Financial Accounting - 8

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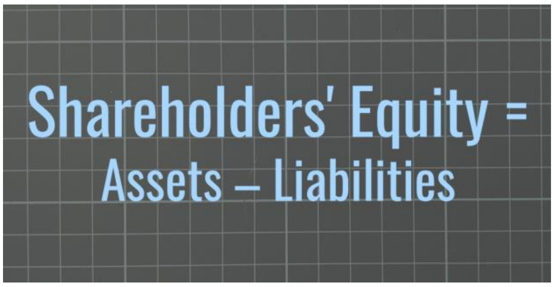

Dear Friends, welcome back to the study of Financial Accounting. Please recall that we used a fictitious case study for an intuitive understanding of the three fundamental accounting statements. Next we undertook a more detailed understanding of the principles behind them, so that we may be able to apply them in our different circumstances. We followed the earlier pattern, where Bala Sir interacts with the ladies of a Self Help Group (SHG) to explain the theory. We learned in some detail the 'Balance Sheet Equation' and how to recognise 'Assets' and 'Liabilities'. In this lesson, we shall learn in some details – Shareholders' Equity more precisely.

Finally, Bala Sir took up 'Shareholders' equity'. He reminded them that all the assets held by a business are on behalf of two sets of claimants: the owners of the business and external parties. After we have accounted for all external claims, termed as Liabilities, whatever remains belongs to the owners. Thus,

Shareholders' equity = Assets – external liabilities

This is how Shareholders' equity or owners' equity is defined.

Bala Sir went on to explain the different ways in which Shareholders' equity arise and accumulate within a business. At the very beginning, do you remember that you contributed Rs. 6000 each to open a bank account in the name of APS? In general, the original promoters of any business bring in some funds, and transfer it to the business in exchange of shares in the business. It is a common practice to put a value for each share, known as 'par value' and an additional amount (optional) as a premium. For example, let us take the case of a small start-up. The individual promoter brings in her own savings of Rs. 100,000. She decides to break this up into 10,000 shares at a par value of Rs. 5 each and a share premium of Rs. 5 each. On the first day, the balance sheet would look like:

Balance Sheet (As on October 1, 2021)			
Assets	Amount	Liabilities	Amount
Cash	100,000	Shareholder's equity	50,000
		Share premium	50,000
Total	100,000	Total	100,000

As the business makes progress, and hopefully some profits are made, after accounting for all revenues and expenses, we get some net income. A business may keep this amount within the business as 'Retained earnings' or distribute it to the shareholders as dividends. We shall explain it shortly. The retained earnings also form another part of the Shareholders' equity.

In case the business makes a loss, we get negative retained earnings. If there were some retained earnings from earlier operations, it gets reduced by this amount. Otherwise, the original shareholders' equity gets eroded or reduced by the loss amount. In any case, *the owners of the business must be ready to face both the situations – a profit or a loss.*

Bala Sir started to explain the term dividends. Dividends are the final fruit of running a business that all shareholders expect. The Board of Directors of the company decides at the end of an accounting year (normally), what to do with the net income. Well, they have two options: 1. To distribute it to the shareholders who are the real owners of the profit and / or 2. To retain it in part or in full, the net income. So, the net income may be divided at the discretion of the Board of Directors into two parts: Retained earnings and dividends. We get another equation:

Net income = Retained Earnings + Dividends

At the end, Bala Sir wanted to give them a glimpse of potential ethical dilemmas for accountants. He gave them a real case, involving a little difficult and slippery situation. He asked them to go through the case below.

Ethicality and Purity of Money

A young monk had studied law before joining the order. The authorities had entrusted him with the task of supervising the real estates – land, buildings etc. belonging to the order. It was customary for several devotees to donate their land / building to the order, or leave a will to such effect. In these cases, the order has the right to sell these properties, and use the proceeds for the service activities of the order. The order wanted to sell such a property. Accordingly, an advertisement was released in the newspapers. Upon seeing the advertisement, a gentleman wanted to assess the value of the property, and in that connection, had a meeting with the monk in-charge of the sales. He offered our young monk to pay 50% more than the offers from other bidders. But he made a request. He requested that the property be registered at half the price being negotiated, and he would pay the remaining half as donation to the order. The amount involved was substantial, therefore, the proposal was liked by a few.

Any proposal for sale of properties must be approved by the trustee board of the order. Before the meeting of the trustee board, the young monk in-charge of the sales, presented the proposal to the President of the order, for his approval to include the item in the agenda of the forthcoming meeting of the trustee board. As soon as the President heard the proposal, he was immensely displeased and rebuked the monk severely. Thereafter, he explained to the young monk, "Would this transaction be truthful and ethical? Will you be able to record the full value of the building, (including the donation amount) in your books of accounts?" The monk replied, "No Sir, I shall write in the books as sale proceeds, only the amount for which it is registered. The amount of donation will be recorded in the 'Donations' account".

The President replied, "This would be completely untruthful and unethical. You know very well that our Lord could not even drink the water brought by any unrighteous person. Do you think, He would accept this money being offered by you?" The monk lowered his head and admitted, "No Sir". The proposal for this unethical transaction was not taken up for discussion.

In the above case, as there was no transaction in the end, nothing needed to be entered in the books of accounts. But this brings up how accountants can get involved in ethical issues, and their job is to uphold the truth and all ethical principles apply, even though legally some transactions may be acceptable. As a matter of fact, such practices in land and building deals are widely prevalent in India and elsewhere. A famous story of Arthur Conan Doyle, the creator of Sherlock Holmes, begins with a sentence similar to this: "Not that the Britishers cannot be purchased, they are a bit costlier to buy". Personally, a land purchase deal did not materialise as I did not agree to a similar condition imposed by the seller, even though the seller continues to be a good friend of mine. He wanted the registration amount to be shown as about one-third of the actual amount, and the remaining to be paid to him separately. He told me that he was helpless. All such land deals must go through a local agent, and the local agent was a part of a very large mafia gang, that had a vested interest in showing lower prices of real estates. Well, we may not be able to fight such vested interests always, but we can surely avoid being a party to such transactions.

With this Bala Sir completed his session for the day.