ଓଡ଼ିଶା ରାଜ୍ୟ ମୁକ୍ତ ବିଶ୍ୱବିଦ୍ୟାଳୟ, ସମ୍ବଲପୁର, ଓଡ଼ିଶା
Odisha State Open University, Sambalpur, Odisha
Established by an Act of Government of Odisha.

DIPLOMA IN MANAGEMENT

DIM-5

Finance and Accounting for Management

Block

2

Unit – 1

Sources of Finance

Unit – 2

Principles of Accounting

Unit – 3

Basic Terminologies of Accounting

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Unit – 1
Sources of Finance

Learning Objectives

After completion of the unit, you should be able to:

- Explain the meaning and concept of sources of finance.
- Describe the characteristics of long term sources of finance.
- Know the criteria for differentiating between owned capital and borrowed capital.
- Assess the sources for obtaining short term finance.
- Also understand the various international sources for obtaining finance.

Structure

1.1 Introduction
1.2 Meaning & Concept of Sources of Finance
1.3 Types of Sources of Finance
1.4 Long Term Sources of Finance
1.5 Owned Capital
1.6 Borrowed Capital
1.7 Short Term Sources of Finance
1.8 External Sources
1.9 Internal Sources
1.10 International Sources of Finance
1.11 Let's Sum-up
1.12 Key Terms
1.13 Self-Assessment Questions
1.14 Further Readings
1.15 Model Questions

1.1 **Introduction**

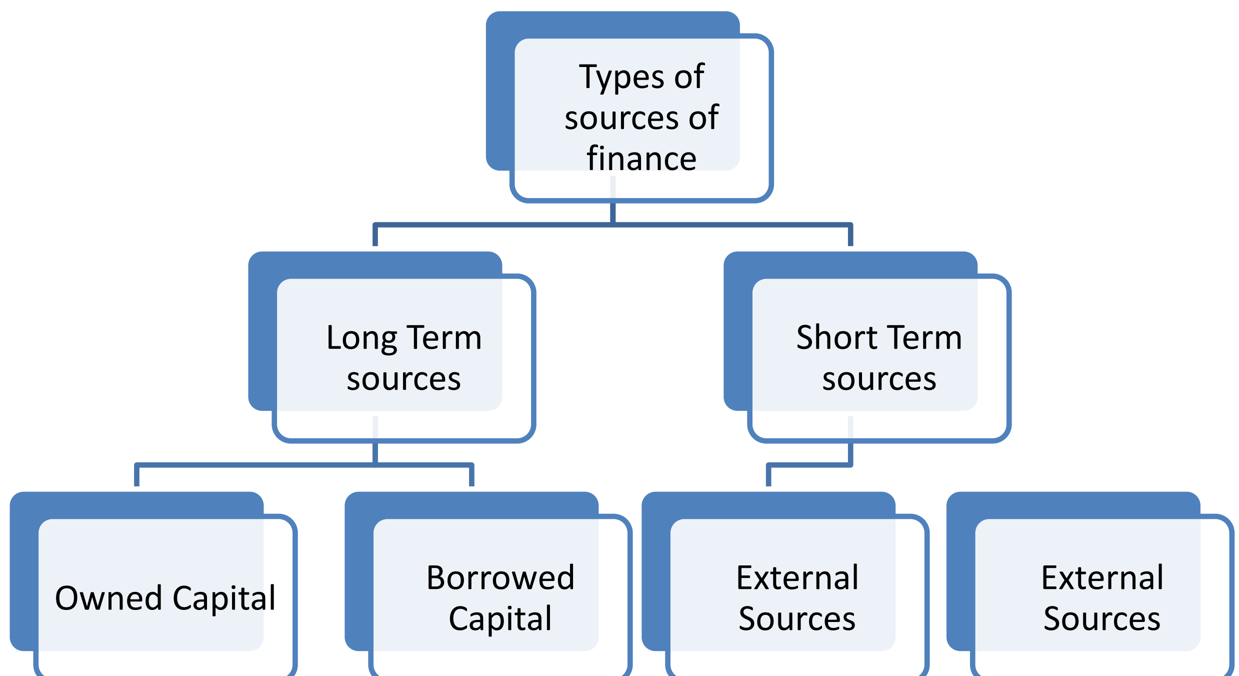
Finance is a significant part of a business organization. Procuring finance is the basic step in the finance function. There are many sources from which finance can be arranged. Procurement of finance further have a direct impact on the cost of capital of a company and consequently on the net earnings.

1.2 Meaning & Concept of Sources of Finance

Sources of finance refers to the key points of procuring money for business purpose. It includes all those institutions whether banking or non-banking from which money can be borrowed. It also includes all forms of securities which can be issued to raise money. Apart from these, there can be certain modes of business transactions which may act as a source of finance. Sources of finance are identified by every business because every organization does not have accessibility to every type of organization.

1.3 Types of Sources of Finance

Finance may be required by an organization for short time period or long time period. Based on the time span for which funds are required, the sources of finance also can be divided into two broad categories:

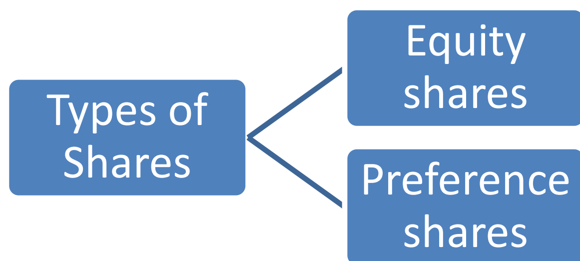


1.4 Long Term Sources of Finance

It means raising of funds for long term i.e. above five years, which is required for improvement & development of existing industry & establishing new industry. The long term sources of finance are used to finance the long term assets of the business. Funds obtained from these sources carry a cost of capital for the firm, whether they are obtained from shareholders or creditors. Long term sources can be categorized into two: Owned Capital and Borrowed Capital.

1.5 Owned Capital

Owned capital refers to the amount of funds raised by means of shares. Share is a unit of ownership whose holder is a partial owner of a company.Shares may be of two types:



Equity Shares:Shares that carry no preferential or special rights in respect of annual dividends and in the repayment of capital at the time of liquidation of the company are called equity shares. The significant features of equity shares are stated below:

1) It doesnot carry preferential right in the payment of dividend & refund of capital.
2) Dividend rate is not fixed.
3) Dividend is paid only after dividend on preference shares & interest on debentures is paid.
4) Market price keeps on changing.
5) They are easily transferable from one shareholder to another.
6) Equity shareholders have right to control the affairs of the business. They also possess the following rights:

- Right to vote in AGM [Annual General Meeting]

- Right to proxy: It means if equity shareholder is unable to attend the AGM, then he can send his representative.
- Right of pre-emption (Right Shares): If company offers new shares then the first right to purchase it,is with the equity shareholders.

Advantages

For the company

- It is a source of permanent capital.
- It increases the debt taking capacity of the company.
- The company does not have to pay a fixed amount of dividend. Thus, there is no fixed obligation the company.
- It is a source of internal financing as it leads to retained earnings.
- It the least expensive source of finance.
- It is a convenient source of finance.

For the shareholders

- It is an attractive investment option for the people having limited income.
- They have the right to participate in the management of the company.
- They receive dividend every year. Thus, there income increases comprehensively.
- The value of share increases in the stock market, thereby leading to a capital gain.
- Right of pre-emption.

Disadvantages

For the company

- Sometimes, the shares are issued through the underwriters. Thus, heavy commission is paid to them, thereby increasing the cost of funds.
- Trading on equity is not possible, if the company issues only equity shares.
- More the equity shareholders, more are the shareholders who have the right to control the company.
- Issuing equity shares leads to encouragement to speculation.

For the shareholders

- It is not suitable for non-risk taking investors.

- Equity shareholders bear a loss in depression.
- When the company is closed down then they suffer a loss on liquidation.
- Actually the equity shareholders do not possess the right of control in real sense.

✓ **Check your progress**

Exercise 1

Suppose you are appointed as a finance manager in anautomobile company. Your company wants to issue equity shares again to raise funds. State with reasons whether the company should issue equity shares again or should adopt any other source of finance.

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Preference Shares: It carry's preferential rights to the payment of dividend at a fix rate & payment of capital at the time of liquidation.Preference shares, more commonly referred to as preferred stock, are shares of a company's stock with dividends that are paid out to shareholders before common stock dividends are issued. If the company enters bankruptcy, the shareholders with preferred stock are entitled to be paid from company assets first.

Types:

I) **Cumulative & Non-Cumulative:** Cumulative preference shareholders receive the arrears of dividend for a year/years, if company has not paid due to lack of profits. On the other hand, non-cumulative describes a type of preferred stock that does not pay the stockholder any unpaid or omitted dividends.

II) **Redeemable &Irredeemable:** Redeemable preference shares are repaid after a certain date. According to Companies Act a company can issue only redeemable shares. Whereas irredeemable preference share refers to the shares on which the capital amount is not paid back during the lifetime of the company.

III) **Participating &Non-Participating:**Participating preference shares means in addition to fixed dividend, they get a share in surplus profits remaining after paying dividend on equity shares.Preference shares, which have no right to participate on the surplus profit or in any surplus on liquidation of the company, are called non-participating preference shares.

IV) **Convertible &Non-Convertible:**Convertible preference shares have the right to convert their shares into equity shares within a fix period of time.Preference shares, which are not convertible into equity shares, are called non-convertible preference shares.

V) **Cumulative, Convertible Preference Shares:** These shares receives the benefit of both – cumulative preference shares and convertible preference shares.

Advantages

For the company

- Wider market for raising capital: The issue of preference shares widens the scope of capital market as they provide the safety to the investors as well as a fixed rate of return. If company does not issue preference shares, it will not be able to attract the capital from such moderate type of investors.
- Flexible capital structure: The company can maintain flexibility in its capital structure by issuing redeemable preference shares as they can be redeemed under terms of issue.
- Preference shareholders have no voting right on matters not directly affecting their right hence promoters or management can retain control over the affairs of the company.
- No charge on assets: No-payment of dividend on preference shares does not create a charge on the assets of the company as is in the case of debentures.

For the shareholders

- Investors in cumulative preference shares get a fixed rate of dividend on preference share regularly even if there is no profit.
- Preference shares carry preferential right as regard to payment of dividend and preferential as regards repayment of capital in case of winding up of company. Thus they enjoy the minimum risk.

- Preference share are fair securities for the shareholders during depression periods when the profits of the company are down.

Disadvantages

For the company

- Most of the preference shares are issued cumulative which means that all the arrears of preference dividend must be paid before anything can be paid to equity shareholders. The company is under an obligation to pay dividend on such shares. It thus, reduces the profits for equity shareholders.

Basis	**Equity Share**	**Preference Share**
Meaning	Equity shares are those shares which have no preferential right in the payment of dividend & refund of capital.	On the other hand preference shares have the preferential right to the payment of dividend at a fix rate & payment of capital at the time of liquidation.
Right to control	The equity shareholders have the right to control in management.	The preference shareholders does not have any control in management.
Dividend Paid	On the equity shares the dividend is not fixed. It may be either very high or very low, or zero or normal.	If a company declares dividend then it must be at fixed percentage.
Claim on assets	In the situation of winding up equity shareholders can claim in the last i.e. after the payment of loans, debts & preference shares.	In case of winding up of the company,the preference shareholders can claim before equity shareholders.
Refund of capital	In case of winding up, they get their capital in the last.	They have priority over equity shares in refund of capital.
Market price	There are variations in the market price of the equity shares.	The price of preference shares remain fixed.
Capital gain	Capital gain is possible due to fluctuation in their market price.	Capital gain is not possible as their price remain fixed.

- Company is to pay higher dividend on these shares than the prevailing rate of interest on debentures of bonds. Thus, it usually increases the cost of capital for the company.
- The credit worthiness of the company is seriously affected by the issue of preference shares. The creditors may anticipate that the continuance of dividend on preference shares and suspension of dividend on equity capital may deprive them of the chance of getting back their principal in full in the event of dissolution of the company, because preference capital has the preference right over the assets of the company.
- The taxable income is not reduced by the amount of preference dividend while in case of debentures or bonds, the interest paid to them is deductible in full.

For the shareholders

- The preference shareholders do not enjoy any voting right except in matters directed affecting their interest.
- The preferential shareholders have no claim over the surplus. They can only ask for the return of their capital investment in the company.
- Company provides no security to the preference capital as is made in the case of debentures. Thus their interests are not protected by the assets of the company.

Difference between Equity share & Preference Share

✓ **Check your progress**

Exercise 2

Which type of preference share is most suitable for a company to issue to the public and why?

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1.6 Borrowed Capital

All liability items, which don't represent equity are considered borrowed capital. It refers to the amount of funds raised in the form of debentures or term loans. These are explained below:

Debenture:It is an acknowledgement of debt by a company. A debenture is a type of debt instrument that is not secured by physical assets or collateral. Debentures are backed only by the general creditworthiness and reputation of the issuer. Both corporations and governments frequently issue this type of bond to secure capital. Following are the key features of debentures:

1) It represents a written agreement.
2) It is a promise made by the company to refund the debt.
3) It leads to a claim on income in the form of fixed interest.
4) It leads to a claims on the assets of the company in the position of winding up.
5) They do not have any right to control the management of the company.
6) The money on debentures can be raised in installments i.e. as and when required.

Types:

1) **Registered & bearer debentures:** Registered debentures 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. Bearer debentures are the debentures which are not recorded in a register of the company. Such debentures are transferable merely by delivery. Holder of bearer debentures is entitled to get the interest.
2) **Redeemable & irredeemable debentures:** Redeemable debentures are the debentures which are issued for a fixed period. The principal amount of such debentures is paid off to the holders on the expiry of such period. These debentures can be redeemed by annual drawings or by purchasing from the open market. Non-redeemable or irredeemable debentures are the debentures which are not redeemed in the life time of the company. Such debentures are paid back only when the company goes to liquidation.
3) **Secured & unsecured debentures:**Secured debentures carry some security with them. The security may be some particular asset. In this case, debentures are said

to be secured by a fixed charge. Security offered for the debentures could be assets, in general. In that case, debentures are said to be secured by a floating charge. Unsecured debentures are those which do not carry any security behind them. They are also called simple or naked debentures.

4) **Convertible & non-convertible:** Convertible debentures are the debentures that can be converted into shares of the company on the expiry of pre-decided period. The terms and conditions of conversion are generally announced at the time of issue of debentures. They can further be classified into fully convertible debentures and partly convertible debentures.
5) **Guaranteed debentures:** Guaranteed debentures are in the form of debt on which payment of interest & principal is guaranteed by third party like bank, government etc. Generally the word "Bonds" is used for them.
6) **Zero interest bond or debentures:** It does not carry any interest but it is sold by issuing company as deep discount bonds at its maturity value.
7) **Secured Premium Notes or Debentures:**These are secured debentures which are redeemed at a premium over the face value of the debentures. They are similar to zero coupon bonds. The only difference is that the discount and premium. Zero coupon bonds are issued at the discount and redeemed at par whereas the secured premium notes are issued at par and redeemed at the premium.
8) **Warrants:**It is an option to buy a number of equity shares at exercise price [particular price]. They are generally issued with debentures. They can be detached from debentures.
9) **Collateral debentures:** Debentures issued as an additional security to the lender of money.
10) **Callable and Puttable Debentures or bonds:**Callable debentures have an option for the company to buyback and repay to the investors whereas, in the case of puttable debentures, the option lies with the investors. Puttable debenture holders can ask the company to redeem their debenture and ask for principal repayment.
11) **First and Second Debentures:**From priority point of view, debentures are classified as first debentures and second debentures. First debentures are those which have to be repaid before other debentures are paid out. Debentures which will be repaid when first debentures have been redeemed are termed as second debentures.

Advantages

For the company

- Issue of debenture does not result in dilution of interest of equity shareholders as they do not have right either to vote or take part in the management of the company.
- Interest on debenture is a tax deductible expenditure and thus it saves income tax.
- Cost of debenture is relatively lower than preference shares and equity shares.
- The equity shareholders can earn more as with the use of debt in the capital structure the earning per share (EPS) increases. This is also referred as trading on equity.
- If the firm makes good profits during the year then unlike equity shares where you have to distribute that profit to the shareholders, debentures holders' payment of interest is fixed and hence firm does not need to share profits with them.
- Debentures provide flexibility in the capital structure of a company as the same can be redeemed as and when the company has surplus funds and desires to do so.
- Even during depression, a company may be able to raise funds through issue of debentures or bonds because of certainty of income and low risk to investors.

For the debenture holders

- Debentures provide a fixed, regular and stable source of income to its investors.
- A debenture is usually more liquid investment and an investor can sell or mortgage his instrument to obtain loans from financial institutions.
- The interest of debenture-holders is protected by various provisions of the debenture trust deed and the guidelines issued by the Securities and Exchange Board of India in this regard.

Disadvantages

For the company

- The fixed interest charges and repayment of principal amount on maturity are legal obligations of the company. These have to be paid even when there are no profits.

- A company cannot raise further loans against the security of assets already mortgaged to debenture-holders.
- The use of debt financing usually increases the risk perception of investors in the firm. This enhanced financial risk increases the cost of equity capital.
- A company who's expected future earnings are not stable or who deals in products with highly elastic demand or who does not have sufficient fixed assets to offer as security to debenture-holders cannot use this source of raising funds to its benefit.

For the debenture holders

- Debentures do not carry any voting rights and hence its holders do not have any controlling power over the management of the company.
- Since debentures are considered as loans or borrowings, the ability of the company to borrow further in case of need of funds reduces considerably.
- Interest on debentures is fully taxable while shareholders may avoid tax by way of stock dividend (bonus shares) in place of cash dividend.

Difference between Equity Shares & Debentures

Basis	**Equity Shares**	**Debentures**
Nature of capital	It is the ownership capital which is not paid during the lifetime of the company.	It is debt capital which is to be repaid after a particular period of time.
Income	It shares in profits as dividend.	They get fix rate of interest
Risk	It is more risky capital.	It carries minimum risk.
Control	It has right to control the company.	No right to control the company.
Issue time	They are generally issued in the initial stage of the business.	They are issued after expansion of business.
Status in winding up	Claim of shareholders is last.	First right in refund of capital.

Term Loans and Institutional financing: It refers to borrowed capital of the companies, repayable in not less than one year & generally not more than ten years.

Term loan is a source financed primarily by banks and financial institutions. Such a type of loan is generally used for financing of expansion, diversification and modernization of projects—so this type of financing is also known as project financing. Term loans are repayable in periodic installments.

Institutional finance means finance raised from financial institutions other than commercial banks. These financial institutions act as an intermediary or link between savers and investors. They provide finance and financial services in areas which are outside the purview of traditional commercial banking.

Conditions included are

1. Security: They are secured against assets.
2. Interest & principal payment: Both are paid at particular time periods.
3. Restrictive conditions: Besides asset security, the lender of the term loans imposes other restrictive covenants to themselves. Lenders ask the borrowers to maintain a minimum asset base, not to raise additional loans or to repay existing loans, etc.
4. Conversion Clause: Term loans may be converted into equity at the option and according to the terms and conditions laid down by the financial institutions.

Institutional financing includes the following:

- Finance raised from Public Financial Institutions (PFIs).
- Finance raised from Non-Banking Finance Companies (NBFCs).
- Finance provided by Investment Trusts and Mutual Funds (ITMF).

✓ **Check your progress**

Exercise 3

List out the various points of differences between preference share and debenture.

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1.7 Short Term Sources of Finance

Short term sources of finance are also known as sources of working capital financing.Funds are required to meet the operational business expenses. Short term sources of finance should be used for funding the short term assets of the business. These short term sources of finance can be further classified into two categories – external sources and internal sources.

1.8 External Sources

The funds which are arranged from outside the company are referred as external sources of short term finance. These sources are explained as under:

1) **Public Sources**: It means money received by non-banking companies by way of deposits from public including employees, customers, & shareholders of the company other than in the form of shares & debentures. The interest paid on public deposits is higher than any other form of deposit.

Advantages:

- ❖ It is the most convenient source for raising funds.
- ❖ It is a low cost option for obtaining funds.
- ❖ Flexible capital structure: The company can reduce the liability any time by returning back the funds to the public when it is not required.
- ❖ Public interest: It provides more interest to the investors and the maturity period is also short.
- ❖ Trading on equity: It is a kind of unsecured debt taken from the public, thus will give an opportunity to the equity shareholders to earn more. Hence, trading on equity is possible.
- ❖ No mortgage of assets: It is an unsecured debt, thus assets are not mortgaged.

Disadvantages:

- ❖ Encourage speculation: People will invest in this source as it is giving high interest but at the same time it is not secured, thus it possess the characteristics of speculation.

- Over capitalization: The company may use this option to raise finance more than its requirement, as it is very convenient source of finance and does not require any security. Thus, it might lead to over capitalization i.e. funds invested in the business are higher than the expected earnings.
- Hurdle in the growth of capital market.
- The interest received by the investors on public deposits is not exempt from taxation.

2) **Bank credit**:Bank credit is the primary institutional source of working capital finance in India. The banks provide working capital finance in the following ways:

- **Loans:** The bank transfers the amount of loan in the current account of the borrower and he is required to pay interest on the total amount borrowed.
- **Bridge Loan:** It refers to making loans or funds available by commercial banks for meeting immediate requirements ofthe business pending release of loans sanctioned by the financial institutions. The nature of bridge finance is to fill in the gap to make immediately the funds available for business.
- **Cash Credit** (CC): It is an agreement by which a bank allows his customer to borrow money up to a certain limit against some securities or guarantees. The interest is charged on daily balance. The borrower enjoys the facility of repaying the amount, partially or fully, as and when he desires.
- **Bank Overdraft** (O/D): The current account holder is allowed to withdraw more than the balance in his account up to a certain limit which is referred as bank overdraft. Interest is charged on daily overdrawn balances.
- **Discounting of bills:** The seller of the goods draws the bill on the purchaser. When the bill is accepted by the purchaser, the seller has the option to offer it to the bank for discounting. It means the bank will advance the money specified in the bill after deduction the discounting charges and it will recover money from the purchaser on the date of maturity.
- **Letter of credit** (L/C):A letter of credit is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase. It is an undertaking by the bank to honor the liability of its customers up to a specified amount.

3) **Trade Credit**:It is the credit given by one business firm to another as incidental to sale or purchase of goods & services. Credit may be extended in any of the following forms:

- Open account: Supplier sends goods to the buyer and the payment will be received in future as per the terms of sales invoice.
- Bill of exchange: When the goods are sold, a bill is drawn by the seller on the buyer. This bill is signed and accepted by the buyer. This bill will act as a documentary evidence in case of default.
- Promissory note: A promissory note is a financial instrument that contains a written promise by one party to pay another party a definite sum of money either on demand or at a specified future date.

Determinants of trade credit: There are many factors which affect the extent of trade credit given by the seller. Some of them are mentioned as below:

- Stock turnover of the product
- Financial position of seller
- Financial position of buyer
- Cash Discount offered
- Degree of risk involved
- Extent of competition
- Credit terms

4) **Factoringor Account receivable credit**: Finance companies or factors provide finance to business firms through purchase of accounts receivable. The sale of accounts receivable is called factoring. The following are the functions performed by the factor:

- Bill discounting facility
- Administration of credit sales including maintenance of sales ledger.
- Collection of accounts receivable.
- Credit control & protection from bad debts.
- Provision of finance.

- Consultancy services.

5) **Commercial Paper**: It is an unsecured promissory note payable to the bearer & issued by business firms for a definite period based on discount, to raise short-term funds. The important features of commercial paper are as follows:

- The maturity period ranges from 90 to 180 days.
- It is issued at a discount and redeemed at the face value.
- Investment in commercial papers may be made by individual, banks, NRIs, FIIs or other corporate bodies.

6) **Certificate of Deposits (CD):**A certificate of deposit popularly known as CDs is a money market instrument that is issued by banks and selected financial institutions in lieu of the money that is deposited.The features of certificates of deposit are enlisted below:

- These instruments can be invested by companies, individuals, trusts, funds, banks and associations, etc.
- For CDs issued by banks the maturity period should not be less than 7 days and not more than one year. For financial institutions the CDs should not be issued for a period less than one year and not exceeding three years from the date of issue.
- Unlike bank deposits that are issued in very nominal amounts, a certificate of deposit should have a minimum amount of Rs. 1 lakh.

✓ **Check your progress**

Exercise 4

If a company wants to raise finance for two months. Which source of finance will you use and why?

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1.9 Internal Sources

Internal sources of finance refers to the funds which can be deployed from within the organization from the free reserves or earnings retained for this purpose.

1) **Retained Earningsor Ploughing back of profit:** The profits which are not distributed completely to the shareholders but are retained are called retained earnings. Following are the important characteristics of this source of finance:

- A good amount of retained earnings provides safety from the ups and downs in the trade cycle.
- It helps a business organization to stabilize the dividend policy by providing funds for distributing dividend when current year profits are insufficient.
- The value of the share increases in the market.
- There is an increase in the collateral value of shares.
- This is a very economic method of financing.
- It might have some adverse impacts like over capitalization, creation of monopoly, restricted flow of capital etc.

2) **Reduction or controlling of working capital**
3) **Sale of assets**

1.10 International Sources of Finance

There are several avenues available for the business houses to raise the funds internationally. Some of such sources are explained below:

1) **Depository Receipts (DRs):**A DR means any instrument in the form of a depository receipt or certificate created by the overseas depository bank outside India and issued to the non-resident investors against the issue or ordinary shares. These securities are listed and traded in international stock exchanges. These can be either global depository receipt (GDR) or American depository Receipt (ADR).
2) **Foreign currency convertible bonds (FCCBs):** It is issued by the Indian company in foreign currency. The principal and interest are also payable in foreign currency. They are equity linked debt securities that has to be converted into equity or depository receipts within the stipulated time limits.
3) **Foreign Currency Exchangeable Bonds (ECEBs):** They allow companies to raise money from overseas markets by issuing bonds. In case of FCEBs, the bonds

can be converted into shares of a group company of the issuer. The exchange option can be exercised at any time before redemption.

4) **Foreign Direct investment (FDI):** Foreign direct investment is an investment made by a company or individual in one country in business interests in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company.

5) **External Commercial Borrowings (ECBs):** ECBs refer to commercial loans availed from non-resident lenders with minimum average maturity of three years. ECB is the borrowing by corporate and financial institutions from international markets. ECBs include commercial bank loans, buyer's credit, credit from export credit agencies and borrowings from international financial institutions. ECBs can be taken in any currency and for varied maturity periods.

1.11 Let's Sum-up

Finance is needed to finance the long term assets and short term assets of the business. The funds for this purpose can be raised from various sources of finance – long term sources and short term sources. The long term sources are further divided into owned funds and borrowed funds. Owned funds comprise of equity shares and preference shares. On the other hand, borrowed funds may be in the form of debentures and term loans. The short term sources of finance can be classified into external sources and internal sources. The external sources include bank credit, public deposits, commercial paper, factoring etc. and the internal sources of funds can be obtained from retained earnings, sale of assets etc. There are certain international sources of finance also from where the funds in foreign currency can be procured.

1.12 Key Terms

Commercial Paper: It is an unsecured promissory note payable to the bearer & issued by business firms for a definite period based on discount, to raise short-term funds.

Institutional Finance: Institutional finance means finance raised from financial institutions other than commercial banks. These financial institutions act as an intermediary or link between savers and investors.

FDI: It is an investment made by a company or individual in one country in business interests in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company.

ADR: An American depositary receipt (ADR) is a negotiable certificate issued by a U.S. bank representing a specified number of shares (or one share) in a foreign stock traded on a U.S. exchange. ADRs are denominated in U.S. dollars, with the underlying security held by a U.S. financial institution overseas.

GDR: A global depositary receipt (*GDR*) is a bank certificate issued in more than one country for shares in a foreign company. The shares are held by a foreign branch of an international bank. The shares trade as domestic shares but are offered for sale globally through the various bank branches.

1.13 Self-Assessment Questions

1. Which long term source of finance should be used by a company which is in the initial phase of its set up?
2. Differentiate between ADR and GDR.

1.14 Further Readings

- M.Y. Khan and P.K.Jain, *Financial Management*, Tata McGraw Hill.
- Prasanna Chandra , *Financial Management*, Tata McGraw Hill.
- Stanley B. Block, Geoffrey A. Hirt, Bartley R. Danielsen, *Foundations of Financial Management*, Tata McGraw Hill.
- Rustagi R. P., *Fundamentals of Financial Management*, Taxmann Publication.

1.15 Model Questions

1. What is business finance? Why do business need funds? Explain.
2. Illustrate the various preferential rights enjoyed by preference shareholders.
3. Differentiate between commercial paper and certificate of deposit.
4. Discuss the sources from which a big business enterprise can raise funds for financing its working capital requirements.

5. What are the different sources of foreign capital available to the Indian entrepreneurs?

Answers to Self-Assessment Questions

1. If the company is in the initial phase of its set up, then to raise long term finance it should go for equity shares.

Shares that carry no preferential or special rights in respect of annual dividends and in the repayment of capital at the time of liquidation of the company are called equity shares. The significant features of equity shares are stated below:

1) It doesnot carry preferential right in the payment of dividend & refund of capital.
2) Dividend rate is not fixed.
3) Dividend is paid only after dividend on preference shares & interest on debentures is paid.
4) Market price keeps on changing.
5) They are easily transferable from one shareholder to another.
6) Equity shareholders have right to control the affairs of the business. They also possess the following rights:

- Right to vote in AGM (Annual General Meeting)
- Right to proxy: It means if equity shareholder is unable to attend the AGM, then he can send his representative.
- Right of pre-emption (Right Shares): If company offers new shares then the first right to purchase it,is with the equity shareholders.

2. Following are the differences between ADR and GDR:

- ADRs are listed on an American Stock Exchange. GDRs are listed in stock exchanges other than American Stock Exchanges.
- ADRs can be issued only to American citizens where as GDRs can be issued to non-American citizens also.
- ADR is mainly an institutional market with higher liquidity whereas GDRs are less liquid.
- ADR enhances shareholders value more than GDR.

Unit – 2
Principles of Accounting

Learning Objectives

After completion of the unit, you should be able to:

- Explain the meaningand objectives of accounting.
- Describe the basic principles of accounting which forms a fundamental base for recording the business transactions.
- Understand the accounting conventions and accounting concepts which are essential to be followed by every business organization.

Structure

2.1 Introduction
2.2 Meaning & Objectives of Accounting
2.3 Meaning of Accounting Principles
2.4 Types of Accounting Principles
2.5 Accounting Conventions
2.6 Accounting Concepts
2.7 Difference between Accounting Principles & Accounting Concepts
2.8 Let’s Sum-up
2.9 Key Terms
2.10 Self-Assessment Questions
2.11 Further Readings
2.12 Model Question

2.1 Introduction

Accounting in pervasive in nature. It is required in every type of organization throughout the country and cross borders too. Accounting statements are prepared on the basis of certain principles. These principles act as guidelines for recording the business transactions. The accounting principles can only be understood after having an insight into the meaning and objectives of accounting which are explained in the following paragraphs.

2.2 Meaning & Objectives of Accounting

Accounting is an art of recording, classifying & summarizing in terms of money & which include transactions of financial nature. It also involves communication of results to the decision makers. The important objectives of accounting are stated as under:

- **To keep systematic record:** It systematically records all monetary transactions into appropriate books of accounts. It is considered as 'DATA BANK'.
- **To find profit or loss:** It keeps a proper record of incomes & expenses of the business. It helps to find the net profit earned or net loss incurred.
- **To find financial position of business:** It is known by preparing the balance sheet on a particular date which illustrates about the business assets and liabilities.
- **To make the information available to users:** It provides information not only to the persons within the company, but also for the use of various outsiders like creditors, bankers etc.

2.3 Meaning of Accounting Principles

Accounting principles are the guidelines which provides a framework for recording the business transactions and suggests certain practices which an organization must adopt during the course of its dealings and financial reporting. These principles must possess the following characteristics:

1) Usefulness: Principles should be useful & increase utility of accounting records. 2) Objectivity: Principles should be supported by facts &should not be influenced by personal bias.

3) Feasibility: Principles should be practical &capable of being applied without much complexity & cost.

2.4 Types of Accounting Principles

The accounting principles can be divided into two categories namely accounting conventions and accounting concepts. Accounting conventions are the guidelines for fair practices which a business should adopt. Accounting concepts are the necessary assumptions and conditions on which the whole accounting process is based upon. It provides a base for carrying out accounting.

2.5 Accounting Conventions

Convention is a statement or rule of practice, which by common consent, is implied in the solution of a given class of problems or guides behaviors in a certain kind of situation. The following conventions which are widely adopted by business concerns are explained below:

1. **Convention of full disclosure:** Every business enterprise prepares final accounts at the end of the accounting year. The interested persons in knowing & studying these statements are the shareholders, owners, employers, debtors, creditors, government & consumers so they should be reported objectively so as to present true & fair view of the enterprise. Thus, this convention emphasizes on disclosing all facts about a business in the financial reports which are published. A business should not hide any relevant facts.

2. **Materiality:** An item should be regarded as material i.e. important, if there is a reason to believe that knowledge of it, would influence the decision of informed investors. In order to make financial statements more meaningful & to minimize the cost, accountants should report only such information, which is material.Thus this convention emphasizes on the reporting of important information and avoidance of immaterial & useless information.

3. **Convention of Consistency:** It implies that same accounting policies should be used for similar items over the years. In this way more meaningful inter period comparisons can be made. This concept says that frequent changes in accounting treatment would make the balance sheet & income statement unreliable for end users, but this does not mean that they cannot make changes in its accounting policies. If it wants to incorporate any changes in the accounting procedure, it may do so but such a change should be reported in its financial statements & its effects on income statement & balance sheet should be shown separately.

4. **Convention of Conservatism (Prudence or carefulness):** Conservatism is a policy of playing safe in the world of uncertainties. This convention emphasizes on keeping a conservative approach in business and make provision for all probable losses. It is a quality of judgment to be used in evaluating risk and uncertainties present in the business to ensure that reasonable provisions are made for anticipated losses in the realization of recorded assets and the settlement of obligations. "Anticipate no gains but provide for all possible losses".This means recognize and make provision for all losses that have incurred or likely to be incurred and record the gains only when they have been actually realized.For e.g. if the value of closing stock has gone down in the market, it should be written

down to the extent of reduction in value, but no write ups should be followed if market shows an upward trend, unless the goods are sold & gain is actually realized.This convention is based on the concept “understatement of earnings & assets is less dangerously misleading than the overstatement”.

5. **Timeliness:** It is related to relevance of the accounting information. The information provided must be current andprovided at the appropriate time as it is the base for making rational decisions. For e.g. the financial statements should be prepared at the end of the financial year so that on the basis of it certain financial and investment decisions can be taken for the coming year.

✓ **Check your progress**

Exercise 1

A company want to change the method of determining the depreciation on fixed assets. Suggest whether the company can change the method or not. Explain with respect to the concerned accounting convention.

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2.6 Accounting Concepts

Accounting concepts are necessary assumptions, conditions & ideas on which accounting is based. The following are the important accounting concepts on which the accounting procedure is based:

1. **The Entity Concept (Also called Business Entity concept):** According to this concept, the business & businessman are two separate & distinct entities. The business and its owner is treated as separate from each other. Any give and take activity between them is recorded as a business transaction. The accounting entity is not necessarily a separate legal entity.Thus, it defines the range & boundaries of the accountant’s activity & limits the number of transactions that are to be included in the records of an enterprise.

2. **Money Measurement Concept:** In accounting, only those transactions are recorded & reported that can be expressed in terms of money. Since, money is a common measuring unit, it makes possible to record & compare dissimilar transactions also. This concept suffers from certain limitations mentioned below:

- The concept measures in terms of rupee & not the purchasing power of money. The accounting records are kept on historical cost basis & the effect of changing price level is not disclosed in accounting records.
- It does not disclose the quality of business or its products or its management.

3. **Going Concern Concept:** It assumes that the business entity will continue to exist indefinitely; it will not be dissolved in near future. The business concerns are therefore treated as going concerns. It simply presumes stability & continuity for a period of time sufficient to carry out present plans, contracts & commitments. This assumption is necessary for carrying out any other accounting procedure and business transactions.

4. **The Cost Concept:** It implies that an asset is recorded in the account books at a price paid to acquire it. The original or acquisition cost relates to the past & so it is called historical cost. Cost concept also means original cost less depreciation to be charged on that asset. It emphasizes that the assets are valued at their historical purchase price and their current market price will not be considered in account books.

5. **The Dual Aspect Concept:** This concept is based on the double-entry system of book keeping which means that a record of each transaction is made in two separate accounts. It is based on accounting equation which implies that for every debit there is an equivalent credit.Every transaction has two aspects – one aspect will be recorded on the debit side and the other aspect will be recorded on the credit side.

6. **The Realization Concept:** It determines the point of time when the revenue is to be recognized. It is also known as revenue recognition principle. It refers to the application of accruals concept towards the recognition of revenue. There may be different point of times at which the revenue is considered to be realized. Revenue may be recognized:

   a) At the time of sale.

   b) At the time when sale value is collected.

   c) At the time when Production is completed.

   d) Recognition proportionately over the performance of contract.

7. **The Accounting Period Concept:** It is assumed that a business will be carried on for an indefinite period. So it is necessary to divide this indefinite period into different accounting periods for judging the progress & performance of the business. The accounting period is generally 1 year or 12 months which is called accounting year or financial year of the business.It implies the period for which the entries are made in accounting records & at the end of which the account books are closed & financial statements prepared.

8. **The Matching Concept:** It is based on the principle that the expenses for a particular accounting period should be matched with the revenues for that period only. On the basis of this concept, outstanding expenses at the end of the year are matched with the revenues, while the prepaid expenses are not matched.This is because the outstanding expenses are related to the current year and prepaid expenses are connected with the next year. This concept faces the following difficulties:

- There are some expenses, which cannot be matched with the revenues of a particular accounting period. e.g. preliminary expenses (expenses incurred before the registration of the company).
- It is not easily ascertainable as to how much amount should be charged as depreciation on a particular fixed asset.

9. **Balance Sheet Equation Concept:** This concept implies that in each transaction the amount to be debited equals the amount to be credited.The journal entries, ledger accounts and trial balance are prepared and verified on the basis of this equation only. The whole accounting procedure is based on this equation.

   Assets = Capital + Liabilities

10. **Accrual Concept:** This concept is concerned with the period in which the revenues & expenses are to be related. Once the revenue is realized the next step is to allocate it among the accounting periods which is done through this concept.

11. **Verifiable Objective Concept:** This concept emphasizes that all accounting entries or business transactions should be backed by appropriate documentary evidence. Proper invoices, bills or cash memos should be there and then only on the basis of it, the transactions must be recorded.

✓ **Check your progress**

Exercise 2

Differentiate between the matching concept and accrual concept.

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2.7 Difference between Accounting Conventions& Accounting Concepts

Following are the differences between accounting conventions and accounting concepts:

- Accounting concepts are the terms which are commonly used inaccounting and they are defined in accounting standards whereas the accounting conventions are not defined in theaccounting standards and they are assumed to be followed in the preparation of final statements of accounts.

- Accounting concepts are established by law whereas accounting conventions are guidelines based on custom and usage.
- Accounting concepts are adopted in an unbiased manner by every organization whereas accounting conventions may be adopted in a biased manner.
- All organizations adopt the accounting concepts in a uniform manner whereas accounting conventions may not be adopted uniformly by all organizations.

2.8 Let's Sum-up

Accounting is based on certain practices and principles. These principles may be classified into two categories – Accounting conventions and accounting concepts. Accounting conventions are the general guidelines which are suggested to all organizations which they should follow to adopt fair business practices. On the other hand, accounting concepts are the rules and underlying assumptions which has to be adopted and is imbibed in the accounting procedure. There is no choice for any organization to follow or unfollow them. They are uniformly followed by all business concerns.

2.9 Key Terms

Accounting: Accounting is an art of recording, classifying & summarizing in terms of money & which include transactions of financial nature.

Accounting Conventions: Accounting convention is a statement or rule of practice, which by common consent, is implied in the solution of a given class of problems or guides behaviors in a certain kind of situation.

Accounting Concepts: Accounting concepts are necessary assumptions, conditions & ideas on which accounting is based.

2.10 Self-Assessment Questions

1. Differentiate between accounting conventions and accounting concepts.
2. 'Carry an umbrella with you even if it is rainy outside'. Which accounting convention is represented by this statement?

2.11 Further Readings

- M Y Khan & P K Jain, *Managerial Accounting*, Tata McGraw Hill Publication.
- Narayanaswamy R., *Financial Accounting: A Managerial Perspective*, PHI.
- Vijay Kumar, *Accounting for Management*, McGraw Hill Publication.
- Anthony, Hawkins, Merchant, *Accounting:Text and Cases*, Tata McGraw Hill Publication.

2.12 Model Questions

1. Why accounting principles are necessary? State the features which all accounting principles must possess.
2. Differentiate between convention of consistency and conservatism.
3. Explain the convention with which the restriction on making of secret profits may be associated.
4. Discuss the concept of revenue realization.
5. What are the limitations of money measurement concept?

Answers to Self-Assessment Questions

1. Following are the differences between accounting conventions and accounting concepts:

- Accounting concepts are the terms which are commonly used inaccounting and they are defined in accounting standards whereas the accounting conventions are not defined in theaccounting standards and they are assumed to be followed in the preparation of final statements of accounts.
- Accounting concepts are established by law whereas accounting conventions are guidelines based on custom and usage.
- Accounting concepts are adopted in an unbiased manner by every organization whereas accounting conventions may be adopted in a biased manner.

2. 'Carry an umbrella with you even if it is rainy outside'. This statement represents convention of conservatism. It means make appropriate provisions before a loss occurs. The occurrence of the loss may be certain or uncertain, but always make provisions. Thus, it represents a conservative approach in business.

Unit – 3

Basic Terminologies of Accounting

Structure

3.1 Accounting
3.2 Accounting Equation
3.3 Assets
3.4 Bad Debts
3.5 Balance Sheet
3.6 Capital
3.7 Cash Discount
3.8 Cost Accounting
3.9 Creditors
3.10 Debtors
3.11 Depreciation
3.12 Drawings
3.13 Fictitious Assets
3.14 Fixed Assets
3.15 Floating Assets
3.16 Generally Accepted Accounting Principles
3.17 General Ledger
3.18 Goodwill
3.19 Gross Margin
3.20 Income Statement
3.21 Insolvent
3.22 Intangible Assets
3.23 Inventory
3.24 Journal
3.25 Liabilities
3.26 Liquid Assets
3.27 Loss
3.28 On Credit
3.29 Receipts
3.30 Revenue
3.31 Subsidiary Books
3.32 Tangible Assets
3.33 Trade Discount
3.34 Trial Balance
3.35 Wasting Assets

3.1 **Accounting**

Accounting is an art of recording, classifying & summarizing in terms of money & which include transactions of financial nature. It also involves communication of results to the decision makers.

3.2 Accounting Equation

Accounting Equation is based on dual aspect concept, according to which double entry is made for each transaction in debit and credit. The entire system of recording business transactions is based on accounting equation.It signifies that the assets of a business are always equal to the total of capital and liabilities. Accounting equation is an accounting formula expressing equivalence of the two expressions of Assets and Liabilities of the business concern.

Capital + Liabilities = Assets

3.3 Assets

Anything which is in the possession (ownership) or is the property of a business enterprise including the amounts due to it from others is called an asset. Assets may be short term or long term in nature.

3.4 Bad Debts

When debtor becomes insolvent/bankrupt, the amount due cannot be realized. This is called bad debts. It is a loss, so it is debited. The loss of bad debts if it is recovered in future, it is called bad debts recovered.

3.5 Balance Sheet

It presents the financial position of business on a particular date. It shows all the assets & liabilities of the business. It is an essential financial statement which is prepared by all business organizations.

3.6 Capital

It refers to the amount invested by the proprietor in a business enterprise. It is the amount with the help of which goods and assets are purchased in the business.

Capital = All assets – External liabilities

3.7 Cash Discount

It is given by the seller to the customer/debtor to make payment within a particular time. It is given to get early payment. It is given when payment is made. It does not reduce the selling price. It is shown in the journal entry.

3.8 Cost Accounting

Cost accounting is a process of collecting, recording, classifying, analyzing, summarizing, allocating and evaluating various alternative courses of action & control of costs. Its goal is to advise the management on the most appropriate course of action based on the costefficiency and capability.

3.9 Creditors

A *creditor* is a person, bank, or other enterprise that has lent money or extended credit to another party.

3.10 Debtors

A debtor is a person or enterprise that owes money to another party.

3.11 Depreciation

The gradual and permanent decrease in the value of an asset is known as depreciation.

3.12 Drawings

It refers to the goods or cash taken away by the owner for personal use. It reduces the amount of capital.

3.13 Fictitious Assets

Assets which do not have any real value but are included assets side of the balance sheet for legal or technical reasons. It includes such items which are not actually assets but are such expenses & losses which have not yet been written off in P&L a/c. Since these items have Dr. Balances so these are shown on the asset side of balance sheet. For e.g. preliminary expenses, deferred revenue expenses, discount on issue of shares etc.

3.14 Fixed Assets

Fixed assets refer to those assets which are held for continued use in the business for the purpose of producing goods or services and are not meant for resale. For example, land and building, plant and machinery, motor vehicles, furniture etc.

3.15 Floating Assets

Those assets whose value is constantly changing as the business proceeds like stock, debtors etc.

3.16 Generally Accepted Accounting Principles

It includes a set of rules, concepts & guidelines used in preparing financial accounting reports.

3.17 General Ledger

Ledger is a book in which personal, real and nominal accounts are opened and posting is made in these accounts of all business transactions. It is prepared to classify the business transactions.

3.18 Goodwill

Goodwill is an intangible asset that arises as a result of the acquisition of one company by another for a premium value. The value of a company's brand name, solid customer base, good customer relations, good employee relations and any patents or proprietary technology represent goodwill.

3.19 Gross Margin

Gross margin is a required income statement entry that reflects total revenue minus cost of goods sold (COGS). Gross margin is a company's profit before operating expenses, interest payments and taxes. Gross margin is also known as gross profit.

3.20 Income Statement

It discloses profit or loss derived during a certain period of time. It is prepared at the end of the financial year by every business enterprise.

3.21 Insolvent

Person or firm whose liabilities exceed the value of owned assets. A person is declared bankrupt by the court in such a situation and the dues cannot be recovered from him. The property of the insolvent person is taken over by the court and partial dues are paid to his creditors from it.

3.22 Intangible Assets

Intangible assets are those assets which do not have a physical existence and which cannot be seen or felt. For e.g. goodwill, patent, trademarks and copyrights.

3.23 Inventory

Inventory is the raw materials, work-in-process products and finished goods that are considered to be the portion of a business's assets that are ready or will be ready for sale. A business possess opening stock and closing stock of all these types of inventories.

3.24 Journal

Journal is a book in which all the transactions are recorded date wise. It is known as the book of original entry.

3.25 Liabilities

It refers to the amount which the firm owes to outsiders (except the amount owed to proprietors).For example, when a firm purchases goods on credit from A, the

amount owing to A is a liability. The liabilities can be classified into two categories – short term liabilities and long term liabilities.

3.26 Liquid Assets

It refers to the assets that can be easily converted into cash like bank balance, bills receivable, short term investment, debtors, stock etc.

3.27 Loss

A loss is a decrease in net income that is outside the normal operations of the business. Losses can result from a number of activities such as; sale of an asset for less than its carrying amount, the write-down of assets, or a loss from lawsuits.

3.28 On Credit

Credit is a contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future, generally with interest.

3.29 Receipts

The term can either mean cash receipt or goods receipt. The cash receipt is a document that proves the receipt of cash. It often refers to the bank receipt which is the slip that the bank sends to you as a proof that the money has been credited to your bank account.

3.30 Revenue

Revenue is the amount of money that a company actually receives during a specific period, including discounts and deductions for returned merchandise. It is the "top line" or "gross income" figure from which costs are subtracted to determine net income.

3.31 Subsidiary Books

Subsidiary Books are those *books* of original entry in which transactions of similar nature are recorded at one place and in chronological order. In total eight books are considered as subsidiary books – cash book, purchase book, sales book, purchase return book, sales return book, bills receivable book, bills payable book and general ledger.

3.32 Tangible Assets

Those assets which can be seen and touched are called tangible assets. In other words, which have a physical existence such as land, building, plant, furniture, stock, cash etc.

3.33 Trade Discount

It is given by the manufacturer to the trader/customer. It is given to increase sales. It is given at the time of sale contract. It reduces the selling price. It is not shown in the journal entry.

3.34 Trial Balance

Trial balance is a list of debit and credit balances which is prepared to check the arithmetical accuracy of ledger and which is also helpful in preparing final accounts. If the trial balance matches, it is not necessary that there are no errors committed in the accounting process. There may be some conceptual errors which may not be disclosed by trial balance.

3.35 Wasting Assets

Wasting assets are those assets which are consumed through being worked or used, such as mines, oil wells etc. Depreciation is charged on these assets by depletion method.