : The debts which cannot be realized at all are

called bad debts.

It must be remembered that while ascertaining the debtors balance at the end of the period certain adjustments may have to be made

e.g. Bad Debts, Discount Allowed, Returns Inwards, etc.

(xvi) Creditor : A creditor is a person to whom the business owes money or money's worth. e.g. money payable to supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.

(xvii) Capital Expenditure: This represents expenditure incurred for the purpose of acquiring a fixed asset which is intended to be used over long term for earning profits there from. e. g. amount paid to buy a computer for office use is a capital expenditure. At times expenditure may be incurred for enhancing the production capacity of the machine. This also will be a capital expenditure. Capital expenditure forms part of the Balance Sheet.

(xviii) Revenue expenditure: This represents expenditure incurred to earn revenue of the current period. The benefits of revenue expenses get exhausted in the year of the incurrence. e.g. repairs, insurance, salary & wages to employees, travel etc. The revenue expenditure results in reduction in profit or surplus. It forms part of the Income Statement.

(xix) Balance Sheet: It is the statement of financial position of the business entity on a particular date. It lists all assets, liabilities and capital. It is important to note that this statement exhibits the state of affairs of the business as on a particular date only. It describes what the business owns and what the business owes to outsiders (this denotes liabilities) and to the owners (this denotes capital). It is prepared after incorporating the resulting profit/losses of Income

Statement.

(xx) Profit and Loss Account or Income Statement: This account shows the revenue earned by the business and the expenses incurred by the business to earn that revenue. This is prepared usually for a particular accounting period, which could be a month, quarter, a half year or a year. The net result of the Profit and Loss Account will show profit earned or loss suffered by the business entity.

(xxi) Trade Discount: It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price.

e.g. the list price of a TV set could be ` 15000. The wholesaler may allow 20% discount thereof to the retailer. This means the retailer will get it for ` 12000 and is expected to sale it to final customer at the list price. Thus the trade discount enables the retailer to make profit by selling at the list price. Trade discount is not recorded in the books of accounts. The transactions are recorded at net values only. In above example, the transaction will be recorded at ` 12000 only.

(xxii) Cash Discount: This is allowed to encourage prompt payment by the debtor. This has to be recorded in the books of accounts. This is calculated after deducting the trade discount.

e.g. if list price is ` 15000 on which a trade discount of 20% and cash discount of 2% apply, then first trade discount of ` 3000 (20% of ` 15000) will be deducted and the cash discount of 2% will be calculated on ` 12000 (`15000 - ` 3000). Hence the cash discount will be ` 240/- (2% of ` 12000) and net payment will be ` 11,760 (`12,000 - ` 240)

Accounting Concepts and Conventions

As seen earlier, the accounting information is published in the form of financial statements. The three basic financial statements are

(i) The Profit & Loss Account that shows net business result i.e. profit or loss for a certain periods.
(ii) The Balance Sheet that exhibits the financial strength of the business as on a particular dates.

(iii) The Cash Flow Statement that describes the movement of cash from one date to the other.

As these statements are meant to be used by different stakeholders, it is necessary that the information contained therein is based on definite principles, concrete concepts and well accepted convention.

Accounting principles are basic guidelines that provide standards for scientific accounting practices and procedures. They guide as to how the transactions are to be recorded and reported. They assure uniformity and understandability. Accounting concepts lay down the foundation for accounting principles. They are ideas essentially at mental level and are self-evident. These concepts ensure recording of financial facts on sound bases and logical considerations. Accounting conventions are methods or procedures that are widely accepted. When transactions are recorded or interpreted, they follow the conventions. Many times, however, the terms-principles, concepts and conventions are used interchangeably.

Professional Accounting Bodies have published statements of these concepts. Over years, many of these concepts are being challenged as outlived. Yet, no major deviations have been made as yet. Path breaking ideas have emerged and the accounting standards of modern days do require companies to record and report transactions which may not be necessarily based on concepts that are in vogue for long. It is essential to study accounting from the basic levels and understand these concepts in entirety

1.3 ACCOUNTING CONCEPTS

The important accounting concepts are discussed hereunder: Business Entity Concept:

It is generally accepted that the moment a business enterprise is 17 started it attains a separate entity as distinct from the persons who own it. In recording the transactions of a business, the important question is:

How do these transactions affect the business enterprise? The question as to how these transactions affect the proprietors is quite irrelevant. This concept is extremely useful in keeping business affairs strictly free from the effect of private affairs of the proprietors. In the absence of this concept the private affairs and business affairs are mingled together in such a way that the true profit or loss of the business enterprise cannot be ascertained nor its financial position. To quote an example, if a proprietor has taken rs.5000/- from the business for paying house tax for his residence, the amount should be deducted from the capital contributed by him. Instead if it is added to the other business expenses then the profit will be reduced by rs.5000/- and also his capital more by the same amount. This affects the results of the business and also its financial position. Not only this, since the profit is lowered, the consequential tax payment also will be less which is against the provisions of the income-tax act.

A. Going Concern Concept:

This concept assumes that the business enterprise will continue to operate for a fairly long period in the future. The significance of this concept is that the accountant while valuing the assets of the enterprise does not take into account their current resale values as there is no immediate expectation of selling it. Moreover, depreciation on fixed assets is charged on the basis of their expected life rather than on their market values. When there is conclusive evidence that the business enterprise has a limited life, the accounting procedures should be appropriate to the expected terminal date of the enterprise. In such cases, the financial statements could clearly disclose the limited life of the enterprise and should be prepared from the 'quitting concern' point of view rather than from a 'going concern' point of view.

B. Money Measurement Concept:

Accounting records only those transactions which can be expressed in monetary terms. This feature is well emphasized in the two definitions on accounting as given by the American institute of certified public accountants and the American accounting principles board.

The importance of this concept is that money provides a common denomination by means of which heterogeneous facts about a business enterprise can be expressed and measured in a much better way. For

e.g. When it is stated that a business owns rs.1,00,000 cash, 500 tons of raw material, 10 machinery items, 3000 square meters of land and building etc., these amounts cannot be added together to produce a meaningful total of what the business owns. However, by expressing these items in monetary terms such as rs.1,00,000 cash, rs.5,00,000 worth raw materials, rs,10,00,000 worth machinery items and rs.30,00,000 worth land and building - such an addition is possible.

C. Cost Concept:

This concept is yet another fundamental concept of accounting which is closely related to the going-concern concept. As per this concept:

(i) an asset is ordinarily entered in the accounting records at the price paid to acquire it i.e., at its cost and (ii) this cost is the basis for all subsequent accounting for the asset.

The implication of this concept is that the purchase of an asset is recorded in the books at the price actually paid for it irrespective of its market value

Dual Aspect Concept (Double Entry System):

This concept is the core of accounting. According to this concept every business transaction has a dual aspect. This concept is explained in detail below:

The properties owned by a business enterprise are referred to as assets and the rights or claims to the various parties against the assets are referred to as equities. The relationship between the two may be expressed in the form of an equation as follows:

Equities = Assets

Equities may be subdivided into two principal types: the rights of creditors and the rights of owners. The rights of creditors represent debts of the business and are called liabilities. The rights of the owners are called capital.

Expansion of the equation to give recognition to the two types of equities results in the following which is known as the accounting equation:

Liabilities + Capital = Assets

It is customary to place 'liabilities' before 'capital' because creditors have priority in the repayment of their claims as compared to that of owners. Sometimes greater emphasis is given to the residual claim of the owners by transferring liabilities to the other side of the equation as:

Capital = Assets - Liabilities

All business transactions, however simple or complex they are, result in a change in the three basic elements of the equation. This is well explained with the help of the following series of examples:

(i) Mr. Prasad commenced business with a capital of rs.3,000: the result of this transaction is that the business, being a separate entity, gets 20 cash-asset of rs.30,000 and has to pay to Mr. Prasad rs.30,000, his capital. This transaction can be expressed in the form of the equation as follows:

Capital = Assets Prasad Cash 30,000 30,000

(ii) purchased furniture for rs.5,000: the effect of this transaction is that cash is reduced by rs.5,000 and a new asset viz. Furniture worth rs.5,000 comes in, thereby, rendering no change in the total assets of the business. The equation after this transaction will be:

Capital = Assets

Prasad Cash + Furniture 30,000 25,000 + 5,000

(iii) borrowed rs.20,000 from Mr. Gopal: as a result of this transaction both the sides of the equation increase by rs.20,000; cash balance is increased and a liability to Mr. Gopal is created. The equation will appear as follows:

Liabilities + Capital = Assets Creditors + Prasad Cash + Furniture 20,000 30,000 45,000 5,000

(iv) purchased goods for cash rs.30,000: this transaction does not affect the liabilities side total nor the asset side total. Only the composition of the total assets changes i.e. Cash is reduced by rs.30,000 and a new asset viz. Stock worth rs.30,000 comes in. The equation after this transaction will be as follows:

Liabilities + Capital =Asset

Creditors Prasad Cash + Stock + Furniture 20,000 30,000 15,000 30,000 5,000

(v) goods worth rs.10,000 are sold on credit to Ganesh for rs.12,000. The result is that stock is reduced by rs.10,000 a new asset namely debtor (Mr. Ganesh) for rs.12,000 comes into picture and the capital of Mr. Prasad increases by rs.2,000 as the profit on the sale of goods belongs to the owner. Now the accounting equation will look as under:

Liabilities + Capital = Asset

Creditors Prasad Cash + Debtors + Stock + Furniture 20,000 32,000 15,000 12,000 20,000 5,000

(vi) paid electricity charges rs.300: this transaction reduces both the cash balance and Mr. Prasad's capital by rs.300. This is so because the expenditure reduces the business profit which in turn reduces the equity.

The equation after this will be:

Liabilities + Capital =Assets

Creditors + Prasad Cash + Debtors + Stock + Furniture 20,000 31,700 14,700 12,000 20,000 5,000

Thus it may be seen that whatever is the nature of transaction, the accounting equation always tallies and should tally. The system of recording transactions based on this concept is called double entry system.

D. Accounting Period Concept:

In accordance with the going concern concept it is usually assumed that the life of a business is indefinitely long. But owners and other interested parties cannot wait until the business has been wound up for obtaining information about its results and financial position. Fore.g. If for ten years no accounts have been prepared and if the business has been consistently incurring losses, there may not be any capital at all at the end of the tenth year which will be known only at that time. This would result in the compulsory winding up of the business.

E. Periodic Matching Of Costs And Revenues:

This concept is based on the accounting period concept. It is widely accepted that desire of making profit is the most important motivation to keep the proprietors engaged in business activities. Hence a major share of attention of the accountant is being devoted towards evolving appropriate techniques of measuring profits. One such technique is periodic matching of costs and revenues.

In order to ascertain the profits made by the business during a period, the accountant should match the revenues of the period with the costs of that period. By 'matching' we mean appropriate association of related revenues and expenses pertaining to a particular accounting period. To put it in other words, profits made by a business in a particular accounting period can be ascertained only when the revenues earned during that period are compared with the expenses incurred for earning that revenue.

F. Realization Concept:

Realization refers to inflows of cash or claims to cash like bills receivables, debtors etc. Arising from the sale of assets or rendering of services. According to realization concept, revenues are usually recognized in the period in which goods were sold to customers or in which services were rendered. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. To illustrate this point, let us consider the case of a, a manufacturer who produces goods on receipt of orders. When an order is received from b, a starts the process of production and delivers the goods to b when the production is complete. B makes payment on receipt of goods. In this example, the sale will be presumed to have been made not at the time when goods are delivered to b. A second aspect of the realization concept is that the amount recognized as revenue is the amount that is reasonably certain to be realized.

G. Accounting Conventions Convention Of Conservatism:

It is a world of uncertainty. So it is always better to pursue the policy of playing safe. This is the principle behind the convention of conservatism. According to this convention the accountant must be very careful while recognizing increases in an enterprise's profits rather than recognizing decreases in profits. For this the accountants have to follow the rule, anticipate no profit, provide for all possible losses, while recording business transactions. It is on account of this convention that the inventory is valued at cost or market price whichever is less, i.e. When the market price of the inventories has fallen below its cost price it is shown at market price i.e. The possible loss is provided and when it is above the cost price it is shown at cost price i.e. The anticipated profit is not recorded. It is for the same reason that provision for bad and doubtful debts, provision for fluctuation in investments, etc., are created.

H. Convention Of Full Disclosure:

the emergence of joint stock company form of business organization resulted in the divorce between ownership and management. This necessitated the full disclosure of accounting information about the enterprise to the owners and various other interested parties. Thus the convention of full disclosure became important. By this convention it is implied that accounts must be honestly prepared and all material information must be adequately disclosed therein.

I. Convention Of Consistency:

According to this concept it is essential that accounting procedures, practices and method should remain unchanged from one accounting period to another. This enables comparison of performance in one accounting period with that in the past. For e.g. If material issues are priced on the basis of fifo method the same basis should be followed year after year. Similarly, if depreciation is charged on fixed assets according to diminishing balance method it should be done in subsequent year also. But consistency never implies inflexibility as not to permit the introduction of improved techniques of accounting.

However if introduction of a new technique results in inflating or deflating the figures of profit as compared to the previous methods, the fact should be well disclosed in the financial statement.

J. Convention Of Materiality:

The implication of this convention is that accountant should attach importance to material details and ignore insignificant ones. In the absence of this distinction, accounting will unnecessarily be overburdened with minute details. The question as to what is a material detail and what is not is left to the discretion of the individual accountant. Further, an item should be regarded as material if there is reason to believe that 25 knowledge of it would influence the decision of informed investor. Some examples of material financial information are: fall in the value of stock, loss of markets due to competition, change in the demand pattern due to change in government regulations, etc. Examples of insignificant financial information are: rounding of income to nearest ten for tax purposes etc. Sometimes if it is felt that an immaterial item must be disclosed, the same may be shown as footnote or in parenthesis according to its relative importance.

What are Accounting Standards?

Companies make many transactions on a daily basis in order to run and engage in their businesses.

* They have to make many statements in this regard, particularly for banks and creditors to make evaluations before lending them funds. The most important statements are the balance sheet and the profit and loss account (also known as the income statement).
* These statements reveal the financial health of the company and enable banks and financial institutions to make sound evaluations.
* Accounting is an intricate process and this allows companies to alter their accounting principles to suit themselves.
* This does not allow other entities to make any comparisons.
* This is precisely the reason accounting standards are recommended.
* Recognized accounting bodies set standards of accounting so that there is a harmonized accounting principle for companies to adhere to.

The main objective of Accounting Standards is to standardize the diverse accounting policies and practices.

Indian Accounting Standards (Ind AS)

Ind AS or Indian Accounting Standards govern the accounting and recording of financial transactions as well as the presentation of statements such as balance sheet and profit and loss account of accompany in India.

* Companies, especially in the west and the developed world, follow the International Financial Reporting Standards (IFRS) for their accounts.
* The Ind AS was prescribed as a result of calls for Indian accounting standards to be on par with the globally accepted standards, the IFRS.
* The Ind AS was issued under the supervision and control of the Accounting Standards Board (ASB).
* The ASB was constituted in 1977 by the Institute of Chartered Accountants of India (ICAI) to harmonize the varied accounting policies and practices.

The Companies Act mandates the balance sheets and income statements of all companies to comply with the accounting standards.

Many companies in India had resisted the imposition of the IFRS stating that the move would result in too many changes to the way their numbers were captured and reported.

The Ind AS was formulated as a compromise formula that tries to harmonies Indian accounting rules with the IFRS.

Journal:

1. **Journalese the following transactions of M/s. Radha& Sons.**

1.1.2000 Business Started with Rs.2,50,000 and cash deposited with Bank 1,50,000

3.1.2000 Purchases machinery on credit from Rangan - 50,000

6.1.2000 Bought furniture from Ramesh for cash - 25,000

12.1.2000 Goods sold to Yesodha - 22,500

13.1.2000 Goods returned by Yesodha - 2,500

15.1.2000 Goods sold for cash - 50,000

17.1.2000 Bought goods for cash - 25,000

20.1.2000 Cash received from Yesodha - 10,000

21.1.2000 Cash paid to Ramola - 20,000

25.1.2000 Cash withdrawn from bank - 50,000

29.1.2000 Paid advertisement expenses -12,500

30.1.2000 Bought office stationery for cash - 5,000

31.1.2000 Cash withdrawn from bank for personal use of the proprietor - 6,25031.1.2000 Paid salaries - 15,000

31.1.2000 Paid rent - 2,500

Books of M/s. Radha & Sons Journal

LEDGER:

2. Record the following transactions in the personal account of Kapil:

1.4.2000 Sold goods to Kapil - 6,000

5.4.2000 Cash received from Kapil - 5,800

and allowed him discount -200 18.4.2000 Kapil purchased goods - 8,000

30.4.2000 Received cash from Kapil on account - Rs.4,500 1.5.2000 Balance from last month b/d - 3,500 12.5.2000 Sold goods to Kapil - 12,000

22.5.2000 Received cash from Kapil - 4,850 and allowed him discount - 150

31.5.2000 Received cash in full settlement of Kapil's A/c

-10,250

Solution:

SUBSIDIARY BOOKS

Subsidiary book is the sub division of Journal. These are known as books of prime entry or books of original entry as all the transactions are recorded in their original form. In these books the details of the transactions are recorded as they take place from day to day in a classified manner. The important subsidiary books used are as following:-

-Cash Book : Used to record all the cash receipts and payments. -

Purchase Book : Used to record all the credit purchases.

-Sales Book : Used to record all the credit sales

-Purchase Return Book : Used to record all goods returned by business to the supplier

-Sales Return Book : Used to record all good returned by the customer to the business.

-Bills Receivable Book : Used to record all accepted bills received by business.

-Bills Payable Book : Used to record all bill accepted by us to our creditors.

-Journal Proper : Used to record those transactions for which there is no separate book. These subsidiary books are maintained because it may be impossible to record each transaction into the ledger as it occurs. And these books record the details of the transactions and therefore help the ledger to become brief. Future reference and any desired analysis becomes easy as transactions of similar nature are recorded together.

3. Record the following transactions for the month of January 1999 in the purchase book of M/s.Narain Electronics:

Jan 4 Purchased from M/s Brown Electronics:

20 Black & White T.Vs @ Rs.5,200 per piece. 10 Colour T.Vs @ Rs.12,000 per piece.

Trade discount on all items @ 12% Jan 10 Purchased from M/s Mani Electronics;

12 Video tapes @ Rs. 600 per piece.

8 Philips tape recorders @ Rs.2,500 per piece.

Jan 19 Purchased from M/s Sehgal Electronics: 10 LG Steros @ Rs. 3,500 per piece

8 LG Colour T.Vs @ Rs.25,000 per piece.Trade discount @ 15%

Jan 24 Purchased from M/s. Gupta Electronics: 200 Audio Cassettes @ Rs.25 per piece 30 Equity toasters @ Rs.500 per piece

Also show posting of the above transactions into ledger accounts from purchase book.Solution:

Books of M/s. NARAIN ELECTRONICS PURCHASES BOOK

Check your progress

1.State the two systems of accounting.

2. What are the two branches of accounting?

3. Analyze the limitations of accounting.

4.State the objectives of accounting standard board.

5. Explain the following accounting concepts: (i) Money measurement concept (ii) Business entity concept (iii) Going concern concept (iv) Realization concept (v) Cost concept.

UNIT- II

PREPARATION OF ANNUAL ACCOUNTS

2.0 INTRODUCTION

The primary objective of any business concern is to earn income. Ascertainment of the periodic income of a business enterprise is perhaps the important objective of the accounting process. This objective is achieved by the preparation of profit and loss account or the income statement. Profit and loss account is generally considered to be of greatest interest and importance to end users of accounting information. The profit and loss account enables all concerned to find out whether the business operations have been profitable or not during a particular period. Usually the profit and loss account is accompanied by the balance sheet as on the last date of the accounting period for which the profit and loss account is prepared. A balance sheet shows the financial position of a business enterprise as of a specified moment of time. It contains a list of the assets, the liabilities and the capital of a business entity as of a specified date, usually at the close of the last day of a month or a year.

Basic Ideas About Income And Expense

Profit and loss account consists of two elements: one element is the inflows that result from the sale of goods and services to customers which are called as revenues. The other element reports the outflows that were made in order to generate those revenues; these are called as expenses. Income is the amount by which revenues exceed expenses. The term ?net income' is used to indicate the excess of all the revenues over all the expenses. The basic equation is:

Revenue - Expenses = Net Income

This is in accordance with the matching concept.

Income And Owner's Equity: The net income of an accounting period increases owner's equity because it belongs to the owner.

Income Vs. Receipts: Income of a period increases the owner's equity but it need not result in increase in cash balance. Loss of a period decreases owner's equity but it need not result in decrease in cash balance. Similarly, increase in cash balance need not result in increased income and owner's equity and decrease in cash balance need not denote loss and decrease in owner's equity.

Expenditures That Are Also Expenses: This is the simplest and most common type of transaction to account for. If an item is acquired during the year, it is expenditure. If the item is consumed in the same year, then the expenditure becomes expense. E.g. Raw materials purchased are converted into saleable goods and are sold in the same year.

Assets That Become Expenses: when expenditures incurred result in benefits for the future period they become assets. When such assets are used in subsequent years they become expenses of the year in which they are used. For e.g. Inventory of finished goods are assets at the end of a particular accounting year. When they are sold in the next accounting year they become expenses.

Expenditures That Are Not Expenses: As already pointed, out when the benefits of the expenditure relate to future periods they become assets and not expenses. This applies not only to fixed assets but also to inventories which remain unsold at the end of the accounting year. For e.g. The expenditure incurred on inventory remaining unsold is asset until it is sold out.

Expenses Not Yet Paid: Some expenses would have been incurred in the accounting year but payment for the same would not have been made within the accounting year. These are called accrued expenses and are shown as liabilities at the year end.

Form And Presentation of Profit And Loss Account / Income Statement In practice there is considerable variety in the format and degree of detail used in income statements. The profit and loss account is usually prepared in? shape. The following (illustration-a) is the summarized profit and loss account of aliakbar ltd.

2.1 Final Accounts for Sole Trader

Introduction

So far in this unit you have looked at different adjustment needed before the final accounts can be

prepared. The final accounts for a sole trader business are the Income Statement (Trading and Profit & loss Account) and the Balance Sheet. The final accounts give a picture of the financial position of your business. It shows where or not your business has made a profit or loss during the accounting period and whether you are able to pay your debts as they become due. Let's now have a look at the final accounts of a sole trader business.

Objectives

Upon the completion of this topic you should be able to;

1. understand how profit/loss is calculated,
2. calculate the cost of goods sold, gross profit and net profit,
3. transfer net profit and drawings to the capital account at the end of the period, and
4. prepare an Income Statement from a trial balance.

Final Accounts

After your trial balance is completed your final accounts are prepared. The final accounts of a sole trader business include the Income Statement (trading and Profit & loss account) and the balance sheet. Remember that your trial balance is the summary of the balances in all your accounts. Some of these balances (those from your nominal accounts) affect the profit and are transferred to the Income statement; the others (real and personal accounts) are transferred to your balance sheet. The Income Statement and the Balance Sheet are prepared at the end of each financial period to record how well the business operated during that financial period

2.2 Income Statement

One of the most important financial statements of any business is the Income Statement. It is used to determine the following:

1. how profitable a business is being run; and
2. comparing the results received with the results expected.

The Income Statement can be divided into two sections the trading account and the Profit & loss account. The gross profit which is the amount of profit made before the expenses are deducted is calculated in the trading account. The purpose of the trading account is to determine the gross profit made from sales. Therefore the accounts that are directly related to buying and selling (trading) will be transferred to the trading account. The accounts directly related to trading are:

* Sales
* Purchase
* Sales Return Purchases Return Carriage Inwards Gross profit is calculated as:

Gross Profit = Net Sales - Cost of Goods Sold (COGS)

Along with gross profit the net sales, cost of goods sold (COGS) and the cost of goods available for sale (COGAFS) is also calculated in the trading account:

Net Sales = Sales - Sales Return (Return Inwards)

Net sales are the total sales figure after allowances have been made for sales returned to the business. COGS = Cost of goods available for sale (COGAFS) - Closing Stock COGAFS

= Opening Stock + (Purchases - Purchases Return) + Carriage Inwards

The net profit of your business is calculated in the Profit & loss account. Net profit is the balance of profit after allowances made for revenue and expenses. It is calculated as:

Net Profit = Gross profit + Revenue - expenses

The revenue and expense charged to the Profit & loss account are those that are not directly related to trading but more to do with the running of the business. Some of these accounts are:

* Rent
* Telephone
* Carriage outwards
* Discount allowed
* Discount received

* Commission received
* Commission paid
* Salary

In Unit Two these accounts were closed off and transferred to the income statement. The income statement can be shown horizontally or vertically. Balance Sheet

The other half of our final accounts is the Balance Sheet. The Balance Sheet is a financial statement showing the book values of the assets, liabilities and capital at the end of the financial period. It shows what the business owes and what it owns. The assets of the business is divided into two categories and recorded as follows

1. Non-Current Assets are assets that:

* are expected to be of use in the business for long time;
* are to be used in the business; and
* were not bought only for the purpose of resale.

Non-current assets are recorded in the balance sheet starting with those assets that will in the business the longest down to those that will be kept for a shorter period. Example of non-current assets and the order of record are:

* Land and Buildings.
* Fixtures and Fittings.
* Machinery.
* Motor Vehicles.

2. Current Assets are recorded next. These are assets will change within the next twelve months. They are recorded as follows:

* Stock (goods bought for resale)
* Debtors.
* Cash at Bank.
* Cash in Hand.

3. Non-current Liability - Sometime referred to as long term liability are those debts that take more than a year to settle. This includes large loans and mortgages.

4. Current Liability - are debts that will be settled in one year or less. This includes creditors and small loans.

Additional Information: All figures in Rs, (1) Stock on 31.3.2013: (i)

Market Price ` 24,000; (ii) Cost Price ` 20,000; (2) Stock valued `

10,000 were destroyed by fire and insurance company admitted the claim to the extent of ` 6,000. (3) Goods purchased for ` 6,000 on 29th March, 2013, but still lying in- transit, not at all recorded in the books. (4) Goods taken for the proprietor for his own use for ` 3,000. (5) Outstanding wages amounted to ` 4,000. (6) Freight was paid in advance for ` 1,000

Profit and Loss Account: The following items will appear in the debit side of the Profit & Loss A/c:

(i) Cost of Sales: This term refers to the cost of goods sold. The goods could be manufactured and sold or can be directly identified with goods.

(ii) Other Expenses: All expenses which are not directly related to main business activity will be reflected in the P & L component. These are mainly the Administrative, Selling and distribution expenses. Examples are salary to office staff, salesmen commission, insurance, legal charges, audit fees, advertising, free samples, bad debts etc. It will also include items like loss on sale of fixed assets, interest and provisions.

(iii) Abnormal Losses: All abnormal losses are charged against Profit & Loss Account. It includes stock destroyed by fire, goods lost in transit etc. The following items will appear in the credit side of Profit & Loss A/c:

(i) Revenue Incomes: These incomes arise in the ordinary course of business, which includes commission received, discount received etc.

(ii) Other Incomes: The business will generate incomes other than from its main activity. These are purely incidental. It will include items like interest received, dividend received, etc .The end result of one component of the P & LA/c is transferred over to the next component and the net result will be transferred to the balance sheet as addition in owners' equity. The profits actually belong to owners of business. In case of company organizations, where ownership is widely distributed, the profit figure is separately shown in balance sheet.

Example : From the following particulars presented by Sri Tirlhankar for the year ended 31st March 2013, Prepare Profit and Loss Account.(All figures in Rs) Gross Profit ` 1,00,000, Rent ` 22,000; Salaries,

` 10,000; Commission (Cr.) ` 12,000; Insurance ` 8,000; Interest

(Cr.) ` 6,000; Bad Debts ` 2,000; Provision for Bad Debts (1.4.2012)

` 4,000; Sundry Debtors ` 40,000; Discount Received ` 2,000; Plant & Machinery ` 80,000.

Adjustments:

(a) Outstanding salaries amounted to ` 4,000;

(b) Rent paid for 11 months;

(c) Interest due but not received amounted to ` 2,000

(d) Prepaid Insurance amounted to ` 2,000;

(e) Depreciate Plant and Machinery by 10% p.a.

(f) Further Bad Debts amounted to ` 2,000 and make a provision for Bad Debts @5% on Sundry Debtors.

(g) Commissions received in advance amounted to ` 2,000.

Balance Sheet: Horizontal format of Balance Sheet is also used by the business other than company A.

Liabilities

(a) Capital: This indicates the initial amount the owner or owners of the business contributed. This contribution could be at the time of starting business or even at a later stage to satisfy requirements of funds for expansion, diversification etc. As per business entity concept, owners and business are distinct entities, and thus, any contribution by owners by way of capital is liability.

(b) Reserves and Surplus: The business is a going concern and will keep making profit or loss year by year. The accumulation of these profit or loss figures (called as surpluses) will keep on increasing or decreasing owners' equity. In case of non-corporate forms of business, the profits or losses are added to the capital A/c and not shown separately in the balance sheet of the business.

(c) Long Term or Non-Current Liabilities: These are obligations which are to be settled over a longer period of time say 5-10 years. These funds are raised by way of loans from banks and financial institutions. Such borrowed funds are to be repaid in installments during the tenure of the loan as agreed. Such funds are usually raised to meet financial requirements to procure fixed assets. These funds should not (d) Short Term or Current Liabilities: A liability shall be classified as Current when it satisfies any of the following :

o It is expected to be settled in the organization’s normal Operating Cycle,

o It is held primarily for the purpose of being traded,

o It is due to be settled within 12 months after the Reporting Date, or

o The organization does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Current liabilities comprise of :

(i) Sundry Creditors - Amounts payable to suppliers against purchase of goods. This is usually settled within 30-180 days.

(ii) Advances from customers - At times customer may pay advance i.e. before they get delivery of goods. Till the business supplies goods to them, it has an obligation to pay back the advance in case of failure to supply. Hence, such advances are treated as liability till the time they get converted to sales.

(iii) Outstanding Expenses: These represent services procured but not paid for. These are usually settled within 30-60 days e.g. phone bill of Sept is normally paid in Oct.

(iv) Bills Payable: There are times when suppliers do not give clean credit. They supply goods against a promissory note to be signed as a

promise to pay after or on a particular date. These are called as bills payable or notes payable.

(v) Bank Overdrafts: Banks may give fund facilities like overdraft whereby, business is permitted to issue cheques up to a certain limit. The bank will honour these cheques and will recover this money from business. This is a short term obligation.

B. Assets In accounting language, all debit balances in personal and real accounts are called as assets. Assets are broadly classified into fixed assets and current assets.

(a) Fixed Assets: These represent the facilities or resources owned by the business for a longer period of time. The basic purpose of these resources is not to buy and sell them, but to use for future earnings. The benefit from use of these assets is spread over a very long period. The fixed assets could be in tangible form such as buildings, machinery, vehicles, computers etc, whereas some could be in intangible form viz. patents, trademarks, goodwill etc. The fixed assets are subject to wear and tear which is called as depreciation. In the balance sheet, fixed assets are always shown as "original cost less depreciation".

(b) Investments: These are funds invested outside the business on a temporary basis. At times, when the business has surplus funds, and they are not immediately required for business purpose, it is prudent to invest it outside business e.g. in mutual funds or fixed deposit. The purpose if to earn a reasonable return on this money instead of keeping them idle. These are assets shown separately in balance sheet. Investments can be classified into Current Investments and Non-current Investments. on-current Investments are investments which are restricted beyond the current period as to sale or disposal. Whereas, current investments are investments that are by their nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made.

(c) Current Assets: An asset shall be classified as Current when it satisfies any of the following :

* It is expected to be realized in, or is intended for sale or consumption in the organization’s normal Operating Cycle
* It is held primarily for the purpose of being traded,
* It is due to be realized within 12 months after the Reporting Date, or
* It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Current assets comprise of:

(i) Stocks: This includes stock of raw material, semi-finished goods or WIP, and finished goods. Stocks are shown at lesser of the cost or market price. Provision for obsolescence, if any, is also reduced. Generally, stocks are physically counted and compared with book stocks to ensure that there are no discrepancies. In case of discrepancies, the same are adjusted to P & L A/c and stock figures are shown as net of this adjustment.

(ii) Debtors: They represent customer balances which are not paid. The bad debts or a provision for bad debt is reduced from debtors and net figure is shown in balance sheet.

(iii) Bills receivables: Credit to customers may be given based on a bill to be signed by them payable to the business at an agreed date in future. At the end of accounting period, the bills accepted but not yet paid are shown as bills receivables.

(iv) Cash in Hand: This represents cash actually held by the business on the balance sheet date. This cash may be held at various offices, locations or sites from where the business activity is carried out. Cash at all locations is physically counted and verified with the book balance. Discrepancies if any are adjusted.

(v) Cash at Bank: Dealing through banks is quite common. Funds held as balances with bank are also treated as current asset, as it is to be applied for paying to suppliers. The balance at bank as per books of accounts is always reconciled with the balance as per bank statement, the reasons for differences are identified and required entries are passed.

(vi) Prepaid Expenses: They represent payments made against which services are expected to be received in a very short period.

(vii) Advances to suppliers: When amounts are paid to suppliers in advance and goods or services are not received till the balance sheet date, they are to be shown as current assets. This is because advances paid are like right to claim the business gets. Please note that both current assets and current liabilities are used in day-to-day business activities. The current assets minus current liabilities are called as working capital or net current assets. The following report is usual horizontal form of balance sheet. Please note that the assets are normally shown in descending order of their liquidity. Also, capital, long term liabilities and short term liabilities are shown in that order.

Example: From the following particulars prepare a Balance Sheet of Mr. X, for the year ended 31st March, 2013. Capital : ` 2,00,000: Drawings : ` 40,000 ; Cash In Hand : ` 15,000 ; Loan from Bank :

` 40,000; Sundry Creditors : ` 40,000; Bills Payable : ` 20,000; Bank Overdraft : ` 20,000; Goodwill : ` 60,000; Sundry Debtors :

` 80,000; Land and Building : ` 50,000; Plant and Machinery : ` 80,000; Investment : ` 20,000; Bills Receivable : ` 10,000. Cash at Bank : ` 25,000.

The following adjustments are made at the time of preparing final accounts:

I. Outstanding L inabilities : Salaries ` 10,000; wages ` 20,000; Interest on Bank Overdraft ` 3,000; and Interest on Bank Loan ` 6,000.

II. Provide Interest on Capital @ 10% p.a.

III. Depreciation on Plant and Machinery by 10% p.a.

IV. Bad Debts amounted to ` 10,000 and make a provision for Bad Debts @ 10% on Sundry Debtors.

V. Closing stock amounted to ` 1,20,000. Net profit for the year amounted to ` 96,000 after considering all the above adjustments.

Check your progress

1. State the types of Accounts.

2. State the examples of:

i) Current Assets ii) Non-current Assets iii) Current Liabilities iv) Non- Current Liabilities

3. Explain the following: (i)cost of sales (ii) Other Expenses (iii)Abnormal Loss (iv) Revenue Income.

UNIT -3

VALUATION OF ASSETS

3.0 INTRODUCTION

Depreciation is the process of spreading the cost of fixed asset over the different accounting periods which drive the benefit from their use. The cost of fixed assets apportioned to a given period from part of the overall cost to be matched with the revenues generated in depreciation is a permanent decline in the value of an asset. The gradual decrease, both in the value and usefulness, of an asset due to its nature and usage is termed as depreciation. Depreciation is the measure of wearing out of a fixed asset. All fixed assets are expected to be less efficient as time goes on. Depreciation is calculated as the estimate of this measure of wearing out and is charged to the Profit & Loss account either on a monthly or annual basis. The cost of the asset less the total depreciation will give you the Net Book Value of the asset.

It is common experience that whenever an asset is used it reduces in value. The net result of depreciation is that sooner or letter, the asset becomes useless. So, it can be stated that depreciation is that portion of the cost of an asset which is reduced from revenues for the services of the asset in the operation of a business.

According to Spicer and Pegler "Depreciation is thee measure of the exhaustion of the effective life of an asset from any cause during

a given period."

According to the Institute Of Chartered Accountants Of India, "Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use effluxion of time or obsolescence through technology and market changes."

According to International Accounting Standards Committee, "Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to income either directly or indirectly."

The following important terms from these definitions are important:

* Depreciable Assets: The assets whose lifetime can be estimated and useful during two or more accounting periods in production or service activities of an organization can be called depreciable assets.

* Useful life: Useful life is the time during which the asset is helpful in the normal business activities of a firm. It can be less than the total life time of the asset. It can be exactly predetermined or it should be estimated on reasonable basis.

* Depreciable Amount: It is the cost of acquisition and installation of an asset after reducing any realizable value at

the end of useful life.

* Realizable value at the end of useful life.

* Effluxion of time: It is the passage of time irrespective of actual use of an asset as in the case of leased assets.

* Obsolescence: It refers to an asset becoming out of date due to improved models or methods. hat. So, depreciation is of great significance in the concept of income measurement.

In common parlance depreciation means a fall in the quality or value of an asset. But in accounting terminology, the concept of depreciation refers to the process of allocating the initial or restated input valuation of fixed assets to the several periods expected to benefit from their acquisitions and use. Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation and not of valuation.

The international accounting standards committee (iasc) (now international accounting standards board) defines depreciation as follows: depreciation is the allocation of the depreciable amount of an asset over the estimated useful life. The useful life is in turn defined as the period over which a depreciable asset is expected to be used by the enterprise. The depreciable amount of a depreciable asset is its historical cost in the financial statements, less the estimated residual value. Residual value or salvage value is the expected recovery or sales value of the asset at the end of its useful life.

3.1 CAUSES OF DEPRECIATION

Among other factors, the two main factors that contribute to the decline in the usefulness of fixed assets are deterioration and obsolescence. Deterioration is the physical process wearing out whereas obsolescence refers to loss of usefulness due to the development of improved equipment or processes, changes in style or other causes not related to the physical conditions of the asset. The other causes of depreciation are:

1. Efflux of time - mere passage of time will cause a fall in the value of an asset even if it is not used. 2. Accidents - an asset may reduce in value because of meeting with an accident.

3. Fall in market price - a sudden fall in the market price of 91 the asset reduces its value even if it remains brand new.

Need For Depreciation Accounting The need for depreciation accounting arises on three grounds:

(i) To calculate proper profit: according to matching concept of accounting, profit of any year can be calculated only when all costs of

earning revenues have been properly charged against them. Asset is an important tool in earning revenues. The fall in the book value of assets reflects the cost of earning revenues from the use of assets in the current year and hence like other costs like wages, salary, etc., it must also be provided for proper matching of revenues with expenses.

(ii) To show true financial position: the second ground for providing depreciation is that it should result in carrying forward only that part of asset which represents the unexpired cost of expected future service. If the depreciation is not provided then the asset will appear in the balance sheet at the overstated value.

(iii) To make provision for replacement of assets: if no changes were made for depreciation, profits of the concern would be more to that extent. By making an annual charge for depreciation, a concern would be accumulating resources enough to enable it to replace an asset when necessary. Replacement, thus, does not disturb the financial position of the concern.

Purpose of Calculating Depreciation

Depreciation has wide-ranging implications in the field of accounting and taxation. Let us understand why.

* Depreciation in accounting: The applicability of depreciation to accounting is based on the matching principle, under which the cost of the asset is matched with the value it generates during the course of its useful life. In order to determine their real cost, the values of assets are reduced during every accounting year and are written off as expenses.

* Depreciation in taxation: Taxation laws allow depreciation to be deducted when tax liabilities are calculated because the depreciated value of an asset is written off as an expense under accounting. Consequently, under the Income Tax Act, 1961, assets can be depreciated at the rates prescribed.

The main purposes of calculating depreciation are:

* Measuring income or loss generated from assets

* Determining the real value of assets

* Ascertaining true expenditure incurred in the production
* Availing tax benefits and deductions

After understanding the meaning of depreciation and its nuances, let us now further see how accounting of depreciation happens.

Accounting of Depreciation

Since depreciation is charged directly against assets, the journal entry for the same involves Depreciation A/c and the relevant Asset A/c. We have to debit Depreciation A/c because it is an expense or loss, while we credit Asset A/c as its value diminishes.

Sometimes, a provision may be made for accumulated depreciation, under which total depreciation is calculated up to a specific date, instead of it being computed in each accounting year. The balance sheet explains this as a deduction from gross fixed assets.

3.2 CALCULATION OF DEPRECIATION

A. Straight Line Method

Straight line method is the simplest way to calculate depreciation. Under this mode, the amount of value reduced from the original cost of the asset remains constant for every accounting year. For example, if we assume the rate of depreciation for a car worth Rs. 10 lakhs to be constant at Rs. 25,000, then its value will reduce by Rs. 25,000 in every accounting year during the course of its useful life. This method which is also known as 'fixed installment system', provides for equal amount of depreciation every year. Under this method, the cost of acquisition plus the installation charges, minus the scrap value, is spread over the estimated life of the asset to arrive at the annual charge. In other words, this method writes off a fixed percentage, say 20%, of the original cost of the asset every year in such a way that the asset is reduced to nil or scrap value at the end of its life.

Evaluation: The chief merit of this method is that it is easy to calculate depreciation, and hence, it is simple. Depreciation charge is constant from year to year, regardless of the extent of use of the asset. This method can be employed in the case of assets like furniture and fixtures, short leases, etc., which involve little capital outlay, or which have no residual value. This method is criticized on the ground that the depreciation charge remaining the same every year, cost of repairs and maintenance would be increasing as the asset becomes older. With the efficiency of the asset declining, it is unfair to charge the same amount of depreciation every year.

B. Diminishing Balance Method:

This method which is also known as the, `reducing installment system', or ‘written down value method', applies depreciation as a fixed percentage to the balance of the net cost of the asset not yet allocated at the end of the previous accounting period. The percentage of depreciation is so fixed that, theoretically, the balance of the unallocated cost at the end of the estimated useful life of the asset should be equal to the estimated residual value.

Evaluation: Unlike the fixed installment system, depreciation under this method is not fixed, but gradually decreasing. As such, in the initial periods, the amount will be much higher, but negligible in the later period of the asset. Thus, this method tends to offset the amount of depreciation on the one hand and repairs and maintenance on the other. This method is also simple, although the calculation of depreciation is a bit complicated. Further, as and when additions are made to the asset, fresh calculations do not become necessary. This method is best suited to assets such as plant and machinery which have a long life

Question 1

On 1-1-2003, machinery was purchased for rs.3,00,000. Depreciation at the rate of 10% has to be written off. Write up the machinery account for three years under: 1. Straight line method (SLM) and 2. Written down value method (WDV)

Question 2:

On 1st April, 2015, a limited company purchased a Machine for ? 1,90,000 and spent ? 10,000 on its installation. At the date of purchase, it was estimated that the scrap value of the machine would be ? 50,000 at the end of sixth year. Give Machine Account and Depreciation A/c in the books of the Company for 4 years after providing depreciation by Fixed Instalment Method. The books are closed on 31st March every year.

Illustration 2: On 1-1-2002, machinery was purchased for rs.30,000. Depreciation at the rate of 10% on original cost was written off during the first two years. For the next two years 15% was written off the diminishing balance of the amount. The machinery was sold for rs.15,000. Write up the machinery account for four years and close the same.

Check your progress

1.State the meaning of Depreciation.

2. What are the causes of depreciation?

3. Explain the Methods of calculating Depreciation.

UNIT - 4

VALUE ADDED ACCOUNTING

4.0 INTRODUCTION

4.1MEANING AND DEFINITION OF VALUE-ADDED STATEMENTS

The main thrust of financial accounting development in the recent decades has been in the area of `how' we measure income rather than ‘whose' income we measure. The common belief of the traditional accountants that profit is a reward of the proprietors has been considered as a very narrow definition of income. This was so because previously the assets were assumed to be owned by the proprietor and liabilities were thought as proprietor's obligations. This notion of proprietorship was accepted and practiced so as long as the nature of business did not experience revolutionary changes. However, with the emergence of corporate entities and the legal recognition of the existence of business entities separate from the personal affairs and interest of the owners led to the rejection of proprietary theory.

Value added is now reported in the financial statements of companies in the form of a statement. Value Added Statement (VAS) is aimed at supplementing a new dimension to the existing system of corporate financial accounting and reporting. This is called value added statement. This statement shows the value created; value added (value generated) and the distribution of it to interest groups viz. Employees, shareholders, promoters of capital and government. Since VAS represents how the value or wealth created or generated by an entity is shared among different stakeholders, it is significant from the national point of view. ICAI, 1985 has defined Value Added Statement as a statement that reveals the value added by an enterprise which it has been able to generate, and its distribution among those contributing to its generation known as stakeholders.

For the purpose of calculating the amount of value added and its distribution, the value added statement is prepared. The main concern of this statement lies in deriving a measure of wealth (i.e. value), the entity has contributed to the society through the collective efforts of the various stakeholders. This statement is prepared and published voluntarily with the annual financial reports. Thus the presentation of a statement of value added aids in disclosure of VA by an enterprise.

Value added statement may be defined as a statement, which shows the income of the company as an entity and how that is divided between the people who have contributed to its creation.

4.2 ASSUMPTIONS IN VALUE ADDED STATEMENTS

Following are the basic assumptions which are used for computation of value added income through the preparation of value added statements.

1. VAS is a supplement, not a substitute to P&L account.

2. The same data which is recorded and processed by the conventional accounting system is used in the preparation of VAS.

3. The basic accounting concepts and principals of accounting remain the same in preparation of VAS.

It is convenient to prepare Value Added statements from conventional Profit & Loss account. However, there is a lot of difference between these two statements since the income statements contain certain non-value added items e.g. provisions, interests, non-trading profit and losses, etc.

4.3 OBJECTIVES OF VALUE-ADDED STATEMENTS

The main objectives of preparing Value Added Statements are:

1. To indicate the value or wealth created by an enterprise. In a way it shows the wealth creating ability of the organization.

2. To show the manner in which the wealth created is distributed amongst the employees, shareholders and the government. The pattern of distribution of value added can be clearly understood.

3. To indicate the organizations contribution to national income.

4. To use it as a basis of making inter-firm and intra-firm analysis, for preparation of financial plans and targets, for developing productivity linked incentive schemes.

Value Added Statements v/s Profit & Loss Account

The traditional Profit & Loss Account is prepared on the theory that the company was created by its shareholders and exists for their benefit. However, the traditional accounting system shows only the profits or losses made by a business enterprise and do not provide any information showing the extent to which the wealth is created by a business unit in a given period. The newly developed accounting method of value added is aiming to add a new dimension to the existing system of corporate financial accounting and reporting through the disclosure of additional information regarding the amount of wealth an entity has created in an accounting period and how it has been divided up by the entity amongst those who have contributed to its creation.

The statement of value added conceives the company as corporate entity in which those who provide capital and those who provide labour cooperate to create wealth which they share amongst themselves and with the government. When the value added statement is prepared, then the company is viewed as a `wealth' producing entity of a number of groups which are known as stock holders. The value added statement shows the wealth obtained by its employees, government, providers of capital or business itself during a period of time and the manner in which the generated value is distributed among the employees, government and the providers of capital. It shows the companies contribution to the national income.

The value added statement is not a substitute, but a supplement to the Profit & Loss Account although it is based on the figures from the latter. The value added statement is essentially a much simpler statement than the profit statement. The Profit & Loss Account is prepared on the basis of double entry system and its preparation is statutorily compulsory, but the value added statement is not prepared in the statutory account.

4.3.1 Advantages of Value Added Statements

The following are some of the advantages of Value Added Statements:

1. Reporting on VA improves the attitude of employees towards their employing companies. This is because the VA statement reflects a broader view of the companies objectives and responsibilities

2. VA statement makes it easier for the company to introduce a productivity linked bonus scheme for employees based on VA. The employees may be given productivity bonus on the basis of VA/payroll ratio

3. VA based (e.g. VA/Payroll, taxation/VA, VA/sales, etc.) are useful diagnostic and predictive tools. Trends in VA ratios comparisons with other companies and international comparisons may be useful.

4. VA provides a very good measure of the size and importance of a company. To use sales figures or capital employed figures as a basis for company ranking can cause distortion. This is because sales may be inflated by large bought-in expenses or a capital intensive company with a few employees may appear to be more important than a highly skilled labour intensive company

5. VA statement links a company's financial accounts to national income. A company's VA indicates the company's contribution to national income.

6. Finally VA statement is built on the basic conceptual foundation which is currently accepted in balance sheet and income statements. Concepts such as going concern, matching, consistency and substance over form are equally applicable to the VA statement.

4.3.2 Criticisms and Limitations of Value Added Statements

It is argued that although the Value Added statements shows the application of VA to several interest groups (like employees, government, shareholders, etc.), the risk associated with the company is only borne by the shareholders. In other words, employees, government and outside financers are only interested in getting their share in VA, but, when the company is in trouble the entire risk associated there in is borne only by shareholders. Therefore, the concept of showing value added as applied to several interested groups is being questioned by many academics. They advocated that since the shareholders are ultimate risk takers, the residual profit remaining after meeting the obligation of outside interest group should only be shown as value added accruing to the shareholders. However, academics have also admitted that from over-all point of view value added statement may be shown as supplementary statement of financial information. But in no case can the VA statement substitute the traditional income statement (i.e. Profit and loss account).

Another contemporary criticism of VA statement is that such statements are non-standardized. However, this practice of non- standardization can be effectively eliminated by bringing out an accounting standard on value added. Therefore, this criticism is a temporary phenomenon.

Thus, along with the advantages, the value added statements embody certain limitations also. These limitations are as follows:

1. Preparation and presentation of value added statement may lead to information overload and confusion, as an ordinary employee reading his company's corporate annual report may not be able to reconcile the value added statement with the earnings statement.

2. Another limitation of Value added statement is that it raises a danger that management may take the maximization of value added as their goal i.e. the inclusion of the value added may wrongly lead management to pursue maximization of firms value.

3. Another argument against a value added statement is that its inclusion in the corporate annual report would involve extra work, therefore, extra costs and delay and also a slight loss of confidentiality in view of the additional disclosure involved.

4. The most severe limitation of value added data emerges from lack of any uniformity and consistency amongst different companies in the preparation and presentation of Value Added statements. VAS is flagrantly standardized.

5. Since there are various methods of calculating VA, it is difficult to make inter-firm comparisons. Even intra-firm comparison is not possible if the treatment of these items is changed in the subsequent years.

6. Value Added statements may lead to confusion especially in the cases where wealth or value added is increasing while earnings are decreasing.

In spite of these limitations, it may be said that the value added statement brings about certain changes in emphasis rather than change in the content in the traditional financial statement. Thus it is considered as a valuable means of social disclosure.

Definition of the term Gross/Net Value Added

What is Value Added?:

The term value added may be simply defined as a positive difference between the value of goods or services produced (i.e. the value of output) and the value of services purchased (i.e. the value of inputs) from other firms in producing output. In equation form it can be stated as follows:

Value Added (VA) = Value of Output (VO) - Value of Inputs (VI)

The Value Added may be classified into two categories: Gross value added (GVA) and Net value added (NVA).

a) Gross Value Added (GVA): The GVA refers to sales plus income from other services less bought-in- materials and services purchased from outside suppliers; and

b) Net Value Added (NVA): The NVA refers to the difference between GVA and Depreciation. In other words, NVA is the sum of the value added to employees, to providers of loan capital, to Government and to owners.

Check your progress

1.What is Value Added Accounting?

2. Write the objectives of Value Added Statements.

3.Discuss the Importance and criticism of Value Added Statements.

UNIT - V

FINANCIAL SHENANIGANS

5.0 INTRODUCTION

Financial shenanigans are actions taken by management that mislead investors about a company's financial performance or economic health. As a result, investors are often tricked into believing that a company's earnings are stronger, its cash flows more robust, and its Balance Sheet position more secure than are really the case.

Some shenanigans can be detected in the numbers presented by carefully reading a company's Balance Sheet, Statement of Income, and Statement of Cash Flows. Proof of other shenanigans might not be explicitly provided in the numbers and therefore requires scrutinizing the narratives contained in footnotes, quarterly earnings releases, and other publicly available representation by management. The book classifies financial shenanigans into three broad categories: Earnings Manipulation Shenanigans, Cash Flow Shenanigans, and Key Metrics Shenanigans.

Financial shenanigans may also include taking independent fraudulent actions, creating fraudulent entities, or building Ponzi Schemes. In almost every instance, the revelation that a company's performance has been due to financial shenanigans will have a calamitous effect on its stock price, future prospects, and potentially management. Depending on the scope of the shenanigans, the repercussions may include a steep sell-off in the stock, bankruptcy, dissolution, shareholder lawsuits, or possibly jail time for those involved.

5.1 FINANCIAL SHENANIGANS EXPLAINED

Financial shenanigans can be broadly classified into a few different types:

1. Schemes that manipulate financial reporting through aggressive, creative, or fraudulent methods.

2. Entities that are based on fraudulent founding or work as a front for fraudulent activities.

3. Independent scammers or fraudulent groups that seek to steal financial information such as credit cards or account numbers

There are a multitude of ways individuals and entities can be involved in financial shenanigans. Manipulating financials to gain an advantage over competitors, obtain better capital rates, or improve the performance of management are often top motivations in creative corporate reporting schemes. This has played out throughout history with many companies making headlines and receiving penalties for the manipulation of their financials. Some of the most well-known cases have included Enron, WorldCom, Lehman Brothers, and the Bernie Madoff Scandal.

5.1.1 THE SEVEN SHENANIGANS

Shenanigan No 1: Recording revenue too soon or of questionable quality - "front-end load". Note that revenue should be recorded after the earnings process has been completed and an exchange has occurred.

Six techniques:

Recording revenue when future services remain to be provided.

Recording revenue before shipment or before the customer's unconditional acceptance. Recording revenue even though the customer is not obligated to pay.

Selling to an affiliated party.

Giving the customer something of value as a quid pro quo. Grossing up revenue.

Shenanigan No 2: Recording bogus revenue

Five techniques for creating fictitious revenue: Recording sales that lack economic substance.

Recording cash received in lending transactions as revenue. Recording investment income as revenue.

Recording supplier rebates tied to future required purchases as revenue.

Releasing revenue that was improperly held back before a merger.

Shenanigan No 3: Boosting Income with one-time gains.

Four easy-to-use techniques:

Boosting profits by selling undervalued assets. Including investment income or gains as part of revenue

Reporting investment income or gains as a reduction in operating expenses Creating income by reclassification of balance sheet accounts.

Shenanigan No 4: Shifting current expenses to a later or earlier period Five techniques to boost profit by excluding expenses:

Capitalizing normal operating costs.

Changing accounting policies and shifting current expenses to an earlier period. Amortizing costs too slowly.

Failing to write down or write off impaired assets. Reducing asset reserves.

Shenanigan No 5. Failing to record or improperly reducing liabilities Five techniques:

Failing to record expenses and related liabilities when future obligations remain. Reducing liabilities by changing accounting assumptions.

Releasing questionable reserves into income.

Creating sham rebates.

Recording revenue when cash is received, even though future obligations remain.

Shenanigan No 6: Shifting current revenue to a later period when the need for them is greater Two techniques:

Creating reserves and releasing them into income in a later period - income smoothing. Improperly holding back revenue just before an acquisition closes to benefit the acquirer.

Shenanigan No 7: Shifting future expenses to the current period as a special charge Three techniques:

Improperly inflating the amount included in a special charge. Improperly writing off in-process R&D costs from an acquisition. Accelerating discretionary expenses into the current period.

Example:

WorldCom: Most Brazen Creation of Fictitious Profit and Cash Flow (financial shenanigans) WorldCom consistently used aggressive accounting practices to inflate its earnings and operating cash flows. One of its principal shenanigans involved making acquisitions, writing off much of the costs immediately, creating reserves, and then releasing those reserves into income as needed. With more than 70 deals over the company's short life, WorldCom continued to reload its reserves so that they were available for future release into earnings.

This shenanigan would probably have been able to continue had WorldCom been allowed to acquire the much larger Sprint in a $129 billion deal announced in October 1999. Antitrust lawyers and regulators at the U.S. Department of Justice and their counterparts at the European Union disapproved of the merger, citing monopoly concerns. Without the acquisition, WorldCom lost the expected infusion of new reserves that it needed, as its prior ones had rapidly been depleted by being released into income.

By early 2000, with its stock price declining and intense pressure from Wall Street to make its numbers, WorldCom embarked on a new and far more aggressive shenanigan-moving ordinary business expenses from its Income Statement to its Balance Sheet. One of WorldCom's major operating expenses was its so- called line costs. These costs represented fees that WorldCom paid to third party telecommunication network providers for the right to lease their networks. Accounting rules clearly require that such fees be expensed and not be capitalized. This trick continued quarter after quarter from mid-2000 through early 2002 until it was uncovered by internal auditors at WorldCom. The company's CFO was immediately fired as internal auditors found $3.8bn in inappropriate accounting entries.

On July 21, 2002, the company filed for Chapter 11 bankruptcy protection, the largest such filing in U.S. history at that time (a record that has since been overtaken by the collapse of Lehman Brothers in September 2008). Under the bankruptcy reorganization agreement, the company paid a $750 million fine to the SEC and restated its earnings in an amount that defies belief. In total, the company reported an accounting restatement that exceeded $70 billion, including adjusting the 2000 and 2001 numbers from the originally reported gain of nearly $10 billion to an astounding loss of over $64 billion. The directors also felt the pain, having to pay almost $25 million to settle class-action litigation.

Investors would have found some clear warning signs in evaluating WorldCom's Statement of Cash Flows (SCF), specifically, its rapidly deteriorating free cash flow. WorldCom manipulated both its net earnings and its operating cash flow.

By treating line costs as an asset instead of an expense, WorldCom improperly inflate its profits. In addition, since it improperly placed those expenditures in the Investing rather than the Operating section of the SCF, WorldCom similarly inflated operating cash flow. While reported operating cash flow appeared consistent with reported earnings, the company's free cash flow told the story.

Check your progress

1.What are Financial Shenanigans?

2. Explain the types of Shenanigans.

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