Points to Ponder

2. Why are assets shown on the Right Hand Side of balance-sheet?
3. Why is depreciation shown twice, in the profit & loss statement as well as in the balance-sheet?
4. Study the treatment of preliminary expenses and drawings.
5. Study the way in which 'raw material consumed', 'cost of goods manufactured', and 'cost of goods sold' are arrived at in the profit & loss statement.
6. Can this profit & loss statement be called profit and loss account? If not, why?
7. What additional data would you need to further analyse the profit & loss statement ?
8. What is the implication of the 'Note' to the balance-sheet?

p 90-92

4

SOME IMPORTANT ASPECTS OF ACCOUNTANCY

HISTORICAL BASIS

As you must have noticed, accounting is written on *Historical Cost Basis.* In other words, an accounting entry is passed only on the occurrence of a *Financial Transaction.*

A piece of land was purchased for Rs. 1,000 in 1939 and if the company continues to own it in 2007, it will always be valued at Rs. 1,000 in the balance-sheet.

This is so because the accounts are being maintained on historical cost basis under the assumption that the business is a going concern (i.e., it is not to be liquidated in the near future).

Points to Ponder

1. What will be the effect of asset revaluation? When and how will it be useful?
2. What is a going concern concept? What happens if the business is likely to be liquidated soon?

P 93

MONETARY UNITS

Another aspect to be kept in mind is that accounting entries are to be passed in monetary units. Besides, they will be entered in books at their *Monetary Cost of Acquisition*, i.e., the price paid for acquiring the asset or the services availed. In other words, if no money is specifically paid for the acquisition of an asset, it would not be recorded in the books of the company.

> ### *Points to Ponder*
>
> 3. What will be the accounting effects in the cases where the company has received gifts?
> 4. Whether, when and how will goodwill be accounted for?
>
> p 93

EXPENSES AND EXPENDITURE

Whenever an expense is incurred, it can either give benefit for a short period or it can give benefit of enduring nature.

The latter are popularly known as *Capital Expenses*, e.g., plant and/ or machinery and similar fixed assets.

Normally repetative expenses are called *Revenue Expenses* which form part of the profit and loss account.

Fixed assets represent capital expenses. They will be shown as Assets. They also have a limited life. They will be consumed over a period of time in order to generate Revenue (Sales). It is therefore a usual practice to allocate the cost of these fixed assets over their useful life.

The amount so allocated is called *Depreciation*. The two effects of charging depreciation would be:

a. owner's equity will go down (as an expense).
b. book value of the asset concerned will also go down.

> ### *Points to Ponder*
>
> 5. How is the rate and method of charging depreciation decided?
>
> p 94

ACCOUNTING YEAR

As we have seen earlier, the profit and loss account helps in finding out the profit/loss for a period. Usually it is for one year. It can be calendar year or financial year or Samvat year or any other period. It is the period between two Balance Sheet dates if one follow calender year.

The Balance Sheets will be prepared on each 31st December and Profit and Loss Account will be for each calender year.

All revenues and expenses relating to the given accounting year will be reflected in the Profit And Loss Account for that year.

One can also select shorter or longer period for preparing the Accounts, subject to applicable laws.

> ### *Points to Ponder*
>
> 6. How should a particular accounting year be selected? Can we change it?
>
> p 94

REALIZATION OF REVENUES

One crucial question that arises while arriving at the revenues for the year is whether revenue is realized when order is booked or when goods are produced, or when delivery is made (or services rendered) or when cash is received. Normally, revenue is realized when goods and services produced/provided by a business enterprise are transferred to a customer either for cash or a promise to pay.

This is an extension of the legal principle relating to transfer of property.

> ### *Points to Ponder*
>
> 7. In case where ultimate recovery of cash is 'not very certain' can you recognize revenue only when cash is received?
> 8. In case where advance orders are booked for products, can you recognize revenue when goods are produced?
>
> p 95

THE MATCHING CONCEPT

Once the aspects of revenue recognition is decided, it is equally important to ensure that expenses incurred to earn that revenue are also accounted for in that accounting year.

In other words, the earnings or revenue and the expenses shown in an income statement, must both refer to the same goods transferred or services rendered to customers during the accounting period.

The first step, therefore, is to determine the revenue for the period and then to determine the expenses incurred in order to generate or earn the revenue.

* As you will appreciate, it will be difficult to identify/relate certain expenses (administrative expenses, interest, etc.) with a specific product or service. Some of them would be spent in manufacturing goods which are to be sold next year.

The usual practice is to charge them as Expenses in the Profit And Loss Account of the period in which they are incurred. They are called '*Period' Expenses'*.

* An interesting aspect of accounting comes into picture here. What if the material purchased is not utilized? What if the goods manufactured are not sold?

Under normal accounting routine all the purchases and the revenue expenses incurred will be shown initially on the expense side. But in order to ensure proper matching, the material not consumed and goods not sold are considered as closing stock and reduced from these expenses, you must have noticed it by looking at the Profit and Loss Statement in the illustration given earlier. The same stock, is also shown as *Closing Stock* on the asset side of the Balance Sheet as on the year end. Next year it will appear as *Opening Stock* in the profit and loss account, next year's purchases and revenue expenses will be added during the course of that year and at the year end of the next year, the *Closing Stock* of the next year will be determined and reduced from expenses side. The cycle will go on.

Due care has to be taken to ensure that the matching concept is not vitiated while preparing a profit and loss account. Various *adjustments*, therefore, have to be made while preparing the final Profit And Loss Account, and the Balance-Sheet.

To name some of these adjustments:

a. Expenses which have been incurred during the year but benefit or revenue from them is to be derived during subsequent years are called *'Pre-Paid Expenses'*. For the current year, they will be treated as *Assets* and during the next year, they will be transferred to the Profit and Loss Account.

b. Conversely, when the benefit or revenue is realized during the current year, but actual expense is not incurred till the year end, it is called an *'outstanding liability'*. In this case, the Profit & Loss account will include this expense and a liability will be created, which can be paid off during the next year.

Points to Ponder

9. What should be the treatment of:

   i. Exceptionally large advertisement expenses incurred by a firm in introducing a new brand of product?

   ii. Large research and development expenditures incurred by a firm. In case,
      a. they are regular
      b. they are exceptionally large

   iii. Large arrears of wages paid because of trade union demand?

   iv. Huge loss of inventory (uninsured) by fire during the year?

   v. What role does inventory valuation play in determining the profit/loss?

   vi. Are profits according to the Profit & Loss account and profits for the purpose of Income Tax Act, same?

   vii. Is 'window-dressing' possible while preparing the profit and loss account and Balance Sheet? If so how? Does 'window-dressing' serve any useful purpose?

p 95-97