M.V.S.R Engineering College

Department of Business Management

CONCEPTS IN FINANCIAL ACCOUNTING AND ANALYSIS

1. **Financial accountancy** (or **financial accounting**) is the field of accountancy concerned with the preparation of financial statements for decision makers, such as stockholders, ,suppliers, banks, employees, government agencies, owners, and other stakeholders. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

2. **Accounting method:** The technique used to report sales, expenses, and profits. Accounting methods include "cash basis" accounting and "accrual basis" accounting.

Accounting Cycle: The sequence of six steps in the processing of financial transactions (from the time they occur to their inclusion in financial statements) pertaining to an accounting period.

These steps are: (1) analyzing the transactions as they occur, (2) recording them in the journals, (3) posting debits and credits from journal entries to the general ledger, (4) adjusting the assets with a trial balance, (5) preparing financial statements, and (6) closing the temporary account.

3. **The basic accounting equation**, also called the balance sheet equation, represents the relationship between the assets, liabilities, and owner's equity of a business. It is the foundation for the double-entry bookkeeping system. For each transaction, the total debits equal the total credits. It can be expressed as

$$Assets = Liabilities + Capital$$

$$a = l + c$$

4. **Suspense A/C:** The account opened to rectify the previous year's one-sided errors is called suspense account. Suspense account is opened for a temporarily period only. Suspense account shows no balance after rectification of all errors and it disappears automatically.

5. **Accounts receivable turnover:** A method used to determine a company's average collection period for receivables. The formula is net sales divided by average accounts receivable.

6. **Accrual basis of accounting:** An accounting system in which revenues are recognized when earned, regardless of when the cash is actually received. Similarly, expenses are recognized when they are incurred, regardless of when the expenses are paid.

7. Accruals: Moneys accumulated but not yet due and payable. Examples include taxes and wages. (Accrue means to accumulate.)

8. Cash or Accrual Basis accounting: A company will select one method or the other and apply it consistently.

9. Amortization: A process of cost allocation; a process of gradually reducing the value of an intangible asset over time by allocating a cost of the asset to the accounting periods it benefits.

10. Double Entry Accounting: A method of recording accounting transactions to maintain the equality of the accounting equation.

11. Fiscal year: Any continuous 12 month accounting period used by a company as its accounting year.

12. Full Disclosure Requirement: This is a requirement that a company disclose all facts and information that are relevant to readers of financial statements including standard reports and schedules, including footnotes.

13. Consistency Principle: It states that companies must use the same accounting method from period to period, and that in the event that a company elects to change certain accounting methods, that fact along with an analysis of the impact of that accounting change must be reported on the financial statements in footnotes.

14. Going Concern: The accounting concept that an company will have a continuing existence for the foreseeable future. If the auditor has a questions about the viability of the company, that information will be reflected in its opinion letter.

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16. Conservatism Principle: This principle states that given a choice of options an independent accountant must select an accounting method that has the least favorable impact on the net income of the company being audited.

17. Matching principle: The accounting principle that states that revenues must be matched with the expenses required to generate those revenues in order to accurately present net income for an accounting period.

18. Materiality: The principle that only items that are of sufficient size to be relevant to the reader of a company's financial statements will be included in the financial statements and footnotes

19. Corporation: A legal entity chartered by a state. Ownership of a corporation is represented by stock.

20. Balance sheet: A financial statement that lists a company's assets, liabilities, and owners' equity on a particular date.

21. Total assets: All current assets, fixed assets, and other assets.

22. Total liabilities: All current liabilities and long-term debt.

23. Classified balance sheet: A balance sheet in which assets and liabilities are divided into current and non-current.

24. Assets: Economic resources owned or controlled by the company.

25. Liabilities: Debt owed by a company.

26. Liquid assets: Current assets minus inventory; also called Quick assets.

27. Fixed assets: Tangible assets such as property, plant, and equipment with a useful life of more than one year.

28.Tangible asset: Tangible assets include property, plant, and equipment.

29. Intangible assets: Assets (such as goodwill) with no tangible, physical characteristics that are of monetary value.

30. Goodwill: The difference between the acquisition cost of an asset and the fair market value or book value of an asset.

31. Contingent liabilities: Typically identified in the notes to the financial statements, contingent liabilities are indefinite as to time or cost but represent a potential obligation. Example: A corporation is being sued for product negligence, and the outcome of that lawsuit is unknown.

32. Liquidity: The ability to sell assets to generate cash to pay debts.

33. Solvency: A somewhat subjective measure of a business entity's ability to meet its short term and long term financial obligations

34. Current assets: The sum of cash, accounts receivable, notes receivable, and inventories. Current assets include cash and any other asset that is expected to be converted into cash in the ordinary course of business within one year.

35. Current liabilities: The sum of all money owed by the company that is payable within one year, or the current operating cycle.

36. Current Ratio: A measure of the liquidity of a business; it is a company's assets divided by current liabilities.

37. Quick assets: Current assets minus inventory; also called Liquid assets.

38. Quick Ratio: A measure of a company's liquidity. The formula for calculating the quick ratio is: Cash + cash equivalents + marketable securities + accounts receivable+ notes receivable Divided by Current liabilities.

39. Accounts receivable: Money due for services performed or goods delivered on open account terms. Accounts receivable pledged as collateral would be footnoted on the financial statements. Accounts receivable is normally stated net of an allowance for uncollectable accounts.

40. Inventory: Inventory includes raw materials, work in progress, and finished goods inventory.

41. Cash equivalents: Short term, highly liquid investments held in place of cash and readily convertible into cash

42. Prepaid expenses: Involves cash paid in advance for goods or services that have not yet been delivered or received.

43. Bad debt: An uncollectible accounts receivable balance.

44. Interest coverage: Interest coverage is defined as earnings before interest and taxes divided by interest expense.

45. Inventory turnover: Defined as the cost of goods sold for an accounting period divided by the average inventory value for that period.

46. **Price-to-earnings ratio:** The P /E ratio is the market value of a common stock divided by the earnings per share of common stock for the fiscal year end. A high price-to-earnings ratio might mean the company stock is overvalued. On the other hand, a high price-to-earnings ratio might also indicate that stockholders expect the company to be even more successful in the near future than it is today.

47. Working capital: Current assets minus current liabilities. Working capital is the amount of cash a company expects to generate in the short term and have available to retire current liabilities

48. Cash Flow statement: **Statement of Cash Flows:** A financial report showing a business entities cash inflows and its cash outflows during an accounting period.

Cash flow statements signify the changes in the cash and cash equivalents of the business due to the business operations in one time period. The statement of cash flows uses information from the other two statements (Income Statement and Balance Sheet) to indicate cash inflows and outflows.

A Cash Flow Statement comprises information on following 3 activities:

- ✓ *Operating Activities*
- ✓ *Investing Activities*
- ✓ *Financing Activities*

a. Operating Activities

Operating activities include cash flows from all standard business operations. Cash receipts from selling goods and services represent the inflows. The revenues from interest and dividends are also included here. The operational expenditures are considered as outflows for

this section. Although interest expenses fall under this section but the dividends are not included .Dividends are considered as a part of financing activity in financial accounting terms.

b. Investing Activities

Investing activities include transactions with assets, marketable securities and credit instruments. The sale of property, plant and equipment or marketable securities is a cash inflow. Purchasing property, plant and equipment or marketable securities are considered as cash outflows. Loans made to borrowers for long-term use is another cash outflow. Collections from these loans, however, are cash inflows.

c. Financing Activities

Financing activities on the statement of cash flows are much more defined in nature. The receipts come from borrowing money or issuing stock. The outflows occur when a company repays loans, purchases treasury stock or pays dividends to stockholders. As the case with other activities on the statement of cash flows depend on activities rather than actual general ledger accounts.

49. Funds flow statement: Funds flow statements report changes in a business's working capital from its operations in a single time period, but have largely been superseded by cash flow statements.

50. Book value: A calculation done by dividing equity of common shares, as listed in the equity section of the balance sheet, by the number of shares of common stock outstanding.

51. Common stock: Common stock represents a claim on the assets of a corporation by common stockholders after all debts and other obligations have been paid in full. Common stock shares give the investor a vote on matters including the election of the company's directors. Common stockholders bear the ultimate risk of loss in liquidation since their claim is subordinated to all other claims and classes of claims.

52. Preferred stock: A class of stock which typically is without voting rights, but which carries a specific, stated dividend rate and a priority over com¬mon stock in dividend payments and in the event of asset liquidation.

53. Stock: Ownership claims on the assets of a business after all creditors have been paid.

Stockholder: A person or company that owns one or more share of stock in a company.

54. Stock dividends: Dividends payable in the form of stock.

55. Bonds: Corporate bonds are debts instruments issued with an initial maturity of more than one year. A bond is a debt security that represents an obligation of the issuer to pay interest to the creditor and to repay the principal at maturity.

56. Convertible bonds: Bonds that can be converted into stock at the option of the owner after a specified period of time.

57. Corporate bonds: Bonds that are issued by a corporation and represent a debt owed by a corporation to the bondholder. They typically include an interest rate as well as a specific maturity date. Bonds do not convey any ownership rights to the holder. Bonds are, in effect, an IOU issued by a corporation.

58. Long-term debt: Any liabilities that are not current liabilities. Long term liabilities due in more than one year.

59. Debenture: A debenture is a bond issued by a corporation that is not backed by the pledge of collateral such as one or more tangible assets of the issuer.

60. Retained earnings: Profits that have not been distributed in the form of dividends to stockholders. Specifically, retained earnings represent the cumulative amount of net profits not paid by a corporation to its stockholders in the form of dividends.

61. Net worth: Assets minus liabilities equals net worth.

62. Note payable: A debt; a short-term obligation evidenced by a contract such as a promissory note.

63. Accounts payable: Money owed to suppliers of goods and services delivered on open account terms and other resources.

64. Treasury stock: Shares of a company's stock issued, sold and then repurchased by the company in a buy-back.

65. Unearned revenues: Moneys received before they have actually been earned.

66. Unsecured Debt: An obligation of a company of corporation not backed by any specific collateral.

67. Commercial Paper: A short term debt represented by a note issued by a corporation with a good to excellent credit rating to raise cash quickly. Typically, commercial paper matures is a little as a week and as many as 270 days.

68. Warrants: Warrants are long-term options to buy stock at a stated price. Warrants are often issued to key personnel as a type of bonus. In many companies, warrants are used as a retention incentive or bonus.

69. P & L: Acronym for Profit and Loss Statement / Income Statement.

70. Income statement: A document reporting revenues, expenses, and net income (or net loss).

71. Cost of goods sold: The expenses incurred to purchase or to manufacture the goods sold during an accounting period

72. Net Income: Net income is income after tax has been paid but before payment of preferred stock and/ or common stock dividends.

73. Net sales: Gross sales (total sales) minus sales returns and allowances.

74. Expenses: The costs incurred in the normal course of business to generate revenues and profits.

75. Discretionary expenses: Expenses under the control of management with respect to timing.

76. Gross profit margin: Gross margin is defined as net sales minus the cost of goods sold.

77. Gross sales: Sales before deducting for any sales returns or allowances.

78. EBIT: Earnings before interest and taxes paid.

79. Extraordinary items: Non-operating gains or losses that is infrequent in occurrence.

80. Depreciation: The reduction in value of a capital asset over time, specifically allocation of the cost of the asset over the useful life of that asset.

In Accountancy, **depreciation** refers to two aspects of the same concept: the decrease in value of assets (fair value depreciation), and the allocation of the cost of assets to periods in which the assets are used (depreciation with the matching principle). The former affects the balance sheet of a business or entity, and the latter affects the net income that they report.

a. **Straight-line:** This method spreads the cost of the fixed asset evenly over its useful life. An accounting procedure in which the value of assets is depreciated evenly over the useful life of the asset. Subsequent events are significant events from an accounting perspective that occur after the balance sheet date, but before the financial statements are issued. Subsidiary: A company or a corporation that is owned and controlled by another.
b. **Declining-balance:** An accelerated method of depreciation, it results in higher depreciation expense in the earlier years of ownership.
c. **Sum-of-the-years' digits:** Compute depreciation expense by adding all years of the fixed asset's expected useful life and factoring in which year you are currently in, as compared to the total number of years.

d. Sinking fund method: A technique for depreciating an asset in bookkeeping records while also generating money to purchase a replacement for the asset when it reaches the end of its useful life. Under the sinking fund method, the business sets aside an amount of money to invest annually so that the principal plus the interest earned in the fund will be enough to replace the asset. The amount of money that needs to be added to the asset-replacement fund each year is calculated by determining how much it will cost to replace the asset, how many years the asset is expected to last and what rate of interest can be earned as well as how much can be earned through the effects of compound interest. The sinking fund method is not common, and is not desirable when interest rates cannot reasonably be predicted.

81. Historical cost: Most assets are recorded at their historical cost less accumulated depreciation. As a result, the value of an asset as recorded on the balance sheet may have little in common with the market value of that asset.

82. Book value of a depreciable asset: The historical or acquisition cost of a depreciable asset minus the accumulated depreciation on that asset.

83. Accumulated Depreciation: The total depreciation recorded against an asset since its acquisition.

84. Inventory valuation: A inventory valuation is a statement which provides information about the value of goods held in inventory. There are a number of ways to perform an inventory valuation and different approaches to maintaining records about inventory.

a. The First1-In-First-Out Method (FIFO)

A method of calculating the cost of inventory in which the first goods purchased are assumed to be the first goods sold This method assumes that the first inventories bought are the first ones to be sold, and that inventories bought later are sold later. It is very common to use the FIFO method if one trades in foodstuffs and other goods that have a limited shelf life, because the oldest goods need to be sold before they pass their sell-by date. First-in, First-out (FIFO) Method Here it is assumed that the stock received first is consumed/sold first. Hence the stock at hand at the end of the year is from the latest purchase. 1st in 1st out.

First-in, First-out (FIFO) Method In case of rising prices, this may lead to overvaluation of stocks and overstatement of profits and in case of falling prices this method leads to understatement of stock and profits. 2nd 3rd etc. 1st in 1st out.

Thus the first-in-first-out method is probably the most commonly used method in small business.

b. The Last-In-First-Out Method (LIFO)

LIFO: A method of valuing inventory in which the last goods purchased are assumed to be the first goods sold.

This method assumes that the *last* inventories bought are the *first* ones to be sold, and that inventories bought first are sold last.

The LIFO method is commonly used in the U.S.A.

d. The Weighted Average Cost Method

This method assumes that **we sell all our inventories simultaneously.**

The weighted average cost method is most commonly used in manufacturing businesses where inventories are piled or mixed together and cannot be differentiated, such as chemicals, oils, etc. Chemicals bought two months ago cannot be differentiated from those bought yesterday, as they are all mixed together.

So we work out an average cost for all chemicals that we have in our possession. The method specifically involves working out an average cost per unit at each point in time after a purchase.

Weighted Average Method Here the average cost is applied i.e. after every purchase an average cost is computed from the cost of purchases and the cost of stock. This method tries to even out the effects of price fluctuations

85. Capital and Revenue Receipts and Expenditures:

a. Capital Expenditure: Capital expenditure occurs when a business gets a long term advantage due to that expenditure. It is usually incurred for accusation of an asset. These expenditures do not occur in the regular day to day transactions of the business. OR An expenditure that is recorded as an asset because the asset purchased is expected to be in use beyond the current accounting period.

Common examples: Purchase of furniture, office building etc.Purchase of additional furniture or machinery Expenditure incurred in connection with the purchase of a fixed asset. For example, carriage paid of machinery purchased. Purchase of patent right, copy rights etc.

b. Revenue Expenditure: Expenditure which is not for increasing the value of fixed assets, but for running the business on a day to day basis, is known as revenue expenditure.

c. Difference between Capital and Revenue expenditure:

Buy a car is capital expenditure because its benefit to the business will be spread over a long time.

Fuel cost for running this care is revenue expenditure and it will be used up in few days and does not add to the value of the fixed asset.

d. **Capital receipts:** Capital receipts consist of additional payments made to the business either by owner or shareholder of the business; or from sale of fixed assets of the business.
e. **Revenue receipts**: Any receipt in the normal running or through day to day transactions of the business is categorized as Revenue receipt. Sales receipts of the business are revenue receipts.
f. **Deferred Revenues**: Payments received in advance of services performed or goods being delivered.

86. Financial report: A report prepared by public companies at the end of the company's fiscal year describing the financial performance of the company; the financial report includes a significant amount of narrative about the successes (or failures) of the company in the fiscal year being reported on.

87. Annual Report: A written report to shareholders detailing and summarizing the prior fiscal year's financial performance

88. Audit: An examination of the financial performance and the financial status of a company performed by an independent accountant or by a CPA.

89. Audit Report: A report issued by an independent CPA that expresses some opinion about the financial statements the report is attached to.

90. Board of Directors: Individuals elected by the board of directors to oversee the managers and offer guidance to a corporation

91. Dividend: A portion of the company's profits paid to common and/or preferred shareholders. Dividends represent profits that are not reinvested by the corporation.

92. Parent company: A company that owns or controls a separate legal entity. Generally, a parent company owns more than 50% of the outstanding stock; but not necessarily 100% of it.

93. Holding company: A corporation that holds a majority of the shares outstanding of a subsidiary company

94. Prospectus: A document describing a stock offering by a corporation. A prospectus contains a wealth of information about a company. If the prospectus relates to an initial public offering, the information contained in the prospectus might be the first time a credit manager has had so much information about a debtor company's financial condition, plans, goals, short-term and long-term strategy, and the competitive environment in which it operates.

95. Securities and Exchange Commission: The SEC is a government entity responsible for regulating the securities markets and for monitoring and regulating the financial reporting of publicly traded companies [companies selling stocks and / or bonds].

96. Face Value: The stated value of a bond certificate.

97. Par value: Par value is the face value of a security instrument. Par value is a stated value below which the corporation will never sell the stock. Par value is typically set quite low; for example, a par value of from one cent to one dollar per share is not uncommon.

98. Fair Market Value: The market value of an asset as determined by supply and demand

99. Earnings per share: Earnings stated as a dollar value per share of stock.

100. Equity Financing: The process of acquiring funds for a corporation in the form of additional investments by owners.

101. Financial statements: These statements typically include the balance sheet, income statement, and cash-flow statement as well as notes to the financial statements and the auditor's opinion letter. Financial statements report the financial status and results of operations of a business entity.

102. Comparative financial statements: Statements in which two or more years of financial results are shown together for the purpose of comparison. Consolidated financial statements: Financial statements that report the combined operating results of two or more legally separate entities - such as a parent company and its wholly owned subsidiary.

103. Interim financial statements: Financial statements for periods of less than one year.

104. Notes to financial statements: Narrative information intended to be an integral part of the financial statements and necessary for a comprehensive review of the statements presented.

105. The Objective Evidence Requirement: The requirement involves the fact that financial statements must be based on hard evidence and documentation that reasonable people would interpret in similar ways.

106. Balanced Scorecard : The balanced scorecard is a strategic planning and management system that is used extensively in business and industry, government, and nonprofit organizations worldwide to align business activities to the vision and strategy of the organization, improve internal and external communications, and monitor organization performance against strategic goals. It was originated by Drs. Robert Kaplan (Harvard Business School) and David Norton as a performance measurement framework that added strategic non-financial performance measures to traditional financial metrics to give managers and executives a more 'balanced' view of organizational performance.

107. Balanced scorecard methodology is an analysis technique designed to translate an organization's mission statement and overall business strategy into specific, quantifiable goals and to monitor the organization's performance in terms of achieving these goals.

108. Human Resource Accounting is the process of identifying and reporting the Investments made in the Human Resources of an Organisation that are presently not accounted for in the conventional accounting practices.

109. Tax Planning:

Introduction: The avid goal of every taxpayer is to minimize his Tax Liability. To achieve this objective taxpayer may resort to following Three Methods :

- Tax Planning
- Tax Avoidance
- Tax Evasion

a. **Meaning of Tax planning: Pl**anning involves planning in order to avail all exemptions, deductions and rebates provided in Act. The Income Tax law itself provides for various methods for Tax Planning, Generally it is provided under exemptions u/s 10, deductions u/s 80C to 80U and rebates and relief's. Some of the provisions are enumerated below :

- Investment in securities provided u/s 10(15) . Interest on such securities is fully exempt from tax.
- Exemptions u/s 10A, 10B, and 10BA
- Residential Status of the person
- Choice of accounting system
- Choice of organization.

- For availing benefits, one should resort to bonafide means by complying with the provisions of law in letter and in spirit.
- Where a person buys machinery instead of hiring it, he is availing the benefit of depreciation. If is his exclusive right either to buy or lease it . In the same manner to choice the form of organization, capital structure, buys or make products are the assessee's exclusive right. One may look for various tax incentives in the above said transactions provided in this Act, for reduction of tax liability. All this transaction involves tax planning.

b. **Tax Evasion**: An illegal practice where a person, organization or corporation intentionally avoids paying his/her/its true tax liability. Those caught evading taxes are generally subject to criminal charges and substantial penalties.

There is a difference between tax minimization/avoidance and tax evasion. All citizens have the right to reduce the amount of taxes they pay as long as it is by legal means.

c. **Tax avoidance**: The use of legal methods to modify an individual's financial situation in order to lower the amount of income tax owed. This is generally accomplished by claiming the permissible deductions and credits. This practice differs from tax evasion, which is illegal.

Most taxpayers use some forms of tax avoidance. For example, individuals who contribute to employer-sponsored retirement plans with pre-tax funds are engaging in tax avoidance because the amount of taxes paid on the funds when they are withdrawn is usually less than the amount that the individual would owe today. Furthermore, retirement plans allow taxpayers to defer paying taxes until a much later date, which allows their savings to grow at a faster rate.

110. Indian Accounting Standards, (abbreviated as I**ndia AS**) are a set of accounting standards notified by the Ministry of Corporate Affairs which are converged with International Financial Reporting Standards (IFRS). These accounting standards are formulated by Accounting Standards Board of Institute of Chartered Accountants of India.

111. GAAP: Generally Accepted Accounting Principles define appropriate accounting practices for CP As and other accountants.

112. FASB: The Financial Accounting Standards Board is a private organization that established Generally Accepted Accounting Principles.

113. Qualified opinion: An opinion of an independent auditor in which the auditor states the company did not follow GAAP, and/or did not allow the auditor to perform an audit necessary to offer an Unqualified Opinion letter.

114. Disclaimer of opinion: A statement by an auditor that he or she was unable to satisfy the requirement that the financial statements presented followed GAAP.

115. Hedging: The process of lowering risk by purchasing a security or another product that has the effect of offsetting an undesirable risk characteristic.

116. Lease: A contract that specifies for how long, for what cost, and under what terms and conditions the owner of an asset [the lessor] agrees to transfer the right to use the asset to another party [the lessee].

117. Capital lease: A lease that is, in effect, a purchase made by the lessee. The leased property is reported on the balance sheet. The lessee treats the transaction like a purchase of the leased property.

118. Break-even analysis: A calculation to determine the level of sales at which the company will break even-the point at which net income is zero.

119. Depletion: The process of cost allocation on a non-renewable natural resource.

120. Leverage: A company is said to be leveraged if it has an abnormally high debt to equity ratio. Leverage is positive to the extent that the money borrowed generated more income than is required to repay the debt and to justify the higher interest costs.

121. Exchange rate: The value of one currency in terms of another currency.

122. Liquidation: The process of dissolving a business and selling the assets of the business in order to pay the company's debts.