

FINANCIAL ACCOUNTING AND ANALYSIS

UNIT – I

ORIGIN AND GROWTH OF ACCOUNTING

The history of accounting or accountancy is thousands of years old and can be traced to ancient civilizations. The early development of accounting dates back to ancient Mesopotamia, and is closely related to developments in writing, counting and money.

It is believed that in India Chanakya created a work similar to a financial management book, during the period of the Maurya Empire. His book "Arthashastra" contains few detailed aspects of maintaining books of accounts for a Sovereign State.

The Italian Luca Pacioli, recognized as The Father of accounting and book-keeping was the first person to publish a work on double-entry bookkeeping, which then developed in medieval Europe. Luca Pacioli's 27-page treatise on bookkeeping, "Particularis de Computis et Scripturis" (Latin: "Details of Calculation and Recording") was first printed and published in Venice in 1494.

The development of joint-stock companies (especially from about 1600) built wider audiences for accounting information, as investors without firsthand knowledge of their operations relied on accounts to provide the requisite information. This development resulted in a split of accounting systems for internal (i.e. management accounting) and external (i.e. financial accounting) purposes, and subsequently also in accounting and disclosure regulations and a growing need for independent attestation of external accounts by auditors.

Accounting began to transition into an organized profession in the nineteenth century. Thus, the art of accounting has been practiced for centuries but it is only in the late 19 thirties that the study of the subject 'Accounting' has been taken up seriously.

MEANING AND DEFINITION OF ACCOUNTING

The American Institute of Certified Public Accountants (AICPA), which has played a noble part in the development of Accounting, defines the concept "Accounting" as follows: "Accounting is the art of recording, 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 American accounting association (AAA), the accounting organization consisting of largely accounting educators defines accounting as: "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of information."

Taylor and Shearing: "Accounting may be defined as the art and science of recording business transactions in a methodological manner so as to show: (a) the true state of affairs of a business of a particular period of time and, (b) the surplus or deficiency which has accrued during a specific period."

Once, we break the above definitions for better understanding, we find the term 'Accounting' contains the following components:

FEATURES/ CHARACTERISTICS OF ACCOUNTING

- **Recording:** Recording is the basic function of Accounting. Events and transactions, which are of financial character, either fully or partly, are recorded in an orderly manner in books of accounts. The transactions are recorded in a journal, as and when they happen or occur.
- **Classifying:** It is concerned with the systematic analysis of the recorded data so as to accumulate the transactions of similar type at one place. This function is performed by maintaining the ledger in which different accounts are opened to which related transactions are posted.
- **Summarising:** When posting is complete in the ledger, totals are made for debit and credit side in each head of account and final balance (heavier balance), be it debit or credit is arrived. The individual accounts find a place in a summarised manner, which is called 'Trial Balance'. Income statement (Trading and Profit and Loss account) and Balance Sheet are prepared from the Trial Balance.
- **Deals with Financial Transactions:** Accounting transactions, which are of financial character only, are recorded in books of accounts. In other words, if a transaction cannot be expressed in terms of money, they are not recorded in accounting books.
- **Analysis and Interpretation:** Analysis refers to methodical classification of data. And interpretation means drawing conclusions from the data and explaining the conclusions in a simple language, easy to understand and plan further course of action. Analysis and interpretation are complementary to each other. Interpretation is not possible without analysis. Analysis is of no use unless followed by interpretation.
- **Communication:** Communication is the final product of accounting. Financial statements such as Profit and Loss account and Balance Sheet are the means of communication. Financial Statements are vital as they are public documents, available for everyone to read, if the firm is a joint stock company. Accounting reports, normally in the form of accounting ratios, graphs, diagrams, funds flow statement are the additional information, which are made available to management for decision making. Modern management wants the data in a simple form, easy to understand and ready to act, immediately.

OBJECTIVES OF ACCOUNTING

Objective of accounting may differ from business to business depending upon their specific requirements. However, the following are the general objectives of accounting.

- **To keeping systematic record:** It is very difficult to remember all the business transactions that take place. Accounting serves this purpose of record keeping by promptly recording all the business transactions in the books of account.
- **To ascertain the results of the operation:** Accounting helps in ascertaining result i.e., profit earned or loss suffered in business during a particular period. For this purpose, a business entity prepares either a Trading and Profit and Loss account or an Income and Expenditure account which shows the profit or loss of the business by matching the items of revenue and expenditure of the same period.
- **To ascertain the financial position of the business:** In addition to profit, a businessman must know his financial position i.e., availability of cash, position of assets and liabilities etc. This helps the businessman to know his financial strength. Financial statements are barometers of health of a business entity.
- **To portray the liquidity position:** Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, cash dividends and other distributions of resources by the enterprise to owners and about other factors that may affect an enterprise's liquidity and solvency.

- **To protect business properties:** Accounting provides up to date information about the various assets that the firm possesses and the liabilities the firm owes, so that nobody can claim a payment which is not due to him.
- **To facilitate rational decision – making:** Accounting records and financial statements provide financial information which help the business in making rational decisions about the steps to be taken in respect of various aspects of business.
- **To satisfy the requirements of law:** Entities such as companies, societies, public trusts are compulsorily required to maintain accounts as per the law governing their operations such as the Companies Act, Societies Act, and Public Trust Act etc. Maintenance of accounts is also compulsory under the Sales Tax Act and Income Tax Act.

FUNCTIONS OF ACCOUNTING:

- **Record Keeping:** Accounting is to maintain systematic and chronological record of financial transactions and to post them subsequently to the various Ledger Accounts and finally to prepare the Final Accounts to find out the profit or loss of the business at the end of the Accounting Period.
- **Ascertain the results of the operation:** Accounting helps in ascertaining result i.e., profit earned or loss suffered in business during a particular period. For this purpose, a business entity prepares either a Trading and Profit and Loss account or an Income and Expenditure account which shows the profit or loss of the business by matching the items of revenue and expenditure of the same period.
- **Ascertain the financial position of the business:** In addition to profit, a businessman must know his financial position i.e., availability of cash, position of assets and liabilities etc. This helps the businessman to know his financial strength. Financial statements are barometers of health of a business entity.
- **Protecting of Properties:** Accounting provides up to date information about the various assets that the firm possesses and the liabilities the firm owes, so that nobody can claim a payment which is not due to him. Accounting designs a desirable system to protect the properties and assets of the business from unauthorized and unwarranted use.
- **Communication of Results:** Accounting is always to communicate the results of the recorded and transactions to the different parties who are interested in the particular business, i.e., properties, investors, creditors, employees, Govt. official and researchers etc.
- **Managerial Function:** Decision making programme is greatly assisted by accounting. The managerial function and decision making programmes, without accounting, may mislead. The day-to-day operations are compared with some predetermined standard. The variations of actual operations with pre-determined standards and their analysis is possible only with the help of accounting.
- **Meeting Legal Requirements:** Auditing is compulsory in case of registered firms. Auditing is not possible without accounting. Thus accounting becomes compulsory to comply with legal requirements. Accounting is a base and with its help various returns, documents, statements etc., are prepared.

NATURE OF ACCOUNTING:

We know Accounting is the systematic recording of financial transactions and presentation of the related information of the appropriate persons. The following aspects comprise the nature of accounting:

- **Accounting is a process:** A process refers to the method of performing any specific job step by step according to the objectives, or target. Accounting is identified as a process as it performs the specific task of collecting, processing and communicating financial information. In doing so, it follows some definite steps like collection of data recording, classification summarization, finalization and reporting.
- **Accounting is an art:** Accounting is an art of recording, classifying, summarizing and finalizing the financial data. The word 'art' refers to the way of performing something. It is a behavioral knowledge involving certain creativity and skill that may help us to attain some specific objectives. Accounting is a systematic method consisting of definite techniques and its proper application requires applied skill and expertise. So, by nature accounting is an art.
- **Accounting is a science:** It is a science as accounts are prepared in accordance of with certain basic principles and laws, which are universally accepted. However, accounting is not a perfect science like Physics or Chemistry, where experiments can be conducted in a laboratory and specific conclusions are drawn. Some people have reservations to treat accountancy as science.
- **Accounting is means and not an end:** Accounting finds out the financial results and position of an entity and the same time, it communicates this information to its users. The users then take their own decisions on the basis of such information. So, it can be said that mere keeping of accounts can be the primary objective of any person or entity. On the other hand, the main objective may be identified as taking decisions on the basis of financial information supplied by accounting. Thus, accounting itself is not an objective, it helps attaining a specific objective. So it is said the accounting is 'a means to an end' and it is not 'an end in itself.'
- **Accounting is an information system:** Accounting is recognized and characterized as a storehouse of information. As a service function, it collects processes and communicates financial information of any entity. This discipline of knowledge has been evolved out to meet the need of financial information required by different interested groups.
- **Accounting is a service activity:** Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions, in making reasoned choices among alternative courses of action. It means that accounting collects financial information for the various users for taking decisions and tackling business issues. Accounting in itself cannot create wealth though, if it produces information which is useful to others, it may assist in wealth creation and maintenance.
- **Accounting is a profession:** A profession is a career that involves the acquiring of a specialised formal education before rendering any service. The accounting education is being imparted to the examinees by national and international recognised the bodies like The Institute of Chartered Accountants of India (ICAI), New Delhi in India and American Institute of Certified Public Accountants (AICPA) in USA etc. In a way, accountancy as a profession has attained the stature comparable with that of lawyer, medicine or architecture.

NEED FOR ACCOUNTING:

We need accounting because it's the only way for business to grow and flourish. Accounting is the backbone of the business financial world. After all, accounting was created in response to the development of trade and commerce during the medieval times. Accounting as an organized method for record-keeping has been around almost as long as the trade and business industries. The need for accounting arises because of the followings:

Need to earn profit and remain solvent: Every business needs to have two prime objectives, such as, to earn profit and to remain solvent and the information in relation to these objectives while ensuring whether they are being accomplished is provided by accounting.

Need to be accountable: Businesses need to be held accountable for the methods they use to run a business because the potential for greed, theft, and dishonesty exist in every business. There are specialized areas of accounting, that when correctly enforced, eliminate the possibility for fraud.

Need to maintain complete records: Accounting is important in the sense that it enables a business house to maintain complete and orderly prepared records of economic events by way of preparing books while facilitating the information for various purposes.

Need to ascertain the net results in terms of profit or loss: Furthermore accounting helps to ascertain the net results in terms of profit or loss (Income Statement) and providing the information about financial position of the business (Balance Sheet) to the owners of a business relating to what the entity owns in the form of assets and what it owes in the form of liabilities at a particular point of time.

Need to provide the information to all the stakeholders: Accounting information is valuable to the concerned managers too so as to ensure whether the business entity is being directed as it should be, and simultaneously it is a means to provide the information to the investors to find out the future prospects of business. It is also useful for the employees and customers in order to know the condition of the business entity.

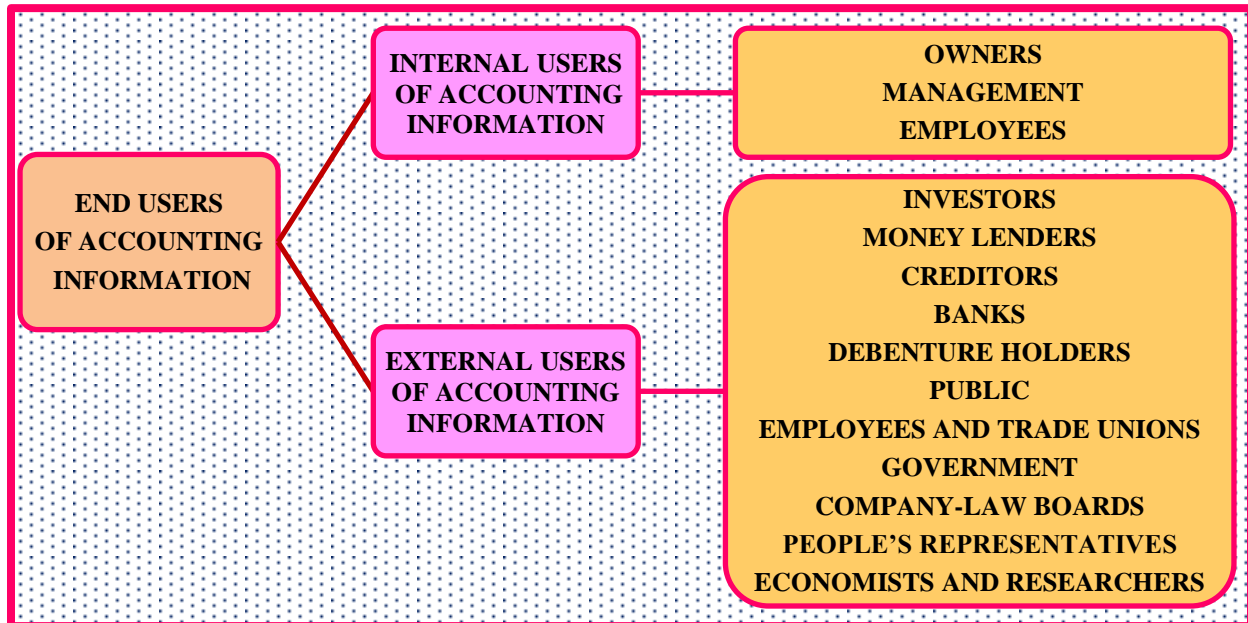
Need to assist the management: Accounting is the basis and of a great assistance to management for planning, controlling and decision making process. It is with the help of accounting information that the performance of an entity can be appraised, at the same time as, its methodical records make possible to eliminate the frauds and the thefts.

Need to ascertain the effectiveness and efficiency of a business: Moreover, being concerned primarily with the creation of financial information for its users, accounting provides useful information for ascertaining the effectiveness and efficiency of a business. Hence, accounting is must for every business. Exclusive of accounting leads to create chaos and discrepancies in business transactions.

Accounting is the conscious of the business world. When handled with care and with respect, it performs as expected. When abuse occurs, and the system is circumvented or overridden because of dishonesty and greed, it doesn't work correctly. Accounting is much like all other systems in place, they are only as good as the people using them.

END USERS OF ACCOUNTING INFORMATION

The basic objective of accounting is to provide information which is useful for persons inside the organisation and for persons or groups outside the organisation. Accounting is the discipline that provides information on which external and internal users of the information may base decisions that result in the allocation of economic resources in society.



I. Internal Users of Accounting Information: Internal users of accounting information are those persons or groups which are within the organization. Following are such internal users:

- **Owners:** The owners provide funds for the operations of a business and they want to know whether their funds are being properly used or not. They need accounting information to know the profitability and the financial position of the concern in which they have invested their funds. The financial statements prepared from time to time from accounting records depict them the profitability and the financial position.
- **Management:** Management is the art of getting work done through others; the management should ensure that the subordinates are doing work properly. The most important functions of management are planning and controlling. Preparation of various budgets, such as sales budget, production budget, cash budget, capital expenditure budget etc., is an important part of planning function. Controlling is the function of seeing those programs laid down in various budgets are being actually achieved i.e. actual performance ascertained from accounting is compared with the budgeted performance, enabling the manager to exercise controlling case of weak performance. Accounting information is also helpful to the management in fixing reasonable selling prices.
- **Employees:** Employees are interested in the financial position of a concern they serve particularly when payment of bonus depends upon the size of the profits earned. They seek accounting information to know that the bonus being paid to them is correct.

II. External Users of Accounting Information: External users are those groups or persons who are outside the organization for whom accounting function is performed. Following can be the various external users of accounting information:

- **Investors:** Those who are interested in investing money in an organization are interested in knowing the financial health of the organization of know how safe the investment already made is and how safe their proposed investment will be. To know the financial health, they need accounting information which will help them in evaluating the past performance and future prospects of the organization.
- **Money Lenders:** These persons want to know the stability of the business, interest-paying capacity of the business and also its ability to repay the principal amount of their loan. These they can know from various financial statement s prepared by the accountant.
- **Creditors:** Creditors would always like to gather definite information regarding the financial fluidity of the business before granting any credit. The financial positions of any business can be known from the various published accounts.
- **Banks:** Whenever any Bank becomes interested to work for any business unit, especially to grant overdrafts, it is essential for it to be sure beforehand regarding the financial soundness of the business. Banks can know this from the final accounts and other information given by the accountant.
- **Debenture Holders:** Like the investors, the Debenture holders also would be very keen to inquire about the financial solvency and soundness of the business. They would also be eager to have regular returns on their investments in debentures. These can be aware of from the various published accounts and reports.
- **Public:** The interested common men can also have some knowledge about the value of shares, debentures etc. and also about the financial strength of the concern from the accounts and allied information.
- **Employees and Trade Unions:** In the interest of their movements, employees' organizations and trade-unions should be always aware of the financial position of the industry and the organization in particular. Their purpose is well augmented by the information given by the accountant.
- **Government:** The Central, state and sometimes the Local Self Government want to have authoritative control over the industrial organizations and business units for the greater interest of the public. When or at what point of time and condition such restrictive measures should be imposed to serve the interest of the common people best, can be easily known from the information supplied by the accounts.
- **Company-Law Boards:** For framing various financial rules and for designing the special accounting techniques and rules for special statutory organizations constituted by special acts of the Legislature, the Company-Law Boards etc. and other authorities should be always well-informed regarding the accounts and other allied reports of business concerns.
- **People's Representatives:** Members of the Parliament and other Representatives of the people should know in minute's details the position of industrial and commercial development within the country. They can judge the situation from different angles with the help of the published accounts and reports and allied information.
- **Economists and Researchers:** The Economist and Researchers also need the help of various types of information supplied by the accounts augment their research-work and developmental thesis.

So, it may be concluded that accounting information are at present essential to almost all types of persons in the Society. Accounting is needed by all and its users are almost universal.

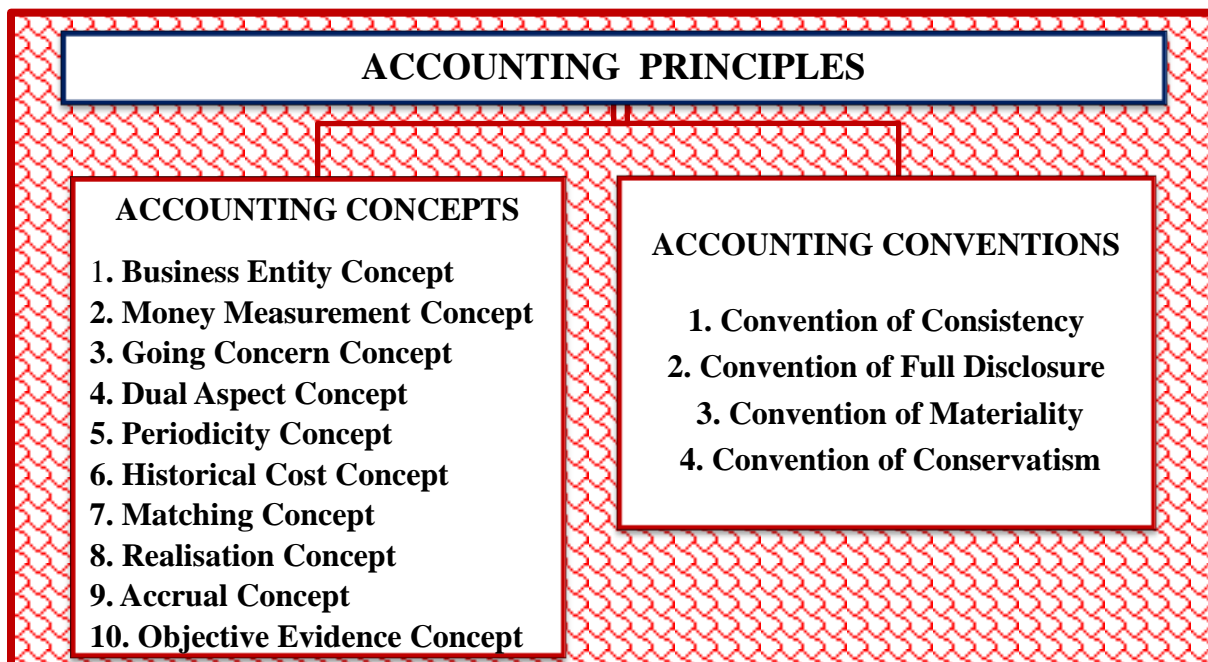
ACCOUNTING PRINCIPLES

In order to maintain uniformity and consistency in accounting records throughout the world, certain rules and principles have been developed which are generally accepted by the accounting profession. These rules/ principles are called by different names such as principles, concepts, conventions, postulates, assumptions. These principles have evolved over a long period of time on the basis of past experiences, usages or customs, etc. These principles are also referred as concepts and conventions.

ACCOUNTING CONCEPTS: The term ‘concept’ denotes accounting postulates, i.e., basic assumptions or conditions upon the edifice of which the accounting super-structure is based. The following are the common accounting concepts adopted by many business concerns.

Business Entity Concept: This concept assumes that for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate. For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as business expense. Thus, the accounting records are made in the books of accounts from the point of view of the business unit and not the person owning the business. This concept is the very basis of accounting.

Let us take an example. Suppose Mr. Sahoo started business investing Rs100000. He purchased goods for Rs40000, Furniture for Rs20000 and plant and machinery of Rs30000. Rs10000 remains in hand. These are the assets of the business and not of the owner. According to the business entity concept Rs100000 will be treated by business as capital i.e. a liability of business towards the owner of the business. Now suppose, he takes away Rs5000 cash or goods worth Rs5000 for his domestic purposes, this withdrawal of cash/goods by the owner from the business is his private expense and not an expense of the business. It is termed as Drawings. Thus, the business entity concept states that business and the owner are two separate/distinct persons.



Money Measurement Concept: Accounting records only those transactions which can be expressed in monetary terms. Money is considered as a common denominator, by means of which various facts, events and transactions about a business can be expressed in terms of numbers. 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 Rs.1,00,000 cash, Rs.5,00,000 worth of raw materials, Rs.10,00,000 worth of machinery items and Rs.30,00,000 worth of land and building – such an addition is possible. In other words, facts, events and transactions which cannot be expressed in monetary terms are not recorded in accounting. Hence, the accounting does not give a complete picture of all the transactions of a business unit. This concept does not also take care of the effects of inflation because it assumes a stable value for measuring.

Going Concern Concept: This concept assumes that the business enterprise will continue to operate for a fairly long period in the future. It is based on the premise that every business entity has continuity of life. Keeping this in view, the suppliers and other companies enter into business transactions with the business unit. It is to be noted that the ‘Going Concern Concept’ does not imply permanent continuation of the enterprise, indefinitely. It rather presumes that the enterprise will continue in operation long enough that the cost of the fixed assets would be charged over the usual lives of the assets. Moreover, the concept applies to the business, as a whole. Even if a branch or division of the business were closed, ability of the business to continue would not be affected.

Dual Aspect Concept: According to this basic concept of accounting, every transaction has a two-fold aspect that is giving certain benefits and receiving certain benefits. The basic principle of double entry system is that every debit has a corresponding and equal amount of credit. This is the underlying assumption of this concept. The accounting equation viz., $\text{Assets} = \text{Capital} + \text{Liabilities}$ or $\text{Capital} = \text{Assets} - \text{Liabilities}$, will further clarify this concept, i.e., at any point of time the total assets of the business unit are equal to its total liabilities. Liabilities here relate both to the outsiders and the owners. Liabilities to the owners are considered as capital.

Accounting Period Concept: All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept. Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. Usually one year is taken as one accounting period which may be a calendar year or a financial year. Calendar Year begins from 1st of January and ends on 31st of December and financial year begins from 1st of April and ends on 31st of March of the following year. As per accounting period concept, all the transactions are recorded in the books of accounts for a specified period of time. Hence, goods purchased and sold during the period, rent, salaries etc. paid for the period are accounted for and against that period only.

Accounting Cost Concept: According to this concept, the transactions are recorded in the books of account with the respective amounts involved. For example, if an asset is purchased, it is entered in the accounting record at the price paid to acquire the same and that cost is considered to be the base for all future accounting. It means that the asset is recorded at cost at the time of purchase but it may be methodically reduced in its value by way of charging depreciation. However, in the light of inflationary conditions, the application of this concept is considered highly irrelevant for judging the financial position of the business.

Matching Concept: 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.

Realisation Concept: This concept states that revenue from any business transaction should be included in the accounting records only when it is realised. The term realisation means creation of legal right to receive money. Selling goods is realisation, receiving order is not. In other words, it can be said that: Revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both has been created.

Let us study the following examples:

(i) N.P. Jeweller received an order to supply gold ornaments worth Rs.500000. They supplied ornaments worth Rs.200000 up to the year ending 31st December 2005 and rest of the ornaments were supplied in January 2006.

(ii) Akshay sold goods on credit for Rs.50, 000 during the year ending 31st December 2005. The goods have been delivered in 2005 but the payment was received in March 2006.

Now, let us analyse the above examples to ascertain the correct amount of revenue realised for the year ending 31st December 2005.

(i) The revenue for the year 2005 for N.P. Jeweller is Rs.200000. Mere getting an order is not considered as revenue until the goods have been delivered.

(ii) Akshay's revenue for the year 2005 is Rs.50, 000, because the goods have been delivered to the customer in the year 2005. Revenue became due in the year 2005 itself.

In the above examples, revenue is realised when the goods are delivered to the customers. The concept of realisation states that revenue is realized at the time when goods or services are actually delivered. In short, the realisation occurs when the goods and services have been sold either for cash or on credit. It also refers to inflow of assets in the form of receivables.

Accrual Concept: The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognised when they become receivable. Though cash is received or not received and the expenses are recognised when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate. Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses. In brief, accrual concept requires that revenue is recognised when realised and expenses are recognised when they become due and payable without regard to the time of cash receipt or cash payment.

Verifiable and Objective Evidence Concept: This principle requires that each recorded business transactions in the books of accounts should have an adequate evidence to support it. For example, cash receipt or vouchers or bills for payments made. The documentary evidence of transactions should be free from any bias. As accounting records are based on documentary evidence which is capable of verification, it is universally acceptable.

ACCOUNTING CONVENTIONS: An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity. They are followed like customs, tradition, etc. in a society. Accounting conventions are evolved through the regular and consistent practice over the years to facilitate uniform recording in the books of accounts. Accounting Conventions help in comparing accounting data of different business units or of the same unit for different periods. These have been developed over the years. The most important conventions which have been used for a long period are:

Convention of consistency: The convention of consistency means that same accounting principles should be used for preparing financial statements year after year. A meaningful conclusion can be drawn from financial statements of the same enterprise when there is comparison between them over a period of time. But this can be possible only when accounting policies and practices followed by the enterprise are uniform and consistent over a period of time. If different accounting procedures and practices are used for preparing financial statements of different years, then the result will not be comparable. For example, if stock is valued at 'cost or market price whichever is less', this principle should be applied in each subsequent year.

Convention of Full Disclosure: Convention of full disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information. Adequate means sufficient set of information to be disclosed. Fair indicates an equitable treatment of users. Full refers to complete and detailed presentation of information. Thus, the convention of full disclosure suggests that every financial statement should fully disclose all relevant information.

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 individual accountant. Further an item should be regarded as material if there is reason to believe that knowledge of it would influence the decision of informed investor. 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.

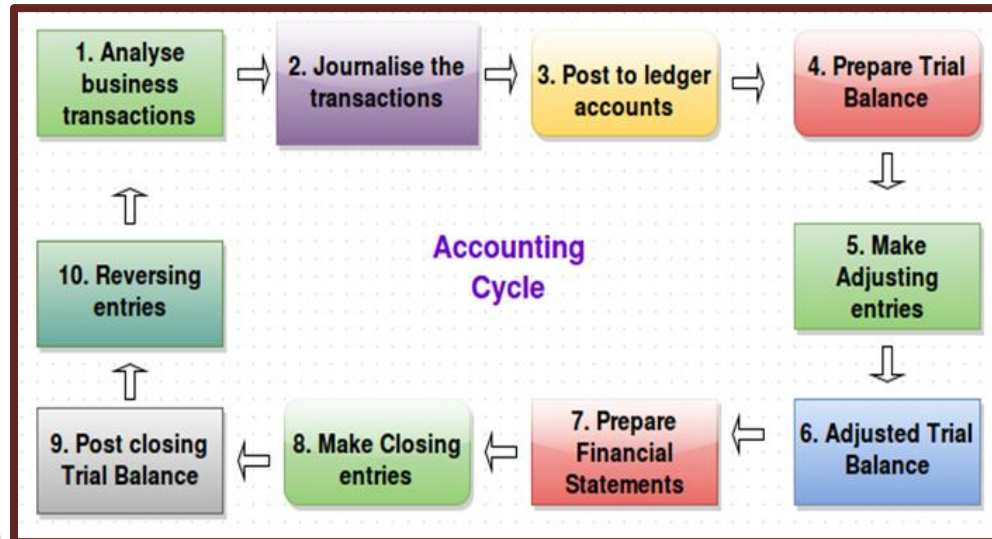
Convention of Conservatism: This convention is based on the principle that "Anticipate no profit, but provide for all possible losses". It is based on the policy of playing safe in regard to showing profit. The main objective of this convention is to show minimum profit. Profit should not be overstated. This convention clearly states that profit should not be recorded until it is realised. But if the business anticipates any loss in the near future, provision should be made in the books of accounts for the same. For example, creating provision for doubtful debts, discount on debtors etc. The convention of conservatism is a very useful tool in situation of uncertainty and doubts.

ACCOUNTING CYCLE/PROCESS

Accounting cycle is the financial process starting with identifying the business transactions and leading up to the preparation of financial statements. This process demonstrates the purpose of financial accounting--to create useful financial information in the form of general-purpose financial statements. In other words, the sole purpose of recording transactions and keeping track of expenses and revenues is turn this data into meaning financial information by presenting it in the form of a balance sheet, income statement, statement of owner's equity, and statement of cash flows.

The accounting cycle is a set of steps that are repeated in the same order every period. The culmination of these steps is the preparation of financial statements. Some companies prepare financial statements on a quarterly basis whereas other companies prepare them annually. This means that quarterly companies complete one entire accounting cycle every three months while annual companies only complete one accounting cycle per year.

Accounting Cycle Diagram



Accounting Cycle Steps:

1. Identifying and Analyzing Business Transactions: The accounting process starts with identifying and analyzing business transactions and events. Not all transactions and events are entered into the accounting system. Only those that pertain to the business entity are included in the process. For example, a personal loan made by the owner that does not have anything to do with the business entity is not accounted for. The transactions identified are then analyzed to determine the accounts affected and the amounts to be recorded. The first step includes the preparation of business documents, or source documents. A business document serves as basis for recording a transaction.

2. Recording in the Journals: A journal is a book – paper or electronic – in which transactions are recorded. Business transactions are recorded using the double-entry bookkeeping system. They are recorded in journal entries containing at least two accounts (one debited and one credited).

To simplify the recording process, special journals are often used for transactions that recur frequently such as sales, purchases, cash receipts, and cash disbursements. A general journal is used to record those that cannot be entered in the special books. Transactions are recorded in chronological order and as they occur. Journals are also known as Books of Original Entry.

3. Posting to the Ledger: Also known as Books of Final Entry, the ledger is a collection of accounts that shows the changes made to each account as a result of past transactions, and their current balances. After the posting all transactions to the ledger, the balances of each account can now be determined. For example, all journal entry debits and credits made to Cash would be transferred into the Cash account in the ledger. We will be able to calculate the increases and decreases in cash; thus, the ending balance of Cash can be determined.

4. Unadjusted Trial Balance: A trial balance is prepared to test the equality of the debits and credits. All account balances are extracted from the ledger and arranged in one report. Afterwards, all debit balances are added. All credit balances are also added. Total debits should be equal to total credits. When errors are discovered, correcting entries are made to rectify them or reverse their effect. Take note however that the

purpose of a trial balance is only test the equality of total debits and total credits and not to determine the correctness of accounting records. Some errors could exist even if debits are equal to credits, such as double posting or failure to record a transaction.

5. Adjusting Entries: Adjusting entries are prepared as an application of the accrual basis of accounting. At the end of the accounting period, some expenses may have been incurred but not yet recorded in the journals. Some income may have been earned but not entered in the books.

Adjusting entries are prepared to update the accounts before they are summarized in the financial statements. Adjusting entries are made for accrual of income, accrual of expenses, deferrals (income method or liability method), prepayments (asset method or expense method), depreciation, and allowances.

6. Adjusted Trial Balance: An adjusted trial balance may be prepared after adjusting entries are made and before the financial statements are prepared. This is to test if the debits are equal to credits after adjusting entries are made.

7. Financial Statements: When the accounts are already up-to-date and equality between the debits and credits has been tested, the financial statements can now be prepared. The financial statements are the end-products of an accounting system. A complete set of financial statements is made up of: (1) Statement of Comprehensive Income (Income Statement and Other Comprehensive Income), (2) Statement of Changes in Equity, (3) Statement of Financial Position or Balance Sheet, (4) Statement of Cash Flows, and (5) Notes to Financial Statements.

8. Closing Entries: Temporary or nominal accounts, i.e. income statement accounts, are closed to prepare the system for the next accounting period. Temporary accounts include income, expense, and withdrawal accounts. These items are measured periodically. The accounts are closed to a summary account (usually, Income Summary) and then closed further to the appropriate capital account. Take note that closing entries are made only for temporary accounts. Real or permanent accounts, i.e. balance sheet accounts, are not closed.

9. Post-Closing Trial Balance: In the accounting cycle, the last step is to prepare a post-closing trial balance. It is prepared to test the equality of debits and credits after closing entries are made. Since temporary accounts are already closed at this point, the post-closing trial balance contains real accounts only.

10. Reversing Entries: Reversing entries are optional. They are prepared at the beginning of the new accounting period to facilitate a smoother and more consistent recording process. In this step, the adjusting entries made for accrual of income, accrual of expenses, deferrals under the income method, and prepayments under the expense method are simply reversed.

BASIC ACCOUNTING EQUATION

The accounting equation, also called the basic accounting equation, forms the foundation for all accounting systems. In fact, the entire double entry accounting concept is based on the basic accounting equation. This simple equation illustrates two facts about a company: what it owns and what it owes.

The accounting equation equates a company's assets to its liabilities and equity. Here is the basic accounting equation.

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

(Or)

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

(Or)

$$\text{Liabilities} = \text{Assets} - \text{Capital}.$$

Assets are always equal to the sum of liabilities and owner's equity. This makes sense when you think about it because liabilities and equity are essentially just sources of funding for companies to purchase assets. The equation is generally written with liabilities appearing before owner's equity because creditors usually have to be repaid before investors in a bankruptcy. In this sense, the liabilities are considered more current than the equity. This is consistent with financial reporting where current assets and liabilities are always reported before long-term assets and liabilities.

This equation holds true for all business activities and transactions. Assets will always equal liabilities and owner's equity. If assets increase, either liabilities or owner's equity must increase to balance out the equation. The opposite is true if liabilities or equity increase. Now that we have a basic understanding of the equation, let's take a look at each accounting equation component starting with the assets.

Assets: An asset is a resource that is owned or controlled by the company to be used for future benefits. Some assets are tangible like cash while others are theoretical or intangible like goodwill or copyrights. Another common asset is a receivable. This is a promise to be paid from another party. Receivables arise when a company provides a service or sells a product to someone on credit. All of these assets are resources that a company can use for future benefits.

Liabilities: A liability is an amount of money owed to another person or organization. Said a different way, liabilities are creditors' claims on company assets because this is the amount of assets creditors would own if the company liquidated. A common form of liability is a payable. Payables are the opposite of receivables. When a company purchases goods or services from other companies on credit, a payable is recorded to show that the company promises to pay the other companies for their assets.

Equity: Equity represents the portion of company assets that shareholders or partners own. In other words, the shareholders or partners own the remainder of assets once all of the liabilities are paid off. Owners can increase their ownership share by contributing money to the company or decrease equity by withdrawing company funds. Likewise, revenues increase equity while expenses decrease equity.

Nature of GAAP

The phrase "Generally Accepted Accounting Principles" (or "GAAP") consists of three important sets of rules: (1) The basic Accounting Principles and Guidelines, (2) The Detailed Rules and Standards issued by FASB (Financial Accounting Standards Board) and its Predecessor the Accounting Principles Board (APB), and (3) The Generally Accepted Industry Practices.

Generally Accepted Accounting Principles (GAAP) is a framework of accounting standards, rules and procedures defined by the professional accounting industry, which has been adopted by nearly all publicly traded U.S. companies. These are the overriding accounting principles, standards, and procedures that companies follow when compiling their financial statements. The term is confined to the US and is, therefore, generally abbreviated as US GAAP. But theoretically, the term "GAAP" covers the entire accounting industry, rather than only the US. GAAP covers a broad array of topics, including:

- Financial statement presentation
- Assets
- Liabilities
- Equity
- Revenue
- Expenses
- Business combinations
- Derivatives and hedging
- Fair value
- Foreign currency
- Leases
- Nonmonetary transactions
- Subsequent events
- Industry-specific accounting, such as airlines, extractive activities, and health care

GAAP are imposed on companies so that investors have a minimum level of consistency in the financial statements they use when analyzing companies for investment purposes. GAAP is exceedingly useful because it attempts to standardize and regulate accounting definitions, assumptions, and methods. Because of generally accepted accounting principles we are able to assume that there is consistency from year to year in the methods used to prepare a company's financial statements. And although variations may exist, we can make reasonably confident conclusions when comparing one company to another, or comparing one company's financial statistics to the statistics for its industry. Over the years the generally accepted accounting principles have become more complex because financial transactions have become more complex.

ACCOUNTING STANDARDS

An accounting standard is a guideline for financial accounting, such as how a firm prepares and presents its business income and expense, assets and liabilities. The accounting concepts and conventions are the core elements in the theory of accounting. These principles, however, permit a variety of alternative practices to co-exist. On account of this the financial results of different companies cannot be compared and evaluated unless full information is available about the accounting methods which have been used. The lack of uniformity among accounting practices have made it difficult to compare the financial results of different companies. It means that there should not be too much discretion to companies and their accountants to present financial information the way they like. In other words, the information contained in financial statements should conform to carefully considered standards.

Accounting standards can be seen as providing an important mechanism to help in the resolution of potential financial conflicts of interest between the various important groups in society. It is essential that accounting standards should command the greatest possible credibility among shareholders, creditors, employee and public at large.

NEED FOR ACCOUNTING STANDARDS:

- + Provide a basic framework for preparing financial statements to be uniformly followed by all business enterprises,
- + Make the financial statements of one firm comparable with the other firm and the financial statements of one period with the financial statements of another period of the same firm,
- + Make the financial statements credible and reliable
- + Create general sense of confidence among the outside users of financial statements
- + Enable the investors make decisions based on published accounting which are based on uniform accounting policies
- + Render accounts of MNCs for the countries in which their shareholders reside and in local country in which they operate; thereby avoiding confusion

The International Accounting Standards Committee (IASC) was established in 1973, The IASC has undertaken the task of drawing up the standards. It has its headquarters at London. At present, the IASC has two classes of membership:

- (a) Founder members, being the professional accounting bodies of the following nine countries: Australia, Mexico, Canada, Netherlands, France, U.K., Germany, U.S.A. and Japan
- (b) Members being accounting bodies from countries other than the nine above which seek and are granted membership.

The International Accounting Standards Board (IASB) replaced the IASC in 2001. Standards that were issued by IASC (the predecessor of IASB) and are still within use today go by the name International Accounting Standards (IAS), while standards issued by IASB are called IFRS.

IFRS (*International Financial Reporting Standards*)

International Financial Reporting Standards (IFRS) are designed as a common global language for business affairs so that company accounts are understandable and comparable across international boundaries. They are a consequence of growing international shareholding and trade and are particularly important for companies that have dealings in several countries. They are progressively replacing the many different national accounting standards. They are the rules to be followed by accountants to maintain books of accounts which are comparable, understandable, reliable and relevant as per the users internal or external. It is currently the required accounting framework in more than 120 countries.

IFRS is used primarily by businesses reporting their financial results anywhere in the world *except* the United States. Generally Accepted Accounting Principles, or GAAP, is the accounting framework used in the United States. GAAP is much more rules-based than IFRS. IFRS focuses more on general principles than GAAP, which makes the IFRS body of work much smaller, cleaner, and easier to understand than GAAP. Since IFRS is still being constructed, GAAP is considered to be the more comprehensive accounting framework.

INDIA AND ACCOUNTING STANDARDS

The Institute of Chartered Accountants of India (ICAI) and the Institute of Cost and Works Accountants of India (ICWAI) are associate members of the IASC.

On 21st April 1977, The Institute of Chartered Accountants of India, as a premier accounting body in our country, set up the “Accounting Standard Board” (ASB) to harmonies the diverse accounting policies and practice prevalent in our country.

The primary duty of ASB is to formulate the accounting standards for India. During formulation of accounting standards, the ASB considered the applicable laws, usages, customs and the business environment existing in our country.

The composition of the ASB is broad based to include industry, representatives of various departments of government and regulatory authorities, financial institutions and academic and professional bodies. Industry is represented on the ASB by their associations, viz., ASSOCHAM, CII and FICCI. As regards government departments and regulatory authorities, Reserve Bank of India, Ministry of Company Affairs, Comptroller & Auditor General of India, Controller General of Accounts and Central Board of Excise and Customs are represented on the ASB. Besides these, representatives of academic and professional institutions such as Universities, IIM, ICWAI and ICSI are also represented on the ASB.

Indian Accounting Standards

The accounting standards board of the Institute of Chartered Accountants of India has issued the following Accounting Standards:

- AS 1 – Disclosure of Accounting policies
- AS 2 – Valuation of Inventories
- AS 3 – Cash Flow Statement
- AS 4 – Contingencies and Events Occurring after the Balance Sheet Date
- AS 5 – Net Profit/Loss for the period, Prior Period Items and Changes in Accounting Policies
- AS 6 – Depreciation Accounting
- AS 7 – Construction Contracts (Revised 2002)
- AS 8 – Accounting for Research and Development (AS-8 is no longer in force since it was merged with AS-26)
- AS 9 – Revenue Recognition
- AS 10 – Accounting for Fixed Assets
- AS 11 – The Effects of Changes in Foreign Exchange Rates (revised 2003),
- AS 12 – Accounting for Government Grants
- AS 13 – Accounting for Investments
- AS 14 – Accounting for Amalgamations
- AS 15 – Employee Benefits (revised 2005)
- AS 16 – Borrowing Costs
- AS 17 – Segment Reporting
- AS 18 – Related Party Disclosures

- AS 19 – Leases
- AS 20 – Earnings Per Share
- AS 21 – Consolidated Financial Statements
- AS 22 – Accounting for Taxes on Income.
- AS 23 – Accounting for Investments in Associates in Consolidated Financial Statements
- AS 24 – Discontinuing Operations
- AS 25 – Interim Financial Reporting
- AS 26 – Intangible Assets
- AS 27 – Financial Reporting of Interests in Joint Ventures
- AS 28 – Impairment of Assets
- AS 29 – Provisions, Contingent` Liabilities and Contingent Assets
- AS 30 – Financial Instruments: Recognition and Measurement and Limited Revisions to AS 2, AS 11 revised 2003), AS 21, AS 23, AS 26, AS 27, AS 28 and AS 29
- AS 31 – Financial Instruments: Presentation
- AS 32 – Financial Instruments: Disclosures, and limited revision to Accounting Standard

ADVANTAGES OF FINANCIAL ACCOUNTING

- **Keeps systematic record:** It is very difficult to remember all the business transactions that take place. Accounting serves this purpose of record keeping by promptly recording all the business transactions in the books of account.
- **Helps in ascertaining the results of the operation:** Accounting helps in ascertaining result i.e., profit earned or loss suffered in business during a particular period. For this purpose, a business entity prepares either a Trading and Profit and Loss account or an Income and Expenditure account which shows the profit or loss of the business by matching the items of revenue and expenditure of the same period.
- **Facilitates Comparative study:** A systematic record enables a business to compare one year's results with those of other years and locate significant factors leading to the change if any.
- **Assistance to management:** Accounting provides information to the management to enable it to do its work properly. Such information helps in the Planning, Decision making and controlling.
- **Facilitates rational decision – making:** Accounting records and financial statements provide financial information which help the business in making rational decisions about the steps to be taken in respect of various aspects of business.
- **Helps in determining the financial position of the business:** In addition to profit, a businessman must know his financial position i.e., availability of cash, position of assets and liabilities etc. This helps the businessman to know his financial strength. Financial statements are barometers of health of a business entity.
- **Protects business properties:** Accounting provides up to date information about the various assets that the firm possesses and the liabilities the firm owes, so that nobody can claim a payment which is not due to him.
- **Evidence in the court:** Systematic record of transactions is often treated by the courts and tribunals as good evidence in case of disputes.
- **Helps in complying legal formalities:** Accounting helps in complying with certain legal formalities like filing of income-tax and sales-tax returns. If the accounts are properly maintained, the assessment of taxes is greatly facilitated.
- **Helps in detecting errors and frauds:** Accounting records are balanced periodically which helps in early detection of errors and frauds.

LIMITATIONS OF FINANCIAL ACCOUNTING

Significant information is available from financial accounting such as profit earned or loss suffered during a particular period and the financial position at the end of a specified period. But, it has some limitations too. These limitations must be kept in mind when information provided by financial accounting is used. Some of the limitations arise from the fundamental principles, concepts and assumptions.

The limitations are as follows:

- **Financial accounting is of historical nature:** Financial accounting is just the postmortem of all events of business in past. Net effect of transactions are recorded in financial accounting which has happened in past. It is prepared at the end of the accounting period. It fails to provide day-to-day information to pre-determine cost.
- **Financial accounting deals with overall profitability:** Accounts of business are made by a way which shows only overall profitability. It does not show net profit per product, or per department or according to job.
- **Subject to fraud:** The management team of a company may deliberately skew the results presented. This situation can arise when there is undue pressure to report excellent results, such as when a bonus plan calls for payouts only if the reported sales level increases. One might suspect the presence of this issue when the reported results spike to a level exceeding the industry norm.
- **Records only monetary Transactions:** Accounting does not record events which are not financial in nature. Thus, financial statements do not show true and fair view of business.
- **Incomplete knowledge of costs:** From cost point of view, financial accounting is incomplete. In financial accounting, accountant does not calculate each and every product's total cost. So, financial accounting does not help to determine the price of product of business.
- **No helpful in price fixation:** Financial accounting does not provide adequate information for fixation of selling prices of the product produced or services rendered by the business. It is not also able to prepare tender or quotations.
- **No cost control method:** Financial Accounting does not have proper mechanism to control expenditure on various elements of cost namely material and labor, as a result, misappropriation, wastage and losses of materials are left unchecked. Proper utilization of labor becomes impossible and suitability of different labor incentive plans goes without evaluation.
- **Not always comparable across companies:** If a user wants to compare the results of different companies, their financial statements are not always comparable, because the entities use different accounting practices. These issues can be located by examining the disclosures that accompany the financial statements.
- **Financial statements not free from personal judgment:** Many events of financial statements are affected from personal judgment of accountant. Method of calculating depreciation, rate of provision of doubtful debts and stock valuation method are decided by accountant.
- **No predictive value:** The information in a set of financial statements provides information about either historical results or the financial status of a business as of a specific date. The statements do not necessarily provide any value in predicting what will happen in the future.

ETHICAL ISSUES IN ACCOUNTING

Ethics is concerned with what society considers being right or wrong. It therefore relates to standards of behavior. Ethics are a system of moral principles which defines what is good for individuals and society. The word 'ethics' is derived from the Greek word 'ethos' (character) and Latin word 'moras' (customs). Taken together these two words define how individuals choose to interact with one another. Thus, ethics is about choices. It signifies how people act in order to make the 'right' choice and produce 'good' behavior.

Ethics in accounting are concerned with how to make good and moral choices in regard to the preparation, presentation and disclosure of financial information. The nature of the work carried out by accountants requires a high level of ethics. Shareholders, potential shareholders, and other users of the financial statements rely heavily on the yearly financial statements of a company as they can use this information to make an informed decision about investment.

Accounting is the process of describing business processes in numbers. For a company's accounting to truly represent what is going on in its financial arena, its bookkeeping numbers must be honest and accurate. Honesty and accuracy in accounting are ethical as well as financial issues. Bookkeepers and accountants have a responsibility to represent information in ways that genuinely represent what is going on in the business. Failure to do so can have consequences for business owners, stakeholders and tax reporting agencies.

Recent highly publicized accounting scandals have made it clear that ethical conduct of accountants has not met the standards. Businesses need to be held accountable for the methods they use to run a business because the potential for greed, theft, and dishonesty exist in every business. We read the current events section of the newspaper only to realize how rampant corporate abuse is in business today. We have Enron, HealthSouth, and Martha Stewart examples to show us just how extensive the problem has become. In India a series of financial reporting scandals like Harshad Mehta scam, Satyam Scam, Ketan Parekh securities scam and Saradha chit Fund scam brought this issue into the forefront.

ETHICAL ISSUES/ CHALLENGES

Fraudulent Financial Reporting: Most accounting scandals over the last two decades have centered on fraudulent financial reporting. Fraudulent financial reporting is the misstatement of the financial statements by company management. Usually, this is carried out with the intent of misleading investors and maintaining the company's share price. While the effects of misleading financial reporting may boost the company's stock price in the short-term, there are almost always ill effects in the long run. This short-term focus on company finances is sometimes known as "myopic management."

The majority of cases of fraudulent financial reporting involve making a company's financial health appear better than it really is. There are a number of methods by which this can be accomplished: (1) Overstating Revenues; (2) Understating Expenses; (3) Understating Liabilities and (4) Overstating Assets.

(1) Overstating revenues: Fictitious revenue can be created by recording sales to customers who do not exist (ghost customers) or by recording inflated sales to actual customers. If the latter method is chosen, management will need to take care not to over-bill the actual customers, and so although fake documentation will be required, careful records must be kept. The lengths to which some managers go to perpetrate this kind of fraud can be amazing.

(2) Understating expenses: Understating expenses is a fraudulent technique that has the same effect on net income as overstating revenues. Because net income equals revenue minus expenses, any time expenses are understated, net income will be overstated.

(3) Understatement of liabilities: Some businesses owners may fraudulently make understatements of liabilities on their balance sheets to show more profits to investors. Business owners who use this method will usually keep two sets of books, one for official purposes and the other to keep track of their actual finances. Business assets include cash, inventory, accounts receivable, prepaid expenses, property and equipment. Liabilities include accounts payable, income taxes, lease obligations, and short and long-term debt. Because assets equal total liabilities plus the owner's equity on a balance sheet, an understatement of liabilities will increase assets and owner's equity. This may make the business' financial position seem stronger than it is.

(4) Overstatement of assets: The more assets a company has, the healthier it appears. Because the balance sheet must remain in balance, it will appear that more of the company is owned than owed. Asset accounts are manipulated to enhance a company's balance sheet, especially to positively impact important ratios involving assets. Any asset can be overstated, but commonly the following assets are targeted: Inventory, Accounts Receivable, Fixed assets (Property, Plant, and Equipment)

Misappropriation of Assets: On an individual employee level, the most common ethical issue in accounting is the misappropriation of assets. Misappropriation of assets is the use of company assets for any other purpose than company interests. Otherwise known as stealing or embezzlement, misappropriation of assets can occur at nearly any level of the company and to nearly any degree. For example, a senior level executive may charge a family dinner to the company as a business expense. At the same time, a line-level production employee may take home office supplies for personal use. In both cases, misappropriation of assets has occurred.

Disclosure: As a subtopic of fraudulent financial reporting, disclosure violations are errors of ethical omission. While intentionally recording transactions in a manner that is not in accordance with generally accepted accounting principles is considered fraudulent financial reporting, the failure to disclose information to investors that could change their decisions about investing in the company could be considered fraudulent financial reporting, as well. Company executives must walk a fine line; it is important for management to protect the company's proprietary information. However, if this information relates to a significant event, it may not be ethical to keep this information from the investors.

Because investors and creditors place great reliance on financial statements in making their investment and credit decisions, it is imperative that the financial reporting process be truthful and dependable. Accountants are expected to behave in an entirely ethical fashion. Those who are preparing to enter the accounting profession should do so with the intention of behaving with honor and integrity.

OVERCOMING ETHICAL ISSUES / ETHICS IN THE ACCOUNTING PROFESSION

Accountants should always exercise sound moral judgment in all accounting activities. Accountants have the unique responsibility to provide clients with professional services while presenting a truthful and accurate assessment of a company's financial health to the general public.

Integrity: Integrity is an important fundamental element of the accounting profession. Integrity requires accountants to be honest, candid and forthright with financial information. Accountants should restrict themselves from personal gain or advantage using confidential information.

Objectivity and Independence: Objectivity and independence are important ethical values in the accounting profession. Accountants must remain free from conflicts of interest and other questionable business relationships when conducting accounting services. Failure to remain objective and independent may hamper an accountant's ability to provide an honest opinion about the company's financial information. Objectivity and independence are also important ethical values for auditors.

Due Care: Due care is the ethical value requiring accountants to observe all technical or ethical accounting standards. Professional accountants are often required to review generally accepted accounting principles (GAAP) and apply this framework to specific financial information. Due care requires accountants to exercise competence, diligence and a proper understanding of financial information. Competence is usually based on education and experience. Thus, due care may require senior accountants to supervise and direct other accountants with less experience in the accounting profession.

SOME BASIC TERMS

Capital: Capital is the amount, initially, invested while commencing the business. Capital need not be in the form of cash, alone. Capital can be introduced in the form of goods or any type of assets. Even after commencement of business, additional capital can be introduced.

Drawings: Drawings is the amount withdrawn from the business by the proprietor. Drawings can be, again, cash or goods. Drawings are reduced from the capital amount.

Turnover: The total amount of sales during a particular period is called 'Turnover'. The turnover can be cash sales or credit sales or both.

Debtor or Book Debt: The person to whom goods or services are sold on credit is called 'Debtor'. The amount due from the debtor is called Book Debt.

Creditor: The person from whom goods or services are purchased on credit, is called creditor till the payment due to him is made.

Bad Debts: Amount that cannot be recovered from a debtor is called 'Bad Debt'. Bad debts result in reduction of profits of the firm.

Transaction: Transaction refers to exchange of goods and services, big or small, like purchase of machinery or pencil. The exchange of the dealing has to be expressed in terms of money.

Equity: All claims against the assets of the firm are called as 'Equity'. The claim of the outsiders is called 'creditor's equity' or liabilities. The claim of the proprietor is called 'owner's equity' or capital.

Assets: Assets are the properties owned by the firm. Examples of Assets are Building, Plant and Machinery, Debtors, Bills Receivable, Goodwill, Preliminary expenses etc.

Liabilities: Liabilities are the amounts that are payable. Advances or loans received have to be repaid. Goods or services when bought on credit are shown as creditors, which are also liabilities. Capital invested by proprietor or partner is also a liability as the business firm is independent from them, so far as accounting is concerned. This is the reason why capital is shown on the liability side in the balance sheet. Capital, loan, outstanding expenses and bills payable are some of the examples of liabilities.

Entry: The record made in the books of accounts in respect of a transaction or an event is called an entry.

Books of Account: The registers or books maintained by any business firm or institution for recording the business transactions are called "Books of Account".

Cash Method of Accounting (Cash Basis of Accounting): Under this method, all incomes are considered to be earned only when they are actually received in cash. Similarly, expenses are deemed to be incurred only when they are actually paid in cash.

Accrual Basis of Accounting (Mercantile Basis of Accounting): This method is commonly adopted by business concerns. Incomes are recorded or credited to the period in which they are earned irrespective of the fact that whether the same has actually been received or not. Similarly, expenses are charged to the period in which they relate irrespective of the fact that they have actually been paid or not.

Hybrid or Mixed Basis of Accounting: Under this method, both cash basis and accrual basis are followed. Incomes are recorded on cash basis whereas expenses are taken on accrual basis. The net income is ascertained by matching expenses on accrual basis with income on cash basis.

FINANCIAL ACCOUNTING AND ANALYSIS

UNIT – II THE MECHANICS OF ACCOUNTING

THE ACCOUNT

The account is the basic building block of any accounting system. An account is a summary of the relevant transactions at one place relating to a particular head. It records not only the amount of transaction but also their effect and direction.

An account exists, therefore, for each asset, liability, owner capital, revenue and expense item. The account is used to record increases and decreases in these items (asset, liability, owner capital, revenue and expense) resulting from business transactions.

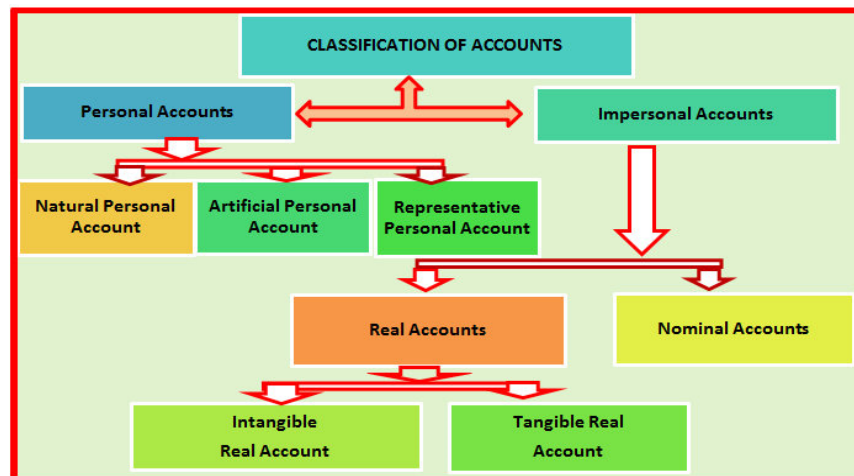
We can classify accounts in two different ways. These are:

- Traditional Classification of Accounts
- Modern Classification of Accounts/ Classification according to Accounting Equations

TRADITIONAL CLASSIFICATION OF ACCOUNTS:

This is a very old method of classifying accounts. Under this method, accounts are classified into two types. These are:

1. Personal Accounts:
 - a. Natural Personal Account
 - b. Artificial Personal Account
 - c. Representative Personal Account
2. Impersonal Accounts:
 - a. Real Accounts:
 - Tangible Real Account
 - Intangible Real Account
 - b. Nominal Accounts



1. Personal Accounts: Accounts which are related to individuals, firms, companies, co-operative societies, banks, financial institutions are known as personal accounts. The personal accounts may further be classified into three categories:

(a) Natural Personal Accounts: Accounts of individuals (natural persons) such as Akhils' A/c, Rajesh's A/c, Sobhan's A/c are natural personal accounts.

(b) Artificial Personal Accounts: Accounts of Firms, Companies, Banks, Financial Institutions such as Reliance Industries Ltd., Lions Club, M/s Sham & Sons, Punjab National Bank etc. are artificial personal accounts.

(c) Representative Personal Accounts: The accounts recording transactions relating to limited expenses and incomes are classified as nominal accounts. But in certain cases (due to the matching concept of accounting) the amount on a particular date, is payable to the individuals or recoverable from individuals. Such amount (i) relates to the particular head of expenditure or income and (ii) represents persons to whom it is payable or from whom it is recoverable. Such accounts are classified as representative personal account e.g., Wages outstanding account, Pre-paid insurance account etc.

2. Impersonal Accounts: Accounts which are not held in the name of the persons are known as impersonal accounts. Non-personal accounts may be divided into Real Accounts and Nominal Accounts.

(a) Real Accounts: Real accounts are the accounts related to assets/properties. These may be classified into tangible real account and intangible real account. The accounts relating to tangible assets (which can be touched, purchased and sold) such as building, plant, machinery, cash, furniture etc. are classified as tangible real accounts. Intangible real accounts (which do not have physical shape) are the accounts related to intangible assets such as goodwill, trademarks, copyrights, patents etc.

(b) Nominal Accounts: The accounts relating to income, expenses, losses and gains are classified as nominal accounts. For example Wages Account, Rent Account, Interest Account, Salary Account, Bad Debts Accounts, Purchases; Account etc. fall in the category of nominal accounts.

MODERN CLASSIFICATION OF ACCOUNTS/ CLASSIFICATION ACCORDING TO ACCOUNTING EQUATIONS:

Modern accountants classify accounts as follows:

ACCOUNTS					
1	2	3	4	5	6
Assets Account	Liabilities Account	Capital Account	Revenue Account	Expenditure Account	Withdrawal Account

Assets A/c: It relates to tangible or intangible assets. Ex. Plant A/c, Goodwill A/c

Liabilities A/c: These accounts represent the final obligation of the enterprise towards outsiders. Ex. Trade creditors, bills payable

Capital A/c: These accounts relate to owners of an enterprise. Ex. Capital A/c, Drawings A/c

Revenue A/c: These accounts relate to amount earned by the enterprise by rendering goods and services. Ex. Sales A/c, Discount received A/c

Expense A/c: These accounts relate to the amount loss or incurred in the process of earning revenue. Ex. Purchase A/c, Loss by Theft A/c.

Drawing or Draw Account: The money or assets withdrawn is recorded in the company's accounting record in what is referred to as a drawing or draw account.

METHODS OF ACCOUNTING

Business transactions are recorded in two different ways.

- Single Entry
- Double Entry

Single Entry: It is incomplete system of recording business transactions. The business organization maintains only cash book and personal accounts of debtors and creditors. So the complete recording of transactions cannot be made and trail balance cannot be prepared.

Double Entry: In this system every business transaction is having a twofold effect of benefits giving and benefit receiving aspects. The recording is made on the basis of both these aspects. Double Entry is an accounting system that records the effects of transactions and other events in at least two accounts with equal debits and credits.

Steps involved in Double Entry System:

- (a) **Preparation of Journal:** Journal is called the book of original entry. It records the effect of all transactions for the first time. Here the job of recording takes place.
- (b) **Preparation of Ledger:** Ledger is the collection of all accounts used by a business. Here the grouping of accounts is performed. Journal is posted to ledger.
- (c) **Trial Balance preparation:** Summarizing. It is a summary of ledger balances prepared in the form of a list.
- (d) **Preparation of Final Account:** At the end of the accounting period to know the achievements of the organization and its financial state of affairs, the final accounts are prepared.

INTRODUCTION TO DEBITS AND CREDIT

Having Latin roots, the term "debit" comes from the word "debitum", meaning "what is due", and "credit" comes from "creditum", defined as "something entrusted to another or a loan". So when you increase assets, the change in the account is a debit because something must be due for that increase (the price of the asset). Conversely, an increase in liabilities is a credit because it signifies an amount that someone else has entrusted (loaned) to you and which you used to purchase something (the cause of the corresponding debit in the assets account).

One theory asserts that the DR and CR come from the Latin past participles of debitum and creditum which are "debere" and "credere", respectively. Another theory is that DR stands for "debit record" and CR stands for "credit record". Finally, some believe the DR notation is short for "debtor" and CR is short for "creditor".

Under the double-entry system every business transaction is recorded in at least two accounts. One account will receive a "debit" entry, meaning the amount will be entered on the left side of that account. Another account will receive a "credit" entry, meaning the amount will be entered on the right side of that account.

GOLDEN RULES OF DEBIT AND CREDIT

<i>ACCOUNTS</i>	<i>DEBIT</i>	<i>CREDIT</i>
<i>Personal Account</i>	<i>The Receiver</i>	<i>The Giver</i>
<i>Real Account</i>	<i>What Comes In</i>	<i>What Goes Out</i>
<i>Nominal Account</i>	<i>All Expenses and Losses</i>	<i>Incomes and Gains</i>

MODERN RULES OF DEBIT AND CREDIT

<i>ACCOUNTS</i>	<i>TO BE DEBITED WHEN</i>	<i>TO BE CREDITED WHEN</i>
<i>Assets A/c</i>	<i>Increase</i>	<i>Decrease</i>
<i>Liabilities A/c</i>	<i>Decrease</i>	<i>Increase</i>
<i>Capital A/c</i>	<i>Decrease</i>	<i>Increase</i>
<i>Revenue A/c</i>	<i>Decrease</i>	<i>Increase</i>
<i>Expense A/c</i>	<i>Increase</i>	<i>Decrease</i>
<i>Drawing or Draw Account</i>	<i>Increase</i>	<i>Decrease</i>

MEANING AND FORMAT OF A JOURNAL

When the business transactions take place, the first step is to record the same in the books of original entry or subsidiary books or books of prime or journal. Thus journal is a simple book of accounts in which all the business transactions are originally recorded in chronological order and from which they are posted to the ledger accounts at any convenient time. This is also called the book of first entry since every transaction is recorded firstly in the journal. The format of a journal is shown as follows:

Journal Book

Date	Particulars	L.F.	Debit	Credit

(a) Date Column: This column shows the date on which the transaction is recorded. The year and month is written once, till they change.

(b) Particular Column: Under this column, first the names of the accounts to be debited, then the names of the accounts to be credited and lastly, the narration (i.e. a brief explanation of the transaction) are entered.

(c) L.F., i.e. Ledger Folio Column: Under this column, the ledger page number containing the relevant account is entered at the time of posting.

(d) Debit amount Column: Under this column, the amount to be debited is entered.

(e) Credit amount Column: Under this column, the amount to be credited is entered.

(f) Narration: Narration is a short explanation of each transaction is written under each entry which is called narration. The subject matter of the transaction can be ascertained through narration. Besides this, if there be any mistake in determining debit or credit aspect of a transaction, it can be easily detected from narration. "A journal entry is not complete without narration".

(g) Journalizing: Journalising refers to the act of recording each transaction in the journal and the form in which it is recorded is known as a journal entry.

(g) Simple journal Entry: Every transaction affects two accounts - one is debited and another is account is credited. Thus in recording a transaction in a journal one account is debited and another account is credited. This type of entry is called simple journal entry.

(h) Compound journal Entry: The entry in which more than one account is debited or more than one account is credited, is known as compound entry. Three or more accounts are connected with a compound journal entry.

Opening Entry: In case of a running business, the assets and liabilities appearing in the previous year's balance sheet will have to be brought forward to the current year. This is done by means of a journal entry which is termed as 'Opening Entry'. All Assets Accounts are debited while all Liabilities Accounts are credited. The excess of assets over liabilities is the proprietor's capital and is credited to his Capital Account.

Advantages of Journal:

1. The transactions are recorded in journal as and when they occur so the chances of error are minimized.
2. It helps in preparation of ledger.
3. Any transfer from one account to another account is made through Journal.
4. The entry recorded in journal is self-explanatory as it includes narration also.
5. It can record any such transaction which cannot be entered in any other books of account.
6. Every transaction is recorded in chronological order (date wise) so the chances of manipulations are reduced.
7. Journal shows all information in respect of a transaction at one place.
8. The closing balances of previous year of accounts related to assets and liabilities can be brought forward to the next year by passing journal entry in journal.

Limitations of Journal:

(i) Bulky and voluminous: Journal is a main book of original entry which records all business transactions. Sometimes, it becomes so bulky and voluminous that it cannot be handled easily.

(ii) Information in scattered form: In this book, all information is recorded on daily basis and scattered form; hence it is very difficult to locate a particular transaction unless one remembers the date of occurrence of that transaction.

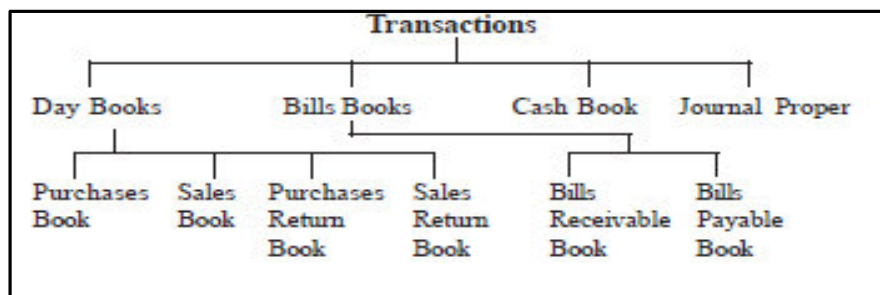
(iii) Time consuming: Unlike posting from subsidiary books, posting the transactions from journal to ledger accounts takes too much time because every time one has to post the transactions in different ledger accounts.

(iv) Lack of internal control: Unlike other books of original entries like subsidiary books and cash book, journal does not facilitate the internal control, because in journal only transactions are recorded in chronological order. However, subsidiary books and cash book gives a clear picture of special type of transactions recorded therein.

SUB-DIVISION OF JOURNAL/ SUBSIDIARY BOOKS/SPECIAL PURPOSE BOOKS

When innumerable number of transactions takes place, the journal, as the sole book of the original entry becomes inadequate. Thus, the number and the number and type of journals required are determined by the nature of operations and the volume of transactions in a particular business. There are many types of journals and the following are the important ones:

- ✚ Sales Day Book- to record all credit sales.
- ✚ Purchases Day Book- to record all credit purchases.
- ✚ Cash Book- to record all cash transactions of receipts as well as payments.
- ✚ Sales Returns Day Book- to record the return of goods sold to customers on credit.
- ✚ Purchases Returns Day Book- to record the return of goods purchased from suppliers on credit.
- ✚ Bills Receivable Book- to record the details of all the bills received.
- ✚ Bills Payable Book- to record the details of all the bills accepted.
- ✚ Journal Proper- to record all residual transactions which do not find place in any of the aforementioned books of original entry.



Advantages Subsidiary Books:

The advantages of maintaining subsidiary books can be summarised as under:

- **Division of Labour:** The division of journal, resulting in division of work, ensures more clerks working independently in recording original entries in the subsidiary books.
- **Efficiency:** The division of labour also helps the reduction in work load, saving in time and stationery. It also gives advantages of specialisation leading to efficiency.
- **Prevents Errors and Frauds:** The accounting work can be divided in such a manner that the work of one person is automatically checked by another person. With the use of internal check, the possibility of occurrence of errors and frauds may be avoided.
- **Easy Reference:** It facilitates easy references to any particular item. For instance total credit sales for a month can be easily obtained from the Sales Book.
- **Easy Postings:** Posting from the subsidiary books are made at convenient intervals depending upon the nature of the business.

PURCHASES BOOK:

Purchases book also known as Bought Day Book is used to record all credit purchases of goods which are meant for resale in the business. Cash purchases of goods, cash and credit purchases of assets are not entered in this book. Before discussing the Purchase Day Book, in detail we are to explain the most significant terms, Trade Discount and Cash Discount.

Trade Discount: Trade discount is an allowance or concession granted by the seller to the buyer, if the customer purchases goods above a certain quantity or above a certain amount. The amount of the purchase made, is always arrived at after deducting the trade discount, i.e., only the net amount is considered. For example, if the list price (price prescribed by the manufacturers or wholesalers) of a commodity is Rs.100, and trade discount granted by manufacturer to the wholesaler is 20% then cost price of the commodity to the wholesaler is Rs.80. Trade discount is not recorded in the books. They are used for determining the net price.

Cash Discount: Sale of goods on credit is a common phenomenon in any business. When goods are sold on credit the customers enjoy a facility of making payment on some date in the future. In order to encourage them to make the payment before the expiry of the credit period a deduction is offered. The deduction so made is

known as cash discount. For example, If Ram purchases goods worth Rs.5, 000 on 30 days credit then, as per the terms of contract, he is authorised to make payment 30 days after the date of purchase. If he is offered a cash discount of 2% on payment within 10 days and if he does so, he is entitled to deduct Rs.100 from the invoice price and pay Rs.4, 900. In this case Rs.100 is cash discount. But if he does not choose to make payment within 10 days then he will not get any cash discount. In this case he will pay Rs.5, 000 after 30 days.

Basis of Distinction Trade Discount Cash Discount

S.No	Basis of Distinction	Trade Discount	Cash Discount
1.	Parties	It is a reduction granted by a manufacturer/supplier	It is a reduction granted by a wholesaler (creditor) to the buyer (debtor).
2.	Purpose	To help the retailer to earn some profit.	To encourage prompt payment within a stipulated period.
3.	Time when allowed	It is allowed on the purchase of goods.	It is allowed when payment is made within the specified period.
4.	Variation	It is usually given at the same rate which is applicable to all customers and will vary with the quantity purchased.	It varies from customer to customer depending on the time and period of payment.
5.	Disclosure	It is shown by way of deduction in the invoice itself.	It is not shown in the invoice.
6.	Ledger Account	A separate Account is not opened in the Ledger.	A separate Account is opened in the Ledger for discount received and discount allowed.

Format of Purchases Book

Purchases Book						
Date	Particulars	Inward Invoice No.	L.F.	Amount		Remarks
				Details Rs.	Total Rs.	

Date Column – Represents the date on which the transaction took place.

Particulars Column – This column includes the name of the seller and the particulars of goods purchased.

Inward Invoice Number Column – Reveals the serial number of the inward invoice.

L.F. Column – This column shows the page number of the suppliers account in the ledger accounts.

Details Column – Reveals the amount of goods purchased and the amount of trade discount.

Total Column – This column represents the net price of the goods, i.e. the amount which is payable to the creditors after adjusting discount and expenses if any.

Remarks Column – Contains any extra information.

SALES BOOK

The sales book is used to record all credit sales of goods dealt with by the trader in his business. **Cash sales, cash and credit sales of assets are not entered in this book.** The entries in the sales book are on the basis of the invoices issued to the customers with the net amount of sale. The format of sales book is shown below:-

Format of Sales Book

Sales Book						
Date	Particulars	Outward Invoice No.	L.F.	Amount		Remarks
				Details Rs.	Total Rs.	

Date Column – Represents the date on which the transaction took place.

Particulars Column – This column includes the name of purchasers and the particulars of goods sold.

Outward Invoice Number Column – Reveals the serial number of the outward invoice.

L.F. Column – The page number of the customers' accounts in the Ledger is recorded.

Details Column – Contains the amount of goods sold and the amount of trade discount if any

Total Column – This column shows the net amount which is receivable from the customers.

Remarks Column – Any other extra information will be recorded.

RETURNS BOOKS

Returns Books are those books in which the goods returned to the suppliers and goods returned by the customers are recorded. The reasons for the return of goods are

- Not according to the order placed.
- Not up to the samples which were already shown.
- Due to damage condition.
- Due to difference in the prices charged.
- Undue delay in the delivery of the goods.

Kinds of Returns Books

The following are the kinds of Returns Books;

- Purchases Return** or **Returns outward book**
- Sales Return** or **Returns inward book**

PURCHASES RETURN BOOK

This book is used to record all returns of goods by the business to the suppliers. The entries in the Purchases Returns Book are usually made on the basis of debit note issued to the suppliers or credit note received from the suppliers. We call it a debit note because the party's (supplier) account is debited with the amount written in this note. The same note is termed as credit note from the receiving party's point of view because he will credit the account of the party from whom he has received the note together with goods. The flow of notes is as follows.



Format of Purchases Return Book

Purchases Return Book						
Date	Particulars	Debit Note No.	L.F.	Amount		Remarks
				Details Rs.	Total Rs.	

Note : The reason for goods returned is recorded in Remarks column.

SALES RETURN BOOK

This book is used to record all returns of goods to the business by the customers. The entries in the sales return book are usually on the basis of credit notes issued to the customers or debit notes issued by the customers.

Format of Sales Return Book

Sales Returns Book						
Date	Particulars	Credit Note No.	L.F.	Amount		Remarks
				Details Rs.	Total Rs.	

Note : Remarks column is meant to record the reason for return of goods.

BILLS BOOKS

When the number of bills received or issued is large journalising of all bill transactions will result in enormous waste of time. Hence, suitable registers like bills receivable book and bills payable book are maintained to record the receipt of bills receivable and issue of bills payable respectively. These books are also called Bills Journals / Books.

BILLS RECEIVABLE (B/R) BOOK: Bills receivable (B/R) book is used for the purpose of recording the details of bills receivable. The individual accounts of parties from whom bills are received will be credited with the amount in the bills receivable book. The periodic total is posted to the debit of bills receivable account in the ledger by writing "To sundries as per Bills Receivable Book".

Format of Bills Receivable (B/R) Book

Sl. No.	Date of Receipt	From Whom Received	Name of the Acceptor	Date of Bill	Term	Date of Maturity	Where Payable	L.F.	Amount

BILLS PAYABLE BOOK:

Bills payable (B/P) book is used for the purpose of recording the details of bills payable. The individual accounts of the parties to whom the bills are issued will be debited with the corresponding amount in the bills payable book. The periodic total is posted to the credit of bills payable account in the ledger by writing "By Sundries as per Bills Payable Book".

Format of Bills Payable (B/P) book

Sl. No.	Date of Bill	Name of the Drawer	Name of the Payee	Term	When Due	Where Payable	L.F.	Amount

CASH BOOK

A cash book is a special journal which is used to record all cash receipts and cash payments. The cash book is a book of original entry or prime entry since transactions are recorded for the first time from the source documents. The cash book is a ledger in the sense that it is designed in the form of a cash account and records cash receipts on the debit side and cash payments on the credit side. Thus, the cash book is both a journal and a ledger. Cash Book will always show debit balance, as cash payments can never exceed cash available. In short, cash book is a special journal which is used for recording all cash receipts and cash payments.

Advantages:

1. **Saves time and labour:** When cash transactions are recorded in the journal a lot of time and labour will be involved. To avoid this all cash transactions are straight away recorded in the cash book which is in the form of a ledger.
2. **To know cash and bank balance:** It helps the proprietor to know the cash and bank balance at any point of time.
3. **Mistakes and frauds can be prevented:** Regular balancing of cash book reveals the balance of cash in hand. In case the cash book is maintained by business concern, it can avoid frauds. Discrepancies if any can be identified and rectified.
4. **Effective cash management:** Cash book provides all information regarding total receipts and payments of the business concern at a particular period. So that effective policy of cash management can be formulated.

Classification of Cash Book such as:

- (1) Simple Cash Book (Single Column)
- (2) Two Column Cash Book (Cash Book with Discount Column)
- (3) Three Column Cash Book (Cash Book with Bank and Discount Column)
- (4) Petty Cash Book

(1) SIMPLE/ SINGLE COLUMN CASH BOOK:

This type of cash book is usually used like an ordinary cash account. It refers to recording of transactions relating to all receipts and payments of cash during a particular period. The specimen ruling of the Simple Column Cash Book is as follows:

Format of Simple/Single Column Cash Book

Date	Particulars	LF.	Amount	Date	Particulars	LF.	Amount
			Rs.				Rs.

From the above specimen of Simple Cash Book Journal the following points can be observed:

- (1) It has divided into two parts, i.e., Debit Side and Credit Side.
- (2) All receipts of cash are recorded in Debit Side and all payments of cash are recorded in Credit side of Cash Book.
- (3) L.F. - Stands for Ledger Folio, i.e., reference to Main Book
- (4) V.N. - Stands for Voucher No., i.e., reference for Payments

(2) DOUBLE/TWO COLUMN CASH BOOK:

It is also known as Cash Book with Discount Column. This Cash Book is meant for recording transactions relating to all receipts and payments of cash and discount. In the two column cash book, on each side there are two columns which are as follows:

Format of Double/Two Column Cash Book

<i>Date</i>	<i>Particulars</i>	<i>LF.</i>	<i>Discount</i>	<i>Cash</i>	<i>Date</i>	<i>Particulars</i>	<i>LF.</i>	<i>Discount</i>	<i>Cash</i>
			<i>Rs</i>	<i>Rs</i>				<i>Rs</i>	<i>Rs</i>

(3) TRIPLE/THREE COLUMN CASH BOOK

Triple/Three Column Cash Book is also known as "Cash Book with Discount and Bank Column." This cash book has divided into three columns on each side which are as follows:

(1) Three Columns with Each Side:

(a) Cash, Discount and Bank Columns with Debit Side.

(b) Cash, Discount and Bank Columns with Credit Side.

(2) L.F. - Stands for Ledger Folio reference to main book.

(3) Contra Entries: When the deposit is made in the bank, it is entered in debit side (receipts side) and credited in cash column on the credit side of the cash book. Similarly, when any amount withdrawn from bank for business purposes, it is recorded in debit side (receipts side) of cash column and bank column is credited on the payment side. Thus, both cash column and bank column in the cash book serves as Cash Account and Bank Account. There is no need to post them in ledger. Such type of entry appearing on both sides of the cash book is known as "Contra Entry." The capital letter 'C' is used for this purpose.

Format of Triple/Three Column Cash Book

<i>Date</i>	<i>Particulars</i>	<i>LF.</i>	<i>Discount</i>	<i>Cash</i>	<i>Bank</i>	<i>Date</i>	<i>Particulars</i>	<i>LF.</i>	<i>Discount</i>	<i>Cash</i>	<i>Bank</i>
			<i>Rs</i>	<i>Rs</i>	<i>Rs.</i>				<i>Rs</i>	<i>Rs</i>	<i>Rs.</i>

PETTY CASH BOOK

Petty Cash Book has been designed in order to minimize the recording of numerous-transactions in the cash book. This is also termed as "Analytical Petty Cash Book." In a business concern many small expenses incurred frequently relating to postage, stationery, carriage, cleaning, and travelling etc. These small expenses are recorded and maintained in a separate cash book is known as "Petty Cash Book." A person who is responsible for recording and maintaining this Petty Cash Book is known as "Petty Cashier." Accordingly all small payments supported by vouchers or receipts are recorded in the petty cash book during a particular period.

To ensure the more convenient and efficient method of recording petty payments, it has divided in to separate column according to their respective heads of expenses in the petty cash book. This is used to record the total expenses incurred under each head is debited to the concerned expenses account (Nominal A/c) and credited to the Petty Cash Account.

Specimen Ruling of Petty Cash Book

Dr. Petty Cash Book Dr.									
<i>Cash Received</i>	<i>Date</i>	<i>Particulars</i>	<i>Vr. No</i>	<i>Total Amt. Paid</i>	<i>Postage & Telegram</i>	<i>Printing & Stationery</i>	<i>Carriage</i>	<i>Traveling Expenses</i>	<i>Sundry Expenses</i>
<i>Rs.</i>			<i>Rs.</i>	<i>Rs.</i>			<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>

LEDGER

Ledger is a main book of account in which various accounts of personal, real and nominal nature, are opened and maintained. In journal, as all the business transactions are recorded chronologically, it is very difficult to obtain all the transactions pertaining to one head of account together at one place. But, the preparation of different ledger accounts helps to get a consolidated picture of the transactions pertaining to one ledger account at a time. Thus, a ledger account may be defined as a summary statement of all the transactions relating to a person, asset, expense, or income or gain or loss which have taken place during a specified period and shows their net effect ultimately. From the above definition, it is clear that when transactions take place, they are first entered in the journal and subsequently posted to the concerned accounts in the ledger. Posting refers to the process of entering in the ledger the information given in the journal. In the past, the ledgers were kept in bound books. But with the passage of time, they became loose-leaf ones and the advantages of the same lie in the removal of completed accounts, insertion of new accounts and arrangement of accounts in any required manner.

Features of Ledger

- ✚ Ledger is an account book that contains various accounts to which various business transactions of a business enterprise are posted.
- ✚ It is a book of final entry because the transactions that are first entered in the journal or special purpose Books are finally posted in the ledger. It is also called the Principal Book of Accounts.
- ✚ In the ledger all types of accounts relating to assets, liabilities, capital, revenue and expenses are maintained.
- ✚ It is a permanent record of business transactions classified into relevant accounts.
- ✚ It is the 'reference book of accounting system and is used to classify and summarise transactions to facilitate the preparation of financial statements.

FORMAT OF A LEDGER SHEET

Title of Account

Dr.				Cr.			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount

IMPORTANCE/ ADVANTAGES OF LEDGER:

Ledger is an important book of Account. It contains all the accounts in which all the business transactions of a business enterprise are classified. At the end of the accounting period, each account will contain the entire information of all the transactions relating to it. Following are the advantages of ledger.

- ✚ **Knowledge of Business results:** Ledger provides detailed information about revenues and expenses at one place. While finding out business results the revenue and expenses are matched with each other.
- ✚ **Knowledge of book value of assets:** Ledger records every asset separately. Hence, you can get the information about the Book value of any asset whenever you need.
- ✚ **Useful for management:** The information given in different ledger accounts will help the management in preparing budgets. It also helps the management in keeping the check on the performance of business it is managing.
- ✚ **Knowledge of Financial Position:** Ledger provides information about assets and liabilities of the business. From this we can judge the financial position and health of the business.
- ✚ **Instant Information:** The business always needs to know what it owes to others and what the others owe to it. The ledger accounts provide this information at a glance through the account receivables and payables.

Posting: Posting refers to the process of transferring debit and credit amounts from the Journal or subsidiary books to the respective heads of accounts in the ledger. Journal will have at a minimum of one debit and one credit for each transaction. The ledger will have either a debit or a credit for each account used in the Journal. Posting may be done daily, weekly fort nightly or monthly according to the convenience and requirements of the business, but care should be taken to complete it before the preparation of annual financial statements.

PROCEDURE/RULES OF POSTING:

The following rules should be followed while posting business transactions to respective accounts in the ledger from the journal:

- i) Enter the date and year of the transaction in the date column.
- ii) Open separate account in the ledger for each person, asset, revenue, liability, expense, income and loss appearing in the Journal.
- iii) The appropriate/relevant account debited in the Journal will be debited in the ledger, but the reference should be given of the other account which has been credited.
- iv) Similarly, the account credited in the Journal should be credited in the ledger, but the reference has to be given of the other account which has been debited in the Journal.
- v) The debit posting should be prefixed by the word 'To' and credit posting should be prefixed by the word 'By'.
- vi) In the Journal Folio (J.F.) column the page number of the book of original entry (Journal) is entered.

BALANCING OF AN ACCOUNT

The difference between the two sides of an account is its balance. The balance is written on the lesser side to make the two sides equal. The process of equalizing the two sides of an account is known as **balancing**. The **rules for balancing an account** are stated as below:

1. Add up the amount columns of both the sides of an account and write the totals in a separate slip of paper.
2. Find out the difference of the two totals.
3. Write down the difference on the lesser side of the account.
4. Now total up both the sides and write the totals and draw double lines under them.
5. Again write the difference on the opposite side below the double line.

If the debit side of an account is heavier, its balance is known as debit balance. And if the credit side of an account is heavier its balance is known as credit balance. If the two sides are equal, that account will show zero balance. The rules for determining the balance is as follows:

Total debit	=	More than total credit	=	Debit balance
Total credit	=	More than total debit	=	Credit balance
Total debit	=	Total credit	=	Nil balance

It may be noted that at the time of balancing an account debit balance is placed on the credit side and credit balance on debit site. This balance is known as closing balance. What is closing balance in this year is the opening balance of the next year.

DISTINCTION BETWEEN JOURNAL AND LEDGER

- Journal is a book of prime entry, whereas ledger is a book of final entry.
- Transactions are recorded daily in the journal, whereas posting in the ledger is made periodically.
- In the journal, information about a particular account is not found at one place, whereas in the ledger information about a particular account is found at one place only.
- Recording of transactions in the journal is called journalising and recording of transactions in the ledger is called posting.
- A journal entry shows both the aspects debit as well as credit but each entry in the ledger shows only one aspect.
- Narration is written after each entry in the journal but no narration is given in the ledger.
- Vouchers, receipts, debit notes, credit notes etc., from the basic documents form journal entry, whereas journal constitutes basic record for ledger entries.

TRIAL BALANCE

Meaning: A trial balance is a statement showing the balances, or total of debits and credits, of all the accounts in the ledger with a view to verify the arithmetical accuracy of posting into the ledger accounts. Trial balance is an important statement in the accounting process as it shows the final position of all accounts and helps in preparing the final statements. The task of preparing the statements is simplified because the accountant can take the balances of all accounts from the trial balance instead of going through the whole ledger. It may be noted that the trial balance is usually prepared with the balances of accounts.

Trial Balance ofas on March 31, 2009

Account Title	L.F.	Debit (Rs.)	Credit(Rs.)
• Capital			XX
• Land and Buildings		XX	
• Plant and Machinery		XX	
• Equipment		XX	
• Furniture and Fixtures		XX	
• Cash in Hand		XX	
• Cash at Bank		XX	
• Debtors		XX	
• Bills Receivable		XX	
• Stock of Raw Materials		XX	
• Stock of Finished Goods		XX	
• Purchases		XX	
• Carriage Inwards		XX	
• Carriage Outwards		XX	
• Sales			
• Sales Return		XX	XX
• Purchases Return			
• Interest Paid			XX
• Commission/Discount Received		XX	
• Salaries			
• Long Term Loan		XX	
• Bills Payable			XX
• Creditors			
• Advances from Customers			XX
• Drawings			XX
		XX	XX
Total		XXX	XXX

It is normally prepared at the end of an accounting year. However, an organisation may prepare a trial balance at the end of any chosen period, which may be monthly, quarterly, half yearly or annually depending upon its requirements.

PREPARATION OF TRIAL BALANCE

In order to prepare a trial balance following steps are taken:

- ✚ Ascertain the balances of each account in the ledger.
- ✚ List each account and place its balance in the debit or credit column, as the case may be. (If an account has a zero balance, it may be included in the trial balance with zero in the column for its normal balance).
- ✚ Compute the total of debit balances column.
- ✚ Compute the total of the credit balances column.
- ✚ Verify that the sum of the debit balances equal the sum of credit balances.

If they do not tally, it indicates that there are some errors. So, one must check the correctness of the balances of all accounts. It may be noted that all assets expenses and receivables account shall have debit balances whereas all liabilities, revenues and payables accounts shall have credit balances.

OBJECTIVES OF PREPARING TRIAL BALANCE

(i) To check arithmetical accuracy: Arithmetical accuracy in ledger posting means writing correct amount, in the correct account and on its correct side while posting transactions from various original books of accounts, such as Cash Book, Purchases Book, Sales Book, etc. It also means not only the correct balance of ledger account but also the totals of the special purpose Books.

(ii) To help in preparing Financial Statements: The ultimate objective of the accounting is to prepare financial statements i.e. Trading and Profit and Loss Account, and Balance sheet of a business enterprise at the end of an accounting year. These statements contain balances of various ledger accounts. As Trial Balance contains balances of all ledger accounts, in financial statements the balances of ledger accounts are carried from the Trial balance for proper analysis.

(iii) Helps in locating errors: If total of two columns of the trial balance agrees it is a proof of arithmetical accuracy in the ledger posting. However, if the totals of the two columns do not tally it indicates that there is some mistake in the ledger accounts. This prompts the accountant to find out the errors.

(iv) Helps in comparison: Comparison of ledger account balances of one year with the corresponding balances with the previous year helps the management taking some important decisions. This is possible by using the Trial Balances of the two years.

(v) Helps in making adjustments: While making financial statements adjustments regarding closing stock, prepaid expenses, outstanding expenses etc. are to be made. Trial balance helps in identifying the items requiring adjustments in preparing the financial statements.

Trial Balance is generally prepared at the end of the year. However it can be prepared at any time during the accounting year to check the accuracy of the posting.

Trial Balance and Suspense A/c: Now suppose the Trial Balance does not agree i.e. there is a difference of some amount in the totals of the two columns of the Trial Balance. What will you do with this difference? A different account i.e. Suspense Account is opened with the difference in amount put in this account. This will result in agreement of Trial Balance. The suspense account with the amount of difference will be put on the lesser side of the Trial Balance. For example total of the debit column exceeds the total of the credit column by Rs.500. This amount of Rs. 500 will be written on the credit column against Suspense Account to make the Trial Balance tally.

The suspense A/c is however a temporary arrangement to make the Trial Balance agree. This account will remain till the error or errors are rectified, this account will disappear as soon as the error or errors are rectified.

Types of Errors:

Errors can be classified into two categories:

- Errors not revealed by the Trial Balance
- Errors revealed by the Trial Balance

Errors Not Revealed by the Trial Balance:

The following errors **do not** affect the equality of the Trial Balance totals:

1. **Errors of Omission:** A transaction is omitted completely from the books so that there is no debit and credit entry of the transaction, e.g. Drawings of Rs.500 cash by the proprietor was not recorded.
2. **Errors of Commission:** An entry is posted to the correct side of the ledger but to the wrong account, i.e. items have been posted to the wrong account of the same class, e.g. Payment of Rs.100 cash by a customer Hari was wrongly posted to the account of another customer, Harish.
3. **Errors of Principle:** An entry is made in the wrong class of account, i.e. when an expense is treated as an asset and vice versa, e.g. Repairs to building Rs.400 was debited to the Building Account.
4. **Complete Reversal of Entries:** An account that should be debited is credited and vice versa, e.g. a cheque Rs.200 received from Sunil was debited to the account of Sunil and credited to the Bank Account.

5. **Compensating Errors:** Errors (or error) on one side of the ledger are compensated by an error (or errors), e.g. The Purchases Account and Sales Account were both overcast by Rs.150.
6. **Errors of Original Entry:** The original figure may be incorrectly entered although the correct double-entry principle has been observed using this incorrect figure, e.g. Credit sales of Rs.87 to Kiran was recorded in the Sales Account and Kiran's account as Rs.78.

Errors Revealed by the Trial Balance:

Errors which are **revealed** by the Trial Balance are those errors which cause the Trial Balance totals to be in disagreement.

1. **Errors in Calculation:** If there is any miscalculation of the Trial Balance totals or the net account balances, the Trial Balance will not balance e.g. there may be an error in the calculation of the cash balance, causing the Trial Balance totals not to balance too.
2. **Errors in Omission of One Entry:** Omission of either the debit or credit entry of a transaction will cause the totals of the Trial Balance not to agree, e.g. a cheque Rs.500 received for commission was debited to the Bank Account only.
3. **Posting to the Wrong Side of An Account:** Entry into the wrong side of an account will cause one side of the ledger to be more than the other, e.g. A cheque of Rs.800 paid to creditor Mr. Kamal was credited instead of debited to his account.
4. **Errors in Amount:** If the debit entry of a transaction differs in amount with the credit entry, the Trial Balance will not balance, e.g. Cash Rs.134 received from Mohan was debited to the Cash Account as Rs.134 and credited to the account of Mohan as Rs.143.

Advantages of Trial Balance:

Trial balance has several advantages. Such of them are as follows:

1. To check the debits equal the credits.
2. To find the uncover errors in journalizing.
3. To find the uncover errors in posting.
4. To locate the errors in ledger accounts.
5. To make financial statements.
6. To list the accounts at a single place.
7. To know the ending balance of each account at a glance.
8. To make the adjustments for unrecorded transactions.
9. To find the missing amount of an account in the special case.
10. To test the mathematical accuracy of recording process.

Disadvantages of Trial Balance:

A trial balance has some disadvantages. Such of them are as follows:

1. It does not prove that all transactions have been recorded.
2. It does not prove that the ledger is correct.
3. Numerous errors may exist even though the trial balance columns agree.
4. It cannot find the missing entry from the journal.
5. It cannot find the missing entry from the ledger.
6. It cannot protect the repeated postings.
7. It cannot protect the offsetting errors.
8. It cannot protect the errors of principles.
9. It cannot protect the errors of commission.
10. It cannot protect the errors of omission.

FINAL ACCOUNTS

Preparation of final account is the last stage of the accounting cycle. The basic objective of every concern maintaining the book of accounts is to find out the profit or loss in their business at the end of the year. Every businessman wishes to ascertain the financial position of his business firm as a whole during the particular period. In order to achieve the objectives for the firm, it is essential to prepare final accounts which include Manufacturing and Trading, Profit and Loss Account and Balance Sheet. The determination of profit or loss is done by preparing a Trading, Profit and Loss Account. The purpose of preparing the Balance Sheet is to know the financial soundness of a concern as a whole during the particular period.

(1) Manufacturing Account:

Manufacturing Account is the important part which is required to preparing Trading, Profit and Loss Account. Accordingly, in order to calculate the Gross Profit or Gross Loss, it is essential to determine the Cost of Goods Manufactured or Cost of Goods Sold. The main purpose of preparing Manufacturing Account is to ascertain the cost of goods manufactured or cost of goods sold, which is transferred to the Trading Account. This account is debited with opening stock and all items of costs including purchases related to production and credited with closing balance of work in progress and cost of goods produced transferred to Trading Account. The term "Cost of Goods Sold" refers to cost of raw materials consumed plus direct related expenses.

Components of Manufacturing Account

The following are the important components to be considered for preparation of Manufacturing Accounts:

- (1) Opening Stock of Raw Materials.
- (2) Purchase of Raw Materials.
- (3) Purchase Returns.
- (4) Closing Stock of Raw Materials.
- (5) Work in Progress (semi-finished goods).
- (6) Factory Expenses.
- (7) Opening Stock of Finished Goods.
- (8) Closing Stock of Finished Goods.

(1) Opening Stock: The term Opening Stock refers to stock on hand at the beginning of the year which includes raw materials, work-in-progress and finished goods.

(2) Purchases: Purchases include both cash and credit purchase of goods. If any purchase is returned, the same will be deducted from gross purchases.

(3) Direct Expenses: Direct expenses are chargeable expenses or productive expenses which include factory rent, wages, and freight on purchases, manufacturing expenses, factory lighting, heating, fuel, customs duty, dock duty and packing expenses. In short, all those expenses incurred in bringing the raw materials to the factory and converting them into finished goods will constitute the direct expenses that are to be shown on the debit side of the trading account.

Calculation of Cost of Goods Sold:

$$\text{Cost of Goods Sold} = \text{Opening Stock} + \text{Cost of Purchases} + \text{Direct Expenses} - \text{Closing Stock}$$

Trading, Profit and Loss Account

Trading Account and Profit and Loss Account are the two important parts of income statements. Trading Account is the first stage in the final account which is prepared to know the trading results of gross profit or loss during a particular period. In other words, it is a summary of the purchases, and sale of a business or production cost of goods sold and the value of sales. The difference between the elements establishes the gross profit or loss which is then carried forward to the profit or loss account for calculation of net profit or net loss. Accordingly, if the sales revenue is higher than the cost of goods sold the difference is known as 'Gross Profit,' similarly, if the sales is less than the cost of goods sold the difference is known as 'Gross Loss'

TRADING ACCOUNT (Horizontal Format) for the year ended.....

Dr.

Cr.

Particulars	Rs.	Particulars	Rs.
To Opening Stock	xxx	By Sales	xxx
To Purchases xxx		Less: Returns inwards (xxx)	xxx
Less: Returns outwards (xxx)	xxx	By Closing Stock	xxx
To Freight & Carriage	xxx	By Gross Loss c/d*	xxx
To Customs & Insurance	xxx		
To Wages	xxx		
To Gas, Water & Fuel	xxx		
To Factory Expenses	xxx		
To Royalty on Production	xxx		
To Cargo Expenses	xxx		
To Shipping Expenses	xxx		
To Import Duty	xxx		
To Custom Duty	xxx		
To Dock Charges	xxx		
To Octroi	xxx		
To Commission on Purchases	xxx		
To Gross Profit c/d*	xxx		
	xxxx		xxxx

Elements of Trading Account (Debit Side):

- (1) Opening Stock.
- (2) Purchases and Purchase Returns.
- (3) Direct Expenses.
- (4) Gross Profit is the excess value of sales over the cost of Sales.

Elements of Trading Account (Credit Side):

- (1) Sales: The term sales refer to the total of sales of goods which include both cash sales and credit sales during the particular period.
- (2) Sales Return: If any goods returned from the customers will be deducted from the total sales.
- (3) Closing Stock: Closing Stock refers to the goods remaining unsold at the end of the particular period. The closing stock may be raw materials, work-in-progress and finished goods. Generally closing stock does not appear in the Trial Balance. Therefore, the closing stock is not brought into the books of accounts but it is credited to Trading Account and also recorded in the assets side of the Balance Sheet.

From the trial balance, the balance of opening stock account, purchases account, returns inwards account and of all direct expenses are transferred on the debit side of the trading account, and the balance of the sales account, returns outwards account, and closing stock account are transferred on the credit side of the trading account. If the credit side of the trading account exceeds the debit side, the result is "gross profit", and if debit side exceeds the credit side, the result is "gross loss".

If credit side exceeds the debit side = Gross profit

If debit side exceeds the credit side = Gross loss

PROFIT AND LOSS ACCOUNT

The determination of Gross Profit or Gross Loss is done by preparation of Trading Account. But it does not reveal the Net Profit or Net Loss of a concern during the particular period. This is the second part of the income statement and is called as Profit and Loss Account. The purpose of preparing the profit and loss account to calculate the Net Profit or Net Loss of a concern. Net profit refers to the surplus which remains after deducting related trading expenses from the Gross Profit. The trading expenses refer to inclusive of office and administrative expenses, selling and distribution expenses. In other words, all operating expenses such as office and administrative expenses, selling and distribution expenses and non-operating expenses are shown on the debit side and all operating and non-operating gains and incomes are shown on the credit side of the Profit and Loss Account. The difference of two sides is either Net Profit or Net Loss. Accordingly, when total of all operating and non-operating expenses is more than the Gross Profit and other non-operating incomes, the difference is the Net Profit and in the reverse case it is known as Net Loss. This Net Profit or Net Loss is transferred to the Capital Account of Balance Sheet.

PROFIT AND LOSS ACCOUNT (Horizontal Format) for the year ended.....

Dr.

Cr.

Particulars	Rs.	Particulars	Rs.
To Gross Loss b/d*	XXX	By Gross Profit b/d*	XXX
To Salaries (Administrative)	XXX	By Commission Earned	XXX
To Office Rent, Rates & Taxes	XXX	By Discount Received	XXX
To Lighting	XXX	By Interest Received	XXX
To Legal Charges	XXX	By Dividend Received	XXX
To Postage	XXX	By Gain on Sale of Fixed Assets	XXX
To Printing	XXX	By Insurance Claims	XXX
To Insurance	XXX	By Net Loss *	XXX
To Audit Fees etc.	XXX	(Transferred to capital account)	
To Carriage Outward	XXX		
To Advertisement Expenses	XXX		
To Godown Rent	XXX		
To Commission	XXX		
To Brokerage	XXX		
To Bad Debts	XXX		
To Provision for bad debts etc.	XXX		
To Interest on loans	XXX		
To Bank Charges	XXX		
To Legal Charges for	XXX		
arranging loans	XXX		
To Discounts and Rebate	XXX		
To Repairs & Renewals	XXX		
To Depreciation	XXX		
To Loss on Sale of Fixed Assets	XXX		
To Loss by Fire etc.	XXX		
To Net Profit *	XXX		
(Transferred to capital account)			
	xxxxx		xxxxx

*Only one figure will appear in the account

PROFIT AND LOSS ACCOUNT (VERTICAL FORMAT) for the year ended.....

Particulars	Schedule	Amount (Rs)
Income		
Sales and operating income	1	.....
Other income	2	.....
Total		.....
Expenditure		
Cost of goods sold	3	.....
Operating and other expenses	4	.....
Depreciation/Amortisation		.....
Interest		.....
Total		.....
Add/(Less): Exceptional items		.....
Profit/(Loss) before tax		.....
Less: Tax		.....
Profit/(Loss) after tax		.....

Components appearing on Debit Side of the P & L A/c:

Those expenses incurred during the manufacturing process of conversion of raw materials into finished goods will be treated as direct expenses which are recorded in the debit side of Trading Account. Any expenditure incurred subsequent to that will be known as indirect expenses to be shown in the debit side of the Profit and Loss Account. The indirect expenses may be classified into: (1) Operating Expenses and (2) Non-Operating Expenses.

(1) Operating Expenses: It refers to those expenses as the day-to-day expenses of operating a business include office & administrative expenses, selling and distribution expenses.

(2) Non-Operating Expenses: Those expenses incurred other than operating expenses. Non-Operating expenses which are related to a financial nature. For example, interest payment on loans and overdrafts, loss on sale of fixed assets, writing off fictitious assets such as preliminary expenses, under writing commission etc.

Components appearing on Credit Side of P&L A/c:

The following are the components as shown on the Credit Side:

- (1) Gross Profit brought down from Trading Account
- (2) Operating Income: It refers to income earned from the operation of the business excluding Gross Profit and Non-Operating incomes.
- (3) Non-Operating Income: Non-Operating incomes refer to other than operating income. For example, interest on investment of outside business, profit on sale of fixed assets and dividend received etc.

Features of Profit and Loss Account:

- ❖ This account is prepared on the last day of an accounting year in order to determine the net result of the business.
- ❖ It is second stage of the final accounts.
- ❖ Only indirect expenses and indirect revenues are shown in this account.
- ❖ It starts with the closing balance of the trading account i.e. gross profit or gross loss.
- ❖ All items of revenue concerning current year - whether received in cash or not - and all items of expenses - whether paid in cash or not - are considered in this account. But no item relating to past or next year is included in it.

If credit side exceeds the debit side	= Net profit
If debit side exceeds the credit side	= Net loss

BALANCE SHEET - LAST STAGE IN FINAL ACCOUNTS

The balance sheet is one of the important statements which is used to owners or investors to measure the financial soundness of the concern as a whole. A statement is prepared to show the list of liabilities and capital of credit balances of the business on the left hand side and list of assets and other debit balances are recorded on the right hand side is known as "Balance Sheet." A balance sheet may be defined as:

"It is a statement of assets, liabilities and owner's equity (capital) on a particular date".

"It is a statement of what a business concern owns and what it owes on a particular date". What is owns are called assets and what it owes are called liabilities.

"It is a statement which discloses total assets, total liabilities and total capital (owner's equity) of a concern on a particular date".

"It is a statement where all the ledger account balances which remain open after the preparation of trading and profit and loss account, find place"

Assets mean all the things and properties under the ownership of the business i.e. building, plant, furniture, machinery, stock, cash etc. Assets also include anything against which money or service will be received i.e. creditors accrued income, prepaid expenses etc.

Liabilities means our dues to others or anything against which we are to pay money or render service, i.e. creditors, outstanding expenses, amount payable to the owner of the business (capital) etc.

Asset side of the balance sheet indicates the different types of assets owned by a concern, while liabilities side discloses the various sources through which funds have been obtained in order to acquire those assets. Balance sheet reveals the financial position of the firm on a particular date at a point of time, so it is also called "**position statement**". It is prepared on the last day of the accounting year and discloses concern for the whole year cannot be determined through the balance sheet because financial position is ever changing.

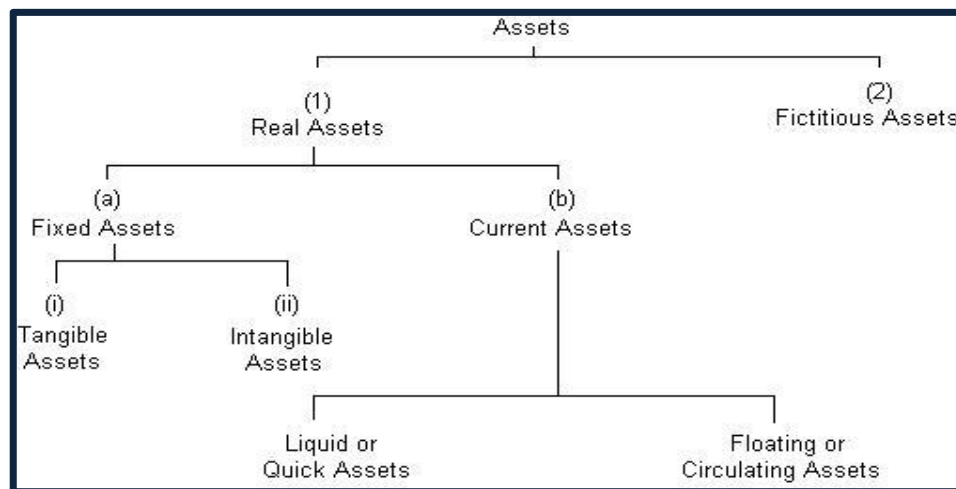
Features of Balance Sheet:

- ✚ It is the last stage of final accounts
- ✚ It is prepared on the last day of an accounting year.
- ✚ It is not an account under the double entry system - it is a statement only.
- ✚ It has two sides - left hand side known as asset side and right hand side known as liabilities side.
- ✚ The total of both sides are always equal.
- ✚ The balances of all asset accounts and liability accounts are shown in it. No expense accounts and revenue accounts are shown here.
- ✚ It discloses the financial position and solvency of the business.
- ✚ It is prepared after the preparation of trading and profit and loss account because the net profit or net loss of a concern is included in it through capital account.

Preparation of Balance Sheet: All the information necessary for the preparation of balance sheet is available from trial balance and from some other ledger accounts. After transferring accounts relating to expenses and revenues to trading and profit and loss account, the trial balance contains only the accounts of assets, liabilities, and capital. All assets have debit balances and all liabilities and capital have credit balances. The assets are shown on the asset side of the balance sheet and liabilities and capital are shown on the liabilities side of the balance sheet after arranging them properly.

Classification of Assets:

Assets may be classified as follows:



Real Assets: Assets which have some market value are called real assets, e.g. building, machinery, stock, debtors, cash, goodwill, etc. Real assets are further divided into two types according to their permanence:

Fixed Assets: Assets which have long life and which are bought for use for a long period of time are called "fixed assets". These are not bought for selling purposes, e.g. land, building, plant, machinery, furniture etc. Fixed assets are again sub-divided into two:

Tangible Assets: Assets which have physical existence and which can be seen, touched and felt are called "tangible assets", e.g. building, plant, machinery, furniture etc.

Intangible Assets: Assets which have no physical existence and which cannot be seen, touched or felt are called "intangible assets", e.g. goodwill, patent right, trade mark etc.

Current Assets: Assets which are short-lived and which can be converted into cash quickly to meet short term liabilities are called "current assets", e.g. stock debtors, cash etc. Such assets change their form repeatedly and so, they are also known as *circulating or floating assets*. For example, on purchase of goods cash is converted into stock and on sale of goods, stock is converted into debtors, on collection from debtors, debtors take the form of cash etc.

Out of current assets those which can be converted into cash very quickly or which are already in the form of cash are called *liquid or quick assets* e.g. debtors, cash in hand, cash at bank etc.

Fictitious Assets: Assets which have no market value are called *fictitious assets*. Examples of fictitious assets include preliminary expenses, loss on issue of shares etc. They are also known as *nominal assets*.

Besides these, there is another type of assets whose value gradually reduce on account of use and finally exhaust completely. This type of assets is called wasting assets e.g. mine, forest etc.

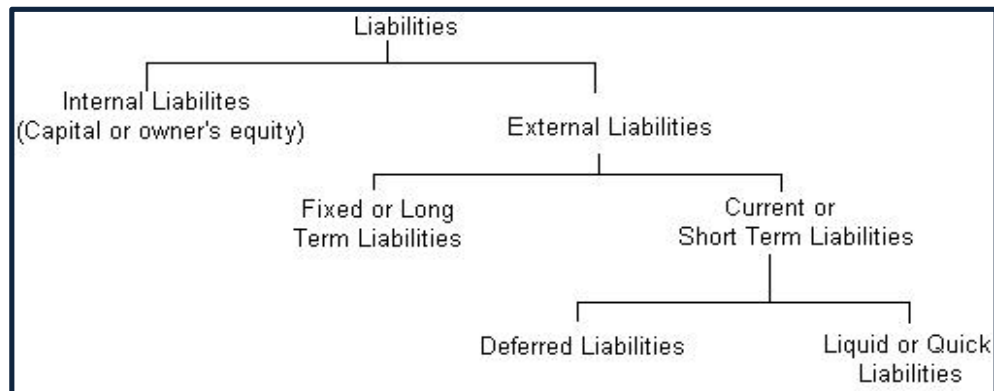
Classification of Liabilities:

Internal Liabilities: The total amount of debts payable by a business to its owner is called internal liability e.g. Owner's equity (capital), reserve etc. From practical view point internal liabilities should not be regarded as liabilities, since there is no question of meeting such liabilities as long as the business continues.

External Liabilities: All debts payable by a business to the outsiders (other than the owner) are called external liabilities e.g. creditors, debentures, bills payable, bank overdraft, etc. External liabilities are further divided into two.

Fixed or Long Term Liabilities: The liabilities which are payable after a long period of time are called fixed or long term liabilities e.g. debentures, loan on mortgage etc.

Current or Short Term Liabilities: The debts which are repayable within a short period of time are called current or short-term liabilities e.g. creditors, bills payable, bank overdraft etc. Current liabilities may again be divided into two:



Deferred Liabilities: Debts which are repayable in the course of less than one year but more than one month are called deferred liabilities e.g. Short term loan etc.

Liquid or Quick Liabilities: Debts are repayable in the course of a month are called liquid or quick liabilities e.g. Bank overdraft, outstanding expenses, creditors etc.

Besides the above, there is another type of liability which is known as *contingent liability*. It is one which is not a liability at present, but which may or may not become a liability in the future.

GROUPING AND MARSHALLING OF ASSETS AND LIABILITIES IN BALANCE SHEET

As we have discussed that the main purpose of balance sheet is to disclose a true and fair financial position of a business on a particular date. So, the assets and liabilities must be shown in such a manner that the financial position of the business can be assessed through it easily and quickly. Thus an arrangement is made in which assets and liabilities are shown in the balance sheet. Such an arrangement is called marshalling of assets and liabilities. Methods of marshalling:

Permanency Preference Method: Under this method, the assets and liabilities are shown in balance sheet in the order of their permanence. In other words, the more permanent the assets and liabilities, the earlier they are shown. This method is adopted by joint stock companies and under this method the balance sheet will take the following form:

HORIZONTAL FORMAT OF BALANCE SHEET (In the order of Permanence) BALANCE SHEET as on.....

Liabilities	Rs.	Assets	Rs.
Capital Account	XXX	Goodwill	XXX
Reserves & Surplus	XXX	Patents	XXX
Loan on Mortgages	XXX	Copy Rights	XXX
Bank Loans	XXX	Trade Marks	XXX
Income Received in Advance	XXX	Land & Buildings	XXX
Outstanding Expenses	XXX	Plant & Machinery	XXX
Bills Payable	XXX	Furniture & fittings	XXX
Sundry Creditors	XXX	Investments	XXX
		Stock	XXX
		Sundry Debtors	XXX
		Bills Receivable	XXX
		Cash at Bank	XXX
		Cash in Hand	XXX
	XXX		XXX

Liquidity Preference Method: Under this method, assets and liabilities are shown in order of their liquidity. The more liquid the assets, the earlier are they shown. The sooner the liabilities are to be paid off, the earlier are they shown. This method is adopted by sole proprietorship and partnership business. Under this method the form of balance sheet is:

HORIZONTAL FORMAT OF BALANCE SHEET (In the order of liquidity) BALANCE SHEET As on...

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	XXX	Cash in Hand	XXX
Bills Payable	XXX	Cash at Bank	XXX
Bank Loans	XXX	Bills Receivable	XXX
Outstanding Expenses	XXX	Sundry Debtors	XXX
Income Received in Advances	XXX	Advance Payments	XXX
Loan on Mortgages	XXX	Stock	XXX
Reserves & Surplus	XXX	Investments	XXX
Capital Account	XXX	Furniture & Fittings	XXX
		Plant & Machinery	XXX
		Land & Buildings	XXX
		Trade Mark	XXX
		Copy Rights	XXX
		Patents	XXX
		Goodwill	XXX
	XXX		XXX

VERTICAL FORMAT OF BALANCE SHEET

Particulars	Schedule No	Figures as at the end year (Rs.)	Figures as as at the end of Previous Financial Year (Rs.)
I. Sources of Funds			
(1) Shareholders' funds			
(a) Capital	---	----	----
(b) Reserves & Surplus	---	----	----
(2) Loan Funds			
(a) Secured loans	---	----	----
(b) Unsecured loans	---	----	----
Total :	---	----	----
II. Application of Funds			
(1) Fixed assets			
(a) Gross Block	---	----	----
Less : Depreciation	---	----	----
(b) Net Block	---	----	----
(c) Capital Work in Progress	---	----	----
(2) Investments			
(3) Current Assets, Loans and Advances			
(a) Inventories	---	----	----
(b) Sundry Debtors	---	----	----
(c) Cash and Bank Balance	---	----	----
(d) Other Current Assets	---	----	----
(e) Loans and Advances	---	----	----
Less: Current liabilities and Provisions	---	----	----
(i) Liabilities	---	----	----
(ii) Provisions	---	----	----
Net Current Assets	---	----	----
(4)(a) Miscellaneous expenditure to the extent not written off or adjusted	---	----	----
(b) Profit & Loss Account			
Total :			

ADJUSTMENTS IN FINAL ACCOUNTS

Final Accounts are prepared, normally, for a complete period. It must be kept in mind that expenses and incomes for the relevant accounting period are to be taken, while preparing final accounts. If an expense has been incurred but not paid during the period, a liability for the unpaid amount should be created, before finding out the operating result and financial position of a concern. In order to prepare the final accounts on mercantile system of accounting, all expenses and incomes relating to the period, whether incurred or not, received or not, should be brought into the books. For doing this, a concern is required to pass certain entries at the end of the year to adjust the various items of incomes and expenses. Such entries are called adjusting entries.

Accounting Treatment:

(1) Closing Stock: The term Closing Stock refers to stock of raw materials, work in progress and finished goods at the end of the year valued at cost price or market price whichever is less. The following adjustment entry is passed:

Closing Stock Account Dr.
To Trading Account

Closing Stock appearing in Trial Balance: Sometimes, opening and closing stock are adjusted through purchases. In this case, closing stock (debit balance) appears in the Trial Balance. Closing stock, under this case, will not be shown on the credit side of the Trading Account but will be shown on the assets side of to Balance Sheet only. Remember, any entry appearing in the Trial Balance appears only once either on the debit side or credit side, depending on the nature of the transaction. Closing stock is a real account, hence appears on the assets side of the balance sheet.

Expenses (Salaries) Account	Dr.
To Outstanding Expenses (Salaries)	

(3) Prepaid Expenses: Prepaid expenses are also known as unexpired expenses. Those expenses which are incurred and paid in advance are known as prepaid expenses. Such expenses are actually related to a future period. In order to ascertain the correct picture of the profit and loss accounts the following adjustment entry is required for adjusting such prepaid expenses.

The amount paid in advance will be deducted from the actual amount paid because it is related to the future accounting period. And the net amount will be debited to profit and loss account and the balance in the prepaid expenses account is shown the advance payment indicates as an amount due to the business concern.

Accrued Income Account Dr.
To Concerned Income Account

(5) Income Received in Advance: Any income received in advance which is not earned during the accounting period. Therefore, if any income received in advance, it should be treated as income for the subsequent year. The adjustment entry will be:

The Income Received in Advance is treated as a liability because an amount due to the party. Therefore, it is shown on the liability side of the balance sheet. The income actually earned alone will appear on the credit side of Profit and Loss Account.

Depreciation Account Dr.
To Fixed Assets Account

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(13) Accidental Losses: Stock of goods may also be destroyed or damaged by fire, etc. As a result, the value of the closing stock will be lower than otherwise. This will reduce the amount of the gross profit and, in turn, net profit, automatically. It is always better to ascertain the gross profit, which would have been earned, in absence of the loss since this enables the firm to judge its trading operations, properly. This will be possible if the amount of the loss of goods is credited to the Trading Account and debited to the Profit and Loss Account. By this entry, the increases in the gross profit will be neutralized by the debit to the Profit and Loss Account and thus the net profit will not be affected. The entries to be passed, say, in case of fire, are as follows:

(a) If Insurance Company admitted the full claim:

Trading Account credit side (Total stock value destroyed by fire)

Balance Sheet Asset side (Insurance Company Accounts)

(b) If Insurance Company admitted the part of the claim: (for example 60%)

Trading Account credit side (Total stock value Destroyed by fire) (100%)

Profit and Loss Account Debit side (Loss by fire) (40%)

Balance Sheet Asset side (Insurance Company Account) (60%)

(14) Commission Payable on Net Profits: Sometimes, Company may provide an incentive to the manager in the form of commission on profits to improve profitability of the company. Suppose the profit earned by the firm is Rs. 80, 000, without considering the commission; commission is 5%. The commission will be then Rs. 4,000. The profit will be reduced to Rs. 76,000. The entry to be passed will be to debit the Profit and Loss Account and credit the Commission Payable Account. This account will be a liability and shown in the balance sheet. Sometimes, commission may be on the net profits of the company. If the rate of the commission is 5%, then the profit remaining after the commission should be Rs. 100. In such an event, the profit before the commission should be Rs. 105. In other words, commission is Rs. 5 out of every Rs. 105 profit, before the commission.

The formula to calculate the commission in such a situation is: $5/105 \times \text{Profits before the commission}$.

CLOSING ENTRIES: Closing entries, also called closing journal entries, are entries made at the end of an accounting period to zero out all temporary accounts and transfer their balances to permanent accounts. In other words, the temporary accounts are closed or reset at the end of the year. This is commonly referred to as closing the books.

Temporary accounts are income statement accounts that are used to track accounting activity during an accounting period. For example, the revenues account records the amount of revenues earned during an accounting period—not during the life of the company. We don't want the 2015 revenue account to show 2014 revenue numbers.

Permanent accounts are balance sheet accounts that track the activities that last longer than an accounting period. For example, a vehicle account is a fixed asset account that is recorded on the balance. The vehicle will provide benefits for the company in future years, so it is considered a permanent account.

At the end of the year, all the temporary accounts must be closed or reset, so the beginning of the following year will have a clean balance to start with. In other words, revenue, expense, and withdrawal accounts always have a zero balance at the start of the year because they are always closed at the end of the previous year. This concept is consistent with the matching principle.

DIFFERENCE BETWEEN TRIAL BALANCE AND BALANCE SHEET

Trial Balance	Balance Sheet
It is prepared to verify the arithmetical accuracy of books of accounts	It is prepared to disclose the true financial position of the business
It is prepared with balances of all the ledger accounts	It is prepared with the balances of assets and liabilities accounts.
It is not a part of final accounts	It is an important part of final accounts.
It is prepared before the preparation of final accounts	It is prepared after the preparation of trading and profit and loss account.
It may be prepared a number of times in an accounting year.	It is generally prepared once at the end of accounting year.
Generally, it includes opening stock but not closing stock.	It always includes closing stock but not opening stock.
There is no rule for arranging the ledger balances in it.	Assets and liabilities must be shown in it according to the rule of marshalling.
It is not required to be filed to anybody.	It must be filed with the registrar of companies if the business is a company.
Auditor need not to sign it.	Auditor must sign it.

DIFFERENCE BETWEEN GROSS PROFIT AND NET PROFIT

Gross Profit	Net Profit
It is the excess of net sales over cost of purchase or manufacture (all expense relating to purchase or manufacture of goods) of goods.	It is the excess of gross profit over all indirect expenses.
It is not true profit of the business	It is true profit of the business.
It shows credit balance of the trading account	It shows credit balance of the profit and loss account.
The progress of the business can be judged by the comparison of gross profit with net sales	The profitability of the business can be measured by the comparison of net profit with net sales.

DIFFERENCE BETWEEN TRADING ACCOUNT AND PROFIT AND LOSS ACCOUNT

Trading Account	Profit and Loss Account
It is the first stage of final accounts.	It is the second stage of the final accounts.
It shows the gross result (gross profit or gross loss) of the business.	It shows the net results (net profit or net loss) of the business.
All direct expenses (expenses connected with purchase or production of goods) are considered in it.	All expenses connected with sales and administration (indirect expenses) of business is considered.
It does not start with the balance of any account.	It always starts with the balance of a trading account (gross profit or gross loss).
Its balance (G.P or G.L) is transferred to profit and loss account.	Its balance (N.P or N.L) is transferred to capital account in balance sheet.

FINANCIAL ACCOUNTING AND ANALYSIS

UNIT – III

ACCOUNTING FOR SHARE CAPITAL

A company form of organisation is the third stage in the evolution of forms of organisation. Its capital is contributed by a large number of persons called shareholders who are the real owners of the company. But neither it is possible for all of them to participate in the management of the company nor considered desirable. Therefore, they elect a Board of Directors as their representative to manage the affairs of the company. In fact, all the affairs of the company are governed by the provisions of the Companies Act, 1956.

According to C. J. Marshal “a company is a person, artificial, invisible, intangible and existing only in the eyes of law. Being a mere creation of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence”.

A company usually raises its capital in the form of shares (called share capital) and debentures (debt capital.) This chapter deals with the accounting for share capital of companies.

FEATURES OF A COMPANY

A company may be viewed as an association of person who contribute money or money's worth to a common inventory and uses it for a common purpose. It is an artificial person having corporate legal entity distinct from its members (shareholders) and has a common seal used for its signature. Thus, it has certain special features which distinguish it from the other forms of organisation. These are as follows:

- **Body Corporate:** A company is formed according to the provisions of Law enforced from time to time. Generally, in India, the companies are formed and registered under Companies Law except in the case of Banking and Insurance companies for which a separate Law is provided for.
- **Separate Legal Entity:** A company has a separate legal entity which is distinct and separate from its members. It can hold and deal with any type of property. It can enter into contracts and even open a bank account in its own name.
- **Limited Liability:** The liability of the members of the company is limited to the extent of unpaid amount of the shares held by them. In the case of the companies limited by guarantee, the liability of its members is limited to the extent of the guarantee given by them in the event of the company being wound up.
- **Perpetual Succession:** The Company being an artificial person created by law continues to exist irrespective of the changes in its membership. A company can be terminated only through law. The death or insanity or insolvency of any member of the company in no way affects the existence of the company. Members may come and go but the company continues.
- **Common Seal:** The Company being an artificial person cannot sign its name by itself. Therefore, every company is required to have its own seal which acts as official signatures of the company. Any document which does not carry the common seal of the company is not binding on the company.
- **Transferability of Shares:** The shares of a public limited company are freely transferable. The permission of the company or the consent of any member of the company is not necessary for the transfer of shares. But the Articles of the company can prescribe the manner in which the transfer of shares will be made.
- **May Sue or be sued:** A company being a legal person can enter into contracts and can enforce the contractual rights against others. It can sue and be sued in its name if there is a breach of contract by the company.

KINDS OF COMPANIES

Companies can be classified either on the basis of the liability of its members or on the basis of the number of members. On the basis of liability of its members the companies can be classified into the following three categories:

(i) **Companies Limited by Shares:** In this case, the liability of its members is limited to the extent of the nominal value of shares held by them. If a member has paid the full amount of the shares, there is no liability on his part whatsoever may be the debts of the company. He need not pay single paise from his private property. However, if there is any liability involved, it can be enforced during the existence of the company as well as during the winding up.

(ii) **Companies Limited by Guarantee:** In this case, the liability of its members is limited to the amount they undertake to contribute in the event of the company being wound up. Thus, the liability of the members will arise only in the event of its winding up.

(iii) **Unlimited Companies:** When there is no limit on the liability of its members, the company is called an unlimited company. When the company's property is not sufficient to pay off its debts, the private property of its members can be used for the purpose. In other words, the creditors can claim their dues from its members. Such companies are not found in India even though permitted by the Companies Act, 1956.

On the basis of the number of members, companies can be divided into two categories as follows:

(i) **Public Company:** A public company means a company which (a) is not a private company, (b) has minimum paid up capital of Rs. 5 lakh rupees or such higher paid-up capital, as may be prescribed and (c) is a company which is not a subsidiary of a private company.

(ii) **Private Company:** A private company is one which has a minimum paid up capital of Rs. 1 Lakh rupees or such higher paid-up share capital as may be prescribed, and which by its articles:

- (a) Restricts the right to transfer its shares;
- (b) Limits the number of its members to 200 (excluding its employees);
- (c) Prohibits any invitation to the public to subscribe for any shares in or debentures of the company.
- (d) Prohibits any invitation or acceptance of deposits from person other than its members, directors, and relatives.

SHARE CAPITAL OF A COMPANY

A company, being an artificial person, cannot generate its own capital which has necessarily to be collected from several persons. These persons are known as shareholders and the amount contributed by them is called share capital. Since the number of shareholders is very large, a separate capital account cannot be opened for each one of them. Hence, innumerable streams of capital contribution merge their identities in a common capital account called as 'Share Capital Account'.

CATEGORIES OF SHARE CAPITAL

• **Authorised Capital:** Authorised capital is the amount of share capital which a company is authorised to issue by its Memorandum of Association. The company cannot raise more than the amount of capital as specified in the Memorandum of Association. It is also called nominal or registered capital. The authorised capital can be increased or decreased as per the procedure laid down in the Companies Act. It should be noted that the company need not issue the entire authorised capital for public subscription at a time. Depending upon its requirement, it may issue share capital but in any case, it should not be more than the amount of authorised capital.

• **Issued Capital:** It is that part of the authorised capital which is actually issued to the public for subscription including the shares allotted to vendors and the signatories to the company's memorandum. The authorised capital which is not offered for public subscription is known as 'unissued capital'. Unissued capital may be offered for public subscription at a later date.

• **Subscribed Capital:** It is that part of the issued capital which has been actually subscribed by the public. When the shares offered for public subscription are subscribed fully by the public the issued capital and subscribed capital would be the same. It may be noted that ultimately, the subscribed capital and issued capital are the same because if the number of share, subscribed is less than what is offered, the company allot only the number of shares for which subscription has been received. In case it is higher than what is offered, the allotment will be equal to the offer. In other words, the fact of over subscription is not reflected in the books.

- **Called up Capital:** It is that part of the subscribed capital which has been called up on the shares. The company may decide to call the entire amount or part of the face value of the shares. For example, if the face value (also called nominal value) of a share allotted is Rs. 10 and the company has called up only Rs. 7 per share, in that scenario, the called up capital is Rs. 7 per share. The remaining Rs. 3 may be collected from its shareholders as and when needed.
- **Paid up Capital:** It is that portion of the called up capital which has been actually received from the shareholders. When the shareholders have paid all the call amount, the called up capital is the same to the paid up capital. If any of the shareholders has not paid amount on calls, such an amount may be called as 'calls in arrears'. Therefore, paid up capital is equal to the called-up capital minus call in arrears.
- **Uncalled Capital:** That portion of the subscribed capital which has not yet been called up. As stated earlier, the company may collect this amount any time when it needs further funds.
- **Reserve Capital:** A company may reserve a portion of its uncalled capital to be called only in the event of winding up of the company. Such uncalled amount is called 'Reserve Capital' of the company. It is available only for the creditors on winding up of the company.

Let us take the following example and show how the share capital will be shown in the balance sheet. Sunrise Company Ltd., New Delhi, has registered its capital as Rs. 40,00,000, divided into 4,00,000 shares of Rs. 10 each. The company offered to the public for subscription of 2, 00,000 shares of Rs. 10 each, as Rs. 2 on application, Rs.3 on allotment, Rs.3 on first call and the balance on final call. The company received applications for 2, 50,000 shares. The company finalised the allotment on 2, 00,000 shares and rejected applications for 50,000 shares. The company did not make the final call. The company received the entire amount except on 2,000 shares where call money has not been received. The above amounts will be shown in the Notes to Accounts of the balance sheet of Sunrise Company Ltd. as follows:

NOTES TO ACCOUNTS

		(Rs.)
Share Capital		
<u>Authorised or Registered or Nominal Capital</u>		<u>40,00,000</u>
4,00,000 Shares of Rs. 10 each		
<u>Issued Capital</u>		<u>20,00,000</u>
2,00,000 Shares of Rs. 10 each Subscribed Capital		
<u>Subscribed but not fully paid up</u>		
2,00,000 Shares of Rs. 10 each, Rs. 8 called up	16,00,000	
Less : Calls in Arrears	(6,000)	15,94,000

NATURE AND CLASSES OF SHARES

Shares refer to the units into which the total share capital of a company is divided. Thus, a share is a fractional part of the share capital and forms the basis of ownership interest in a company. The persons who contribute money through shares are called shareholders. The amount of authorised capital, together with the number of shares in which it is divided, is stated in the Memorandum of Association but the classes of shares in which the company's capital is to be divided, along with their respective rights and obligations, are prescribed by the Articles of Association of the company. As per Section 86 of The Companies Act, a company can issue two types of shares (1) preference shares, and (2) equity shares (also called ordinary shares).

Preference Shares: According to Section 85 of The Companies Act, 1956, a preference share is one, which fulfils the following conditions:

- That it carries a preferential right to dividend to be paid either as a fixed amount payable to preference shareholders or an amount calculated by a fixed rate of the nominal value of each share before any dividend is paid to the equity shareholders.
- That with respect to capital it carries or will carry, on the winding up of the company, the preferential right to the repayment of capital before anything is paid to equity shareholders.

However, notwithstanding the above two conditions, a holder of the preference share may have a right to participate fully or to a limited extent in the surpluses of the company as specified in the Memorandum or Articles of the company. Thus, the preference shares can be participating and non-participating. Similarly, these shares can be cumulative or non-cumulative, and redeemable or irredeemable.

Types of preference shares:

1. **Cumulative preference shares:** In case of these shares, the arrears of dividend are carried forward and paid out of the profits of the subsequent years.
2. **Non-cumulative preference shares:** If dividend not to accumulate and not to carried forward to next year, these are called non-cumulative preference shares.
3. **Participating preference shares:** In addition to a fixed dividend, balance of profit (after meeting equity dividend) shared by some preference shareholders. Such shares are participating preference shares.
4. **Non-participating preference shares:** These shares get only a fixed rate of dividend. These do not get share in the surplus profit.
5. **Redeemable preference shares:** If preference shares are returned after a specified period to shareholders, these preference shares are called redeemable preference shares.
6. **Irredeemable preference shares:** Preference shares which cannot be redeemed throughout the life of the company are known as irredeemable preference shares
7. **Convertible preference shares:** These shares are given the right of conversion into equity shares within a specified period or at a specified date according to the terms of issue.
8. **Non-Convertible preference shares:** Preference shares which cannot be converted into equity shares are called as Non-Convertible preference shares.

Equity Shares: Shares which do not enjoy any preferential right in the payment of dividend or repayment of capital are termed as equity/ordinary shares. The equity shareholders are entitled to share the distributable profits of the company after satisfying the dividend rights of the preference shareholders. The dividend on equity shares is not fixed and it may vary from year to year depending upon the amount of profits available for distribution. The equity share capital may be (i) with voting rights; or (ii) with differential rights as to voting, dividend or otherwise in accordance with such rules and subject to such conditions as may be prescribed.

DIFFERENCE BETWEEN EQUITY SHARES AND PREFERENCE SHARES

EQUITY SHARES	PREFERENCE SHARES
It is an ownership security	It is a hybrid security
Dividend rate is not fixed	Dividend rate is fixed
Capital is repaid only in winding up	Capital is repaid after a stipulated period
These shares have voting rights	These shares generally do not have voting rights
Face value is lower	Face value is higher

ISSUE OF SHARES

A salient characteristic of the capital of a company is that the amount on its shares can be gradually collected in easy instalments spread over a period of time depending upon its growing financial requirement. The first instalment is collected along with application and is thus, known as application money, the second on allotment (termed as allotment money), and the remaining instalment are termed as first call, second call and so on. The word final is suffixed to the last instalment. However, this in no way prevents a company from calling the full amount on shares right at the time of application. The important steps in the procedure of share issue are:

• **Issue of Prospectus:** The Company first issues the prospectus to the public. Prospectus is an invitation to the public that a new company has come into existence and it needs funds for doing business. It contains complete information about the company and the manner in which the money is to be collected from the prospective investors.

• **Receipt of Applications:** When prospectus is issued to the public, prospective investors intending to subscribe the share capital of the company would make an application along with the application money and deposit the same with a scheduled bank as specified in the prospectus. The company has to get minimum subscription within 120 days from the date of the issue of the prospectus. If the company fails to receive the same within the said period, the company cannot proceed for the allotment of shares and application money should be returned within 130 days of the date of issue of prospectus.

• **Allotment of Shares:** If minimum subscription has been received, the company may proceed for the allotment of shares after fulfilling certain other legal formalities. Letters of allotment are sent to those whom the shares have been allotted, and letters of regret to those to whom no allotment has been made. When allotment is made, it results in a valid contract between the company and the applicants who now became the shareholders of the company.

Shares of a company are issued either at par, at a premium or at a discount. Shares are to be issued at *par* when their issue price is exactly equal to their nominal value according to the terms and conditions of issue. When the shares of a company are issued more than its nominal value (face value), the excess amount is called premium. When the shares are issued at a price less than the face value of the share, it is known as shares issued at a discount. Irrespective of the fact those shares are issued at par, premium or discount, the share capital of a company as stated earlier, may be collected in instalments payable at different stages.

ACCOUNTING TREATMENT:

On Application: The amount of money paid with various instalments represents the contribution to share capital and should ultimately be credited to share capital. However, for the sake of convenience, initially individual accounts are opened for each instalment. All money received along with application is deposited with a scheduled bank in a separate account opened for the purpose. The journal entry is as follows:

Bank A/c Dr.

To Share Application A/c

(Amount received on application for — shares @ Rs. _____ per share)

On Allotment: When minimum subscription has been received and certain legal formalities on the allotment of shares have been duly complied with, the directors of the company proceed to make the allotment of shares. The allotment of shares implies a contract between the company and the applicants who now become the allottees and assume the status of shareholders or members.

ALLOTMENT OF SHARES (Implications from Accounting point of view)

- ❖ It is customary to ask for some amount called “Allotment Money” from the allottees on the shares allotted to them as soon as the allotment is made.
- ❖ With the acceptance to the offer made by the applicants, the amount of application money received has to be transferred to share capital account as it has formally become the part of the same.
- ❖ The money received on rejected applications should either be fully returned to the applicant within period prescribed by law/SEBI.
- ❖ In case lesser number of shares has to be allotted, than those applied for the excess application money must be adjusted towards the amount due on allotment from the allottees.
- ❖ The effect of the latter two steps is to close the share application account which is only a temporary account for share capital transactions.
- ❖

The journal entries with regard to allotment of shares are as follows:

1. For Transfer of Application Money

Share Application A/c Dr.

To Share Capital A/c

(Application money on ____ Shares allotted/ transferred to Share Capital)

2. For Money Refunded on Rejected Application

Share Application A/c Dr.

To Bank A/c

(Application money returned on rejected application for ____ shares)

3. For Amount Due on Allotment

Share Allotment A/c Dr.

To Share Capital A/c

4. For Adjustment of Excess Application Money

Share Application A/c Dr.

To Share Allotment A/c

(Application Money on ____ Shares @ Rs. ____ per shares adjusted to the amount due on allotment).

5. For Receipt of Allotment Money

Bank A/c Dr.

To Share Allotment A/c

(Allotment money received on ____ Shares @ Rs. ____ per share Combined Account)

Note: The journal entries (2) and (4) can also be combined as follows:

Share Application A/c

To Share Allotment A/c

To Bank A/c

(Excess application money adjusted to share allotment and balance refunded)

On Calls: Calls play a vital role in making shares fully paid-up and for realising the full amount of shares from the shareholders. In the event of shares not being fully called up till the completion of allotment, the directors have the authority to ask for the remaining amount on shares as and when they decide about the same. It is also possible that the timing of the payment of calls by the shareholders is determined at the time of share issue itself and given in the prospectus.

Two points are important regarding the calls on shares. First, the amount on any call should not exceed 25% of the face value of shares. Second, there must be an interval of at least one month between the makings of two calls unless otherwise provided by the articles of association of the company. When a call is made and the amount of the same is received, the journal entries are as given below:

1. For Call Amount Due

Share Call A/c Dr.

To Share Capital A/c

(Call money due on ____ Shares @ Rs. ____ per share)

2. For Receipt of Call Amount

Bank A/c Dr.

To Share Call A/c

(Call money received)

The word/words first, second, or third must be added between the words “Share” and ‘Call’ in the Share Call account depending upon the identity of the call made. For example, in case of first call it will be termed as ‘Share First Call Account’, in case of second call it will be ‘Share Second Call Account’ and so on.

Another point to be noted is that the words ‘and Final’ will also be added to the last call, say, if second call is the last call it will be termed as ‘Second and Final Call’ and if it is the third call which is the last call, it will be termed as ‘Third and Final Call’. It is also possible that the whole balance after allotment may be collected in one call only. In that case the first call itself shall be termed as the ‘First and Final Call’.

CALLS IN ARREARS

It may happen that shareholders do not pay the call amount on due date. When any shareholder fails to pay the amount due on allotment or on any of the calls, such amount is known as 'Calls in Arrears'/'Unpaid Calls'. Calls in Arrears represent the debit balance of all the calls account. Such amount shall appear as 'Note to Accounts (Refer Chapter 3). However, where a company maintains 'Calls in Arrears' Account, it needs to pass the following additional journal entry:

Calls in Arrears A/c Dr.
To Share First Call Account A/c
To Share Second and Final Call Account A/c
(Calls in arrears brought into account)

The Articles of Association of a company may empower the directors to charge interest at a stipulated rate on calls in arrears. If the articles are silent in this regard, the rule contained in Table A shall be applicable which states that the interest at a rate not exceeding 5% p.a. shall have to be paid on all unpaid amounts on shares for the period intervening between the day fixed for payment and the time of actual payment thereof.

On receipt of the call amount together with interest, the amount of interest shall be credited to interest account while call money shall be credited to the respective call account or to calls in arrears account. When the shareholder makes the payment of calls in arrears together with interest, the entry will be as follows:

Bank A/c Dr.
To Calls in Arrears A/c
To Interest A/c
(Calls in arrears received with interest)

Note: If nothing is specified, there is no need to take the interest on calls in arrears account and record the above entry.

CALLS IN ADVANCE

Sometimes shareholders pay a part or the whole of the amount of the calls not yet made. The amount so received from the shareholders is known as "Calls in Advance". The amount received in advance is a liability of the company and should be credited to 'Call in Advance Account.' The amount received will be adjusted towards the payment of calls as and when they become due. Table A of the Companies Act provides for the payment of interest on calls in advance at a rate not exceeding 6% per annum. The following journal entry is recorded for the amount of calls received in advance.

Bank A/c Dr.
To Calls in Advance A/c
(Amount received on call in advance)

On the due date of the calls, the amount of 'Calls in Advance' is adjusted by the following entry:

Calls in Advance A/c Dr.
To Particular Call A/c
(Calls in advance adjusted with the call money due)

The balance in 'Calls in Advance' account is shown as a separate item under the title *Equity and Liabilities* in the company's balance sheet under the head '*current liabilities*', as sub-head '*others current liabilities*'. It is not added to the amount of paid-up capital.

As 'Calls in Advance' is a liability of the company, it is under obligation, if provided by the Articles, to pay interest on such amount from the date of its receipt up to the date when appropriate call is due for payment. A stipulation is generally made in the Articles regarding the rate at which interest is payable. However, if Articles are silent on this account, Table A is applicable which provides for interest on calls in advance at a rate not exceeding 6% per annum. The accounting treatment of interest on Calls in Advance is as follows:

Interest on Calls in Advance A/c Dr.
To Bank A/c
(Interest paid on Calls in Advance)

OVER SUBSCRIPTION

There are instances when applications for more shares of a company are received than the number offered to the public for subscription. This usually happens in respect of shares issue of well-managed and financially strong companies and is said to be a case of 'Over Subscription'.

In such a condition, three alternatives are available to the directors to deal with the situation: (1) they can accept some applications in full and totally reject the others; (2) they can make a pro-rata allotment to all; and (3) they can adopt a combination of the above two alternatives which happens to be the most common course adopted in practice.

The problem of over subscription is resolved with the allotment of shares. Therefore, from the accounting point of view, it is better to place the situation of over subscription within the total frame of application and allotment, i.e. receipt of application amount, amount due on allotment and its receipt from the shareholders, and the same has been observed in the pattern of entries.

First Alternative: When the directors decide to fully accept some applications and totally reject the others, the application money received on rejected applications is fully refunded. For example, a company invited applications for 20,000 shares and received the applications for 25,000 shares. The directors rejected the applications for 5,000 shares which are in excess of the required number and refunded their application money in full. In this case, the journal entries on application and allotment will be as follows:

1. Bank A/c Dr.
To Share Application A/c
(Money received on application for 25,000 shares @ Rs. _ per share)
2. Share Application A/c Dr.
To Share Capital A/c
To Bank A/c
(Transfer of application for money 20,000 for shares allotted and money refunded on applications for 5,000 shares rejected)
3. Share Allotment A/c Dr.
To Share Capital A/c
(Amount due on the allotment of 20,000 shares @ Rs. _ per share)
4. Bank A/c Dr.
To Share Allotment A/c
(Allotment money received)

Second Alternative: When the directors opt to make a proportionate allotment to all applicants (called 'pro-rata' allotment), the excess application money received is normally adjusted towards the amount due on allotment. In case, the excess application money received is more than the amount due on allotment of shares, such excess amount may either be refunded or credited to calls in advance. For example, in the event of applications for 20,000 shares being invited and those received are for 25,000 shares, it is decided to allot shares in the ratio of 4:5 to all applicants. It is a case of pro-rata allotment and the excess application money received on 5,000 shares would be adjusted towards the amount due on the allotment of 20,000 shares. In this case, the journal entries on application and allotment will be as follows:

1. Bank A/c Dr.
To Share Application A/c
(Application money received on 25,000 shares @ Rs. _ per Share)
2. Share Application A/c Dr.
To Share Capital A/c
To Share Allotment A/c
(Transfer of application money to share capital and the excess application money on 5,000 shares credited to share allotment account)
3. Share Allotment A/c Dr.
To Share Capital A/c
(Amount due on allotment of 25,000 share @ Rs. _ per share)
4. Bank A/c Dr.
To Share Allotment A/c
(Allotment money received after adjusting the amount already received as excess application money)

Third Alternative : When the application for some shares are rejected outright; and pro-rata allotment is made to the remaining applicants, the money on rejected applications is refunded and the excess application money received from applicants to whom pro-rata allotment has been made is adjusted towards the amount due on the allotment of shares allotted.

For example, a company invited applications for 10,000 shares and received applications for 15,000 shares. The directors decided to reject the applications for 2,500 shares outright and to make a pro-rata allotment of 10,000 shares to the applicants for the remaining 12,500 shares so that four shares are allotted for every five shares applied. In this case, the money on applications for 2,500 shares rejected would be refunded fully and that on the remaining 2,500 shares (12,500 shares – 10,000 shares) would be adjusted against the allotment amount due on 10,000 shares allotted and credited to share allotment account, the journal entries on application and allotment recorded as follows:

1. Bank A/c Dr.

To Share Application A/c

(Money received on application for 15,000 shares @ Rs. _ per share)

2. Share Application A/c Dr.

To Share Capital A/c

To Share Allotment A/c

To Bank A/c

(Transfer of application money to share capital, and the excess application amount of pro-rata allottees credited to share allotment and the amount on rejected applications refunded)

3. Share Allotment A/c Dr.

To Share Capital A/c

(Amount due on the Allotment of 10,000 shares @ Rs. _ per share)

4. Bank A/c Dr.

To Share Allotment A/c

(Allotment money received after adjusting the amount already received as excess application money)

Under Subscription: Under subscription is a situation where number of shares applied for is less than the number for which applications have been invited for subscription. For example, a company offered 2 lakh shares for subscription to the public but the applications were received for 1, 90,000 shares, only. In such a situation, the allotment will be confirmed to 1, 90,000 shares and entries shall be made accordingly. However, as stated earlier, it must be ensured that the company has received the minimum subscriptions (not less than 90% of the offer otherwise the procedure for issue of shares cannot proceed further and the company will have to refund the entire subscription amount received).

ISSUE OF SHARES AT A PREMIUM

It is quite common for the shares of financially strong and well-managed companies to be issued at a premium, i.e. at an amount more than the nominal or par value of shares. Thus, when a share of the nominal value of Rs. 100 is issued at Rs. 105, it is said to have been issued at a premium of 5 per cent. When the issue of shares is at a premium, the amount of premium may technically be called at any stage of the issue of shares. However, premium is generally called with the amount due on allotment, sometimes with the application money and rarely with the call money. The premium amount is credited to a separate account called 'Securities Premium Account' and is shown under the title '*Equity and Liabilities*' of the company's balance sheet under the head '*Reserves and Surpluses*'. It can be used only for the following four purposes as laid down by Section 78 of The Companies Act 1956:

- (a) To issue fully paid bonus shares to the extent not exceeding unissued share capital of the company;
- (b) To write-off preliminary expenses of the company;
- (c) To write-off the expenses of, or commission paid, or discount allowed on any of the shares or debentures of the company; and
- (d) To pay premium on the redemption of preference shares or debentures of the company.

The journal entries for shares issued at a premium are as follows:

1. **For Premium Amount called with Application money**

(a) Bank A/c Dr.

To Share Application A/c

(Money received on application for — shares @ Rs. — per share including premium)

(b) Share Application A/c Dr.
To Share Capital A/c
To Securities Premium A/c
(Transfer of application money to share capital and securities premium account)

2. Premium Amount called with Allotment Money

(a) Share Allotment A/c Dr.
To Share Capital A/c
To Securities Premium A/c
(Amount due on allotment of shares @ Rs — per share including premium)
(b) Bank A/c Dr.
To Share Allotment A/c
(Allotment money received including premium)

ISSUE OF SHARES AT A DISCOUNT

There are instances when the shares of a company are issued at a discount, i.e. at an amount less than the nominal or par value of shares, the difference between the nominal value and issue price representing discount on the issue of shares. For example, when a share of the nominal value of Rs. 100 is issued at Rs. 98, it is said to have been issued at a discount of two per cent.

As a general rule, a company cannot ordinarily issue shares at a discount. It can do so only in cases such as 'reissue of forfeited shares' (to be discussed later) and in accordance with the provisions of Section 79 of the Companies Act, 1956. Section 79 of the Companies Act, 1956 states that a company is permitted to issue shares at a discount provided the following conditions are satisfied:

- (a) The issue of shares at a discount is authorised by an ordinary resolution passed by the company at its general meeting and sanctioned by the Company Law Board now Central Government.
- (b) The resolution must specify the maximum rate of discount at which the shares are to be issued but the rate of discount must not exceed 10 per cent of the nominal value of shares. The rate of discount can be more than 10 per cent if the Government is convinced that a higher rate is called for under special circumstances of a case.
- (c) At least one year must have elapsed since the date on which the company became entitled to commence the business.
- (d) The shares are of a class which has already been issued.
- (e) The shares issued within two months from the date of receiving sanction for the same from the Government or within such extended period as the Government may allow.

Whenever shares are issued at a discount, the amount of discount is brought into the books at the time of allotment by debiting an account called 'Discount on the Issue of Shares Account'. The journal entry to be passed for the purpose is as given below:

Share Allotment A/c Dr.
Discount on the Issue of Shares A/c Dr.
Share Capital A/c
(Amount due on allotment of — shares @ Rs — per share and discount on issue brought into account)

FORFEITURE OF SHARES

It may happen that some shareholders fail to pay one or more instalments, viz. allotment money and/or call money. In such circumstances, the company can forfeit their shares, i.e. cancel their allotment and treat the amount already received thereon as forfeited to the company within the framework of the provisions in its articles. These provisions are usually based on Table A which authorise the directors to forfeit the shares for non-payment of calls made. For this purpose, they have to strictly follow the procedure laid down in this regard.

Following is the accounting treatment of shares issued at par, premium or at a discount. When shares are forfeited all entries relating to the shares forfeited except those relating to premium, already recorded in the accounting records must be reversed. Accordingly, share capital account is debited with the amount called-up in respect of shares are forfeited and crediting the respective unpaid calls accounts' or calls in arrears account with the amount already received. Thus, the journal entry will be as follows:

Bank A/c Dr. 1,800
Share Forfeiture A/c Dr. 200
To Share Capital A/c 2,000
(Reissue of 200 forfeited shares at Rs. 9 per share as fully paid)

This shall leave a balance of Rs. 400 in share forfeited account which should be transferred to Capital Reserve Account by recording the following journal entry:

Share Forfeiture A/c Dr. 400
To Capital Reserve 400
(Profit on reissue of forfeited shares transferred)

Another important point to be noted in this context is that the capital profit arises only in respect of the forfeited share reissued, and not on all forfeited shares. Hence, when a part of the forfeited shares are reissued, the whole balance of share forfeiture account cannot be transferred to the capital reserve. In such a situation, it is only the proportionate amount of balance that relates to the forfeited shares reissued which should be transferred to capital reserve, ensuring that the remaining balance in share forfeiture account is proportionate to the amount forfeited on shares not yet reissued.

BUYBACK OF SHARES

Buyback of shares means that any company may purchase their own shares or other specified securities. According to section 77A (1) of the companies Act 1999, a company may purchase its own shares or other securities out of:

- (i) Its free reserves or
- (ii) The securities premium account or
- (iii) The proceeds of any shares or other specified securities.

Specified securities include employee's stock option or other securities as may be notified by the Central Government from time to time. Buyback of shares of any kind is not allowed out of fresh issue of shares of the same kind. In other words, if equity shares are to be bought back, preference shares or debentures may be issued for buyback of equity shares. Companies are allowed to buy back their own shares if they fulfil certain conditions as given in section 77A (2) of the companies Act 1999.

PRELIMINARY CONDITIONS FOR BUY BACK OF SHARES

No company shall purchase its own shares or other specified securities unless:

- (a) The buyback is authorised by its articles.
- (b) A Special resolution has been passed in general meeting of the company authorising the buyback.
- (c) The buyback is for less than 25% of the total paid up capital and free reserves of the company.
- (d) It also provides that buyback shall not be exceeding 25% of total paid up capital.
- (e) The debt equity ratio should not be more than 2:1 after such buyback.
- (f) All the shares or other specified securities for buyback are fully paid up.
- (g) The buyback of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.
- (h) The buyback in respect of shares or other specified securities other those specified in clause
- (i) The buyback should be completed within 12 months from the date of passing the special resolution.

SEBI GUIDELINES FOR BUY BACK OF SHARES

1. Buyback of shares cannot be from any person through negotiated deals whether on or after stock exchange or through spot transactions or through private management. Therefore a company is required to make public announcement in at least one National Daily all with wide circulation where registered office of the company is situated.

2. Public announcement among other things specifying the following:

- ❖ Specified date i.e. the date of the dispatch of the offer letter shall not be less than earlier than 30 days but not later than 42 days.
- ❖ SEBI shall be informed by the company with in seven working days from the date of public announcement.
- ❖ The offer for buyback shall remain open to the members for a period of not less than 15 days but not exceeding 30 days. However the opening date for the offer shall not be earlier than 7 days or later than 30 days from the specified date.
- ❖ The company shall complete the verification of offers within 15 days from the date of closure and shares lodged shall be deemed to have been accepted unless communication of rejection is made within 15 days from the date of closure.

OBJECTIVES OF BUY BACK OF SHARES

- ❖ To provide an additional exit route to shareholders when shares are undervalued or thinly traded;
- ❖ To enhance consolidation of stake in the company;
- ❖ To prevent unwelcome takeover bids;
- ❖ To return surplus cash to shareholders;
- ❖ To achieve optimum capital structure;
- ❖ To support share price during periods of sluggish market condition;
- ❖ To serve the equity more efficiently.

ADVANTAGES OF BUY-BACK OF SHARES

- ❖ The buyback facility enables the companies to manage their cash effectively. Many companies in this country are faced with a problem of surplus cash without having any idea of where to invest them. It would be better for them to return surplus cash to shareholders rather than to go on spending simply for want to alternative.
- ❖ Companies having large amount of free reserves are free to use funds to acquire shares and other specified securities under the buyback process.
- ❖ Buyback shares in helpful co. to reduce its share capital.
- ❖ Buyback of shares is helpful to improvement in the values of shares.
- ❖ Avoid high financial risk and ensure maximum return to the shareholders.
- ❖ Buyback of shares helps the promoters to formulate an effective defence strategy against hostile take-over bids.

DISADVANTAGES OF BUY-BACK OF SHARES

- ❖ The buybacks imply under valuation of companies stock .the companies plough back some of the outstanding shares thereby creating a shortage of shares in the market.
- ❖ Companies go for announcing buyback when they can't find anything better to do with their cash.
- ❖ Well timed buyback of share is a clever way for managers to invest cheaply in a company they know rather than expensively in a company they don't know.
- ❖ All the control of buy back of shares in the hands of promoters, so the position of minority shareholders is weak.
- ❖ It may be used as a tool of insider trading
- ❖ The promoters before the buy back, may understand the earnings by manipulating accounting policies and highlight other unfavourable factors affecting the earnings.
- ❖ High buy back of share may lead to artificial manipulation of stock prices in the stock exchange. Confusion is much more.

Illustration 2

Anu Ltd. furnishes you with the following summarized balance sheet as at 31st March, 2012:

	(₹ in crores)	
<i>Sources of Funds</i>		
<i>Share Capital:</i>		
<i>Authorised</i>		<u>100</u>
<i>Issued:</i>		
<i>12% redeemable preference shares of ₹ 100 each fully paid</i>	75	
<i>Equity shares of ₹ 10 each fully paid</i>	<u>25</u>	100
<i>Reserves and surplus:</i>		

<i>Capital reserve</i>	15	
<i>Securities premium</i>	25	
<i>Revenue reserves</i>	<u>260</u>	<u>300</u>
		<u>400</u>
<i>Application of Funds</i>		
<i>Fixed assets: cost</i>	100	
<i>Less: Provision for depreciation</i>	<u>(100)</u>	Nil
<i>Non-current investments at cost (Market value ₹ 400 Cr.)</i>		100
<i>Current assets</i>	340	
<i>Less: Current liabilities (Trade payables)</i>	<u>(40)</u>	<u>300</u>
		<u>400</u>

The company redeemed preference shares on 1st April, 2012. It also bought back 50 lakhs equity shares of ₹ 10 each at ₹ 50 per share. The payments for the above were made out of the huge bank balances, which appeared as a part of current assets.

You are asked to:

- (i) Pass journal entries to record the above.
- (ii) Prepare balance sheet as at 1.4.2012.

Solution

Journal entries in the books of Anu Ltd.

₹ in crores

	Particulars		Debit	Credit
1 st April, 2012	12% Preference share capital A/c Dr. To Preference shareholders A/c (Being preference share capital account transferred to shareholders account)		75	75
	Preference shareholders A/c Dr. To Bank A/c (Being payment made to shareholders)		75	75
	Shares buy back A/c Dr. To Bank A/c (Being 50 lakhs equity shares bought back @ ₹ 50 per share)		25	25
	Equity share capital A/c (50 lakhs x ₹ 10) Dr. Securities premium A/c (50 lakhs x ₹ 40) Dr. To Shares buy back A/c (Being cancellation of shares bought back)		5 20	25
	Revenue reserve A/c Dr. To Capital Redemption Reserve A/c (Being creation of capital redemption reserve to the extent of the face value of preference shares redeemed and equity shares bought back)		80	80

(ii)

Balance Sheet of Anu Ltd as at 1.4.2012

Particulars	Note No	₹ in crores
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	20
(b) Reserves and Surplus	2	280
(2) Current Liabilities		
(a) Trade payables		40
Total		340
II. Assets		
(1) Non-current assets		
(a) Fixed assets	3	-
(b) Non-current investments -Investment at cost (Market value ₹ 400 crores)		100
(2) Current assets	4	240
Total		340

Notes to Accounts

1.	Share Capital		₹ in crores
	<i>Authorised, Issued and Subscribed</i>		
	200 lakhs Equity shares of ₹ 10 each		20
2.	Reserves and Surplus		
	Capital reserve	15	
	Capital redemption reserve	80	
	Securities premium	25	
	Less: Utilisation for buy back of shares	(20)	5
	Revenue Reserve	260	
	Less: transfer to Capital redemption reserve	(80)	180
			280

3.	Fixed Assets		
	Cost	100	
	Less : Provision for depreciation	(100)	-
4.	Current assets		
	Current assets as on 31.3.2012	340	
	Less: Bank payment for redemption and buy back	(100)	240

Illustration 3

Dee Limited furnishes the following summarized Balance Sheet as at 31st March, 2012:

	₹ '000	₹ '000
Liabilities		
<i>Share capital:</i>		
<i>Authorised capital</i>		<u>30,00</u>
<i>Issued and subscribed capital:</i>		
2,50,000 Equity shares of ₹ 10 each fully paid up	25,00	
2,000, 10% Preference shares of ₹ 100 each	<u>2,00</u>	
(Issued two months back for the purpose of buy back)		27,00
<i>Reserves and surplus:</i>		
Capital reserve	10,00	
Revenue reserve	30,00	
Securities premium	22,00	
Profit and loss account	<u>35,00</u>	97,00
<i>Current liabilities and provisions</i>		14,00
		<u>1,38,00</u>
Assets		
<i>Fixed assets</i>		93,00
<i>Investments</i>		30,00
<i>Current assets, loans and advances (including cash and bank balance)</i>		15,00
		<u>1,38,00</u>

The company passed a resolution to buy back 20% of its equity capital @ ₹ 50 per share. For this purpose, it sold all of its investment for ₹ 22,00,000.

You are required to pass necessary journal entries and prepare the Balance Sheet.

Solution

In the books of Dee Limited

Journal Entries

	Particulars	Dr.	Cr.
		(₹ in '000)	
(i)	Bank Account	Dr. 22,00	
	Profit and Loss Account	Dr. 8,00	
	To Investment Account		30,00
	(Being the investments sold at loss for the purpose of buy back)		
(ii)	Equity Share capital account	Dr. 5,00	
	Premium payable on buy back Account	Dr. 20,00	
	To Equity shares buy back Account		25,00
	(Being the amount due on buy back)		
(iii)	Securities premium Account	Dr. 20,00	
	To Premium payable on buy back Account		20,00
	(Being the premium payable on buy back adjusted against securities premium account)		
(iv)	Revenue reserve Account	Dr. 3,00	
	To Capital Redemption Reserve Account		3,00
	(Being the amount equal to nominal value of equity shares bought back out of free reserves transferred to capital redemption reserve account)		
(v)	Equity shares buy-back Account	Dr. 25,00	
	To Bank Account		25,00
	(Being the payment made on buy back)		

Balance Sheet of Dee Limited as on 1st April, 2012

(After buy back of shares)

Particulars	Note No	(₹ in 000)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	22,00

(b) Reserves and Surplus	2	69,00
(2) Current Liabilities		14,00
Total		10,500
II. Assets		
(1) Non-current assets		
(a) Fixed assets		93,00
(2) Current assets		12,00
Total		10,500

Notes to Accounts

₹ in 000			
1	Share Capital		
	Authorised capital:		<u>30,00</u>
	Issued and subscribed capital:		
	2,00,000 Equity shares of ₹ 10 each fully paid up	20,00	
	2,000 10% Preference shares of ₹ 100 each fully paid up	2,00	22,00
2	Reserves and Surplus		
	Capital reserve	10,00	
	Capital redemption reserve	3,00	
	Securities Premium	22,00	
	Less: Premium payable on buy back of shares	<u>20,00</u>	2
	Revenue reserve	30,00	
	Less: Transfer to Capital redemption reserve	<u>3,00</u>	27,00
	Profit and loss A/c	35,00	
	Less: Loss on investment	<u>8,00</u>	<u>27,00</u>
			69,00

DEBENTURE AND ITS TYPES

The term 'debenture' has been derived from the Latin word 'debere', which means 'to borrow'. Debenture is an instrument in writing given by a company acknowledging debt received from the public. The Companies Act defines debenture as "debenture includes debenture stock, bonds or any other securities of a company, whether constituting a charge on the assets of the company or not".

Features of Debenture:

1. It is an instrument of debt issued by company under its seal.
2. It carries fixed rate of interest.
3. Debenture is a part of borrowed capital.
4. It is repaid after a long period.
5. It is generally secured.

A Debenture is a unit of loan amount. When a company intends to raise the loan amount from the public it issues debentures. A person holding debenture or debentures is called a debenture holder. A debenture is a document issued under the seal of the company. It is an acknowledgment of the loan received by the company equal to the nominal value of the debenture. It bears the date of redemption and rate and mode of payment of interest. A debenture holder is the creditor of the company.

As per section 2(12) of Companies Act 1956, “Debenture includes debenture stock, bond and any other securities of the company whether constituting a charge on the company’s assets or not”.

DIFFERENCE BETWEEN SHARES AND DEBENTURES

Share	Debenture
1. The person holding share is called shareholder	1. The person having debenture is called debenture holder
2. It is part of owned capital	2. It is a part of borrowed capital
3. Dividend is paid on shares	3. Interest is paid on debenture
4. Rate of dividend varies year to year	4. Rate of interest is fixed
5. Shareholder has voting right	5. Debenture holder doesn't have voting right
6. It can't be converted into debenture	6. It can be converted into share

TYPES OF DEBENTURES

Debenture can be classified as under:

1. From security point of view:

(i) **Secured or Mortgage debentures:** These are the debentures that are secured by a charge on the assets of the company. These are also called mortgage debentures. The holders of secured debentures have the right to recover their principal amount with the unpaid amount of interest on such debentures out of the assets mortgaged by the company. In India, debentures must be secured. Secured debentures can be of two types:

(a) **First mortgage debentures:** The holders of such debentures have a first claim on the assets charged.

(b) **Second mortgage debentures:** The holders of such debentures have a second claim on the assets charged.

(ii) **Unsecured debentures:** Debentures which do not carry any security with regard to the principal amount or unpaid interest are called unsecured debentures. These are called simple debentures.

2. On the basis of redemption:

(i) **Redeemable debentures:** These are the debentures which are issued for a fixed period. The principal amount of such debentures is paid off to the debenture holders on the expiry of such period. These can be redeemed by annual drawings or by purchasing from the open market.

(ii) **Non-redeemable debentures:** These are the debentures which are not redeemed in the life time of the company. Such debentures are paid back only when the company goes into liquidation.

3. On the basis of Records:

(i) **Registered debentures:** These are the debentures that are registered with the company. The amount of such debentures is payable only to those debenture holders whose name appears in the register of the company.

(ii) **Bearer debentures:** These are the debentures which are not recorded in a register of the company. Such debentures are transferrable merely by delivery. Holder of these debentures is entitled to get the interest.

4. On the basis of convertibility:

(i) **Convertible debentures:** These are the debentures that can be converted into shares of the company on the expiry of predefined period. The term and conditions of conversion are generally announced at the time of issue of debentures.

(ii) **Non-convertible debentures:** The debenture holders of such debentures cannot convert their debentures into shares of the company.

5. On the basis of priority:

(i) **First debentures:** These debentures are redeemed before other debentures.

(ii) **Second debentures:** These debentures are redeemed after the redemption of first debentures.

ACCOUNTING TREATMENT FOR ISSUE OF DEBENTURES

From consideration point of view:

a. For consideration in cash: Debentures can be issued either at par, at premium or at discount. The entry will be:

Bank A/c Dr

Discount on issue of debentures A/c Dr (if issue at discount)

To Debentures A/c

To Security premium A/c (if issue at premium)

b. For consideration other than cash: The entries are

i. For purchase of assets

Sundry Assets A/c Dr

To Vendor A/c

ii. For issuing debentures for payment of purchase consideration

Vendor A/c Dr

To Debentures A/c

c. As collateral security: When debentures are issued as subsidiary or secondary security in addition to the principal security against a loan or bank overdraft such an issue of debentures is called issue of debentures as collateral security.

2. From price point of view:

From this point of view debentures can be issued either at par, at premium or at discount.

a. When debentures are issued at par:

Bank A/c Dr (with face value)

To debentures A/c

b. When debentures are issued at discount:

Bank A/c Dr (net amount received)

To Discount on issue of Debentures A/c (amount of discount)

To Debentures A/c (with face value)

c. When debentures are issued at premium:

Bank A/c Dr (total amount)

To Debentures A/c (with face value)

To Security premium A/c (amount of premium)

3. From condition of redemption point of view:

There are six cases on the basis of terms of issue and conditions of redemption of debentures. They are as follows:

A. When issued at par and redeemable at par:

Bank A/c Dr

To Debentures A/c

B. When issued at premium and redeemable at par:

Bank A/c Dr (face value+ premium)

To Debentures A/c (face value)

To security premium A/c (premium)

C. When issued at discount and redeemable at par:

Bank A/c Dr (amount received)

Discount on issue of debentures A/c Dr (discount)

To Debentures A/c (face value)

D. When issued at par and redeemable at premium:

Bank A/c Dr (amount received)

Loss on issue of debentures A/c Dr (premium on redemption)

To debentures A/c (face value)

To premium on redemption A/c (premium on redemption)

E. When issued at discount and redeemable at premium:

Bank A/c Dr (amount received)

Loss on issue of debentures A/c Dr (issue discount+ redemption premium)

To debentures A/c (face value)

To premium on redemption A/c (redemption premium)

F. When issued at premium and redeemable at premium:

Bank A/c Dr (amount received)

Loss on issue of debentures A/c Dr (redemption premium)

To debentures A/c (face value)

To security premium A/c (issue premium)

To premium on redemption A/c (redemption premium)

Discount or Loss on issue of Debentures: Discount or loss on issue of debentures and premium on redemption are capital losses. They are shown in the balance sheet under the head “Miscellaneous Expenditure”. Being the losses, they are to be written off against capital reserve or security premium A/c. In its absence it is written off to P& L A/c during the life of debentures. The entry is:

Capital reserve/ Security premium A/c/ P & L A/c Dr

To Discount / Loss on issue of debentures A/c

REDEMPTION OF DEBENTURES: Redemption of debentures refers to the discharge of liability on account of debentures. It simply means repayment of debentures. As per Companies Act, the debentures should be redeemed in accordance with the terms and conditions of issue. The following entries are passed for redemption of debentures.

When debentures are redeemed at par:

i. Debentures A/c Dr

To debenture holders A/c

ii. Debenture holders A/c Dr

To Bank A/c

When debentures are redeemed at premium:

i. Debentures A/c Dr

Premium on redemption A/c Dr

To debenture holders A/c

ii. Security premium/ General reserve/P&L A/c Dr

To Premium on redemption A/c

iii. Debenture holders A/c Dr

To Bank A/c