MVSR ENGINEERING COLLEGE

MBA DEPARTMNET

FINANCIAL ACCOUNTING AND ANALYSIS

Accounting :

The systematic and comprehensive recording of financial transactions pertaining to a business. Accounting also refers to the process of summarizing, analyzing and reporting these transactions. The financial statements that summarize a large company's operations, financial position and cash flows over a particular period are a concise summary of hundreds of thousands of financial transactions it may have entered into over this period. Accounting is one of the key functions for almost any business; it may be handled by a bookkeeper and accountant at small firms or by sizable finance departments with dozens of employees at larger companies.

Objectives of Accounting :

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

i) To keeping systematic record: It is very difficult to remember all the business transactions that take place. Accounting serves this purpose of record keeping by promptly recording all the business transactions in the books of account.

ii) To ascertain the results of the operation: Accounting helps in ascertaining result i.e., profit earned or loss suffered in business during a particular period. For this purpose, a business entity prepares either a Trading and Profit and Loss account or an Income and Expenditure account which shows the profit or loss of the business by matching the items of revenue and expenditure of the some period.

iii) To ascertain the financial position of the business: In addition to profit, a businessman must know his financial position i.e., availability of cash, position of assets and liabilities etc. This helps the businessman to know his financial strength. Financial statements are barometers of health of a business entity.

iv) To portray the liquidity position: Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, cash dividends and other distributions of resources by the enterprise to owners and about other factors that may affect an enterprise’s liquidity and solvency.

v) To protect business properties: Accounting provides upto date information about the various assets that the firm possesses and the liabilities the firm owes, so that nobody can claim a payment which is not due to him.

vi) To facilitate rational decision – making: Accounting records and financial statements provide financial information which help the business in making rational decisions about the steps to be taken in respect of various aspects of business.

vii) To satisfy the requirements of law: Entities such as companies, societies, public trusts are compulsorily required to maintain accounts as per the law governing their operations such as the Companies Act, Societies Act, and Public Trust Act etc. Maintenance of accounts is also compulsory under the Sales Tax Act and Income Tax Act .

Journal :

When the business transactions take place, the first step is to record the same in the books of original entry or subsidiary books or books of prime or journal. Thus journal is a simple book of accounts in which all the business transactions are originally recorded in chronological order and from which they are posted to the ledger accounts at any convenient time. Journalsing refers to the act of recording each transaction in the journal and the form in which it is recorded, is known as a journal entry.

LEDGER :

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

SUBSIDIARY BOOKS:

Journal is subdivided into various parts known as subsidiary books or subdivisions of journal. Each one of the subsidiary books is a special journal and a book of original or prime entry. There are no journal entries when records are made in these books. Recording the transactions in

a special journal and then in the ledger accounts is the practical system of accounting which is also referred to as English System. Though the usual type of journal entries are not passed in these sub-divided journals, the double entry principles of accounting are strictly followed.

Cash Book:

Cash Book is a sub-division of Journal recording transactions pertaining to cash receipts and payments. Firstly, all cash transactions are recorded in the Cash Book wherefrom they are posted subsequently to the respective ledger accounts. The Cash Book is maintained in the form of a ledger with the required explanation called as narration and hence, it plays a dual role of a journal as well as ledger. All cash receipts are recorded on the debit side and all cash payments are recorded on the credit side. All cash transactions are recorded chronologically in the Cash Book. The Cash Book will always show a debit balance since payments cannot exceed the receipts at any time.

Accounting concepts:

The term 'concept' is used to denote accounting postulates, i.e., basic assumptions or conditions upon the edifice of which the accounting super-structure is based. The following are the common accounting concepts adopted by many businessconcerns.

Business Entity Concept:

A business unit is an organization of persons established to accomplish an economic goal. Business entity concept implies that the business unit is separate and distinct from the persons who provide the required capital to it. This concept can be expressed through an accounting equation, viz., Assets = Liabilities + Capital. The equation clearly shows that the business itself owns the assets and in turn owes to various claimants.

Money Measurement Concept:

In accounting all events and transactions are recode in terms of money. Money is considered as a common denominator, by means of which various facts, events and transactions about a business can be expressed in terms of numbers. In other words, facts, events and transactions which cannot be expressed in monetary terms are not recorded in accounting. Hence, the accounting does not give a complete picture of all the transactions of a business unit. This concept does not also take care of the effects of inflation because it assumes astable value for measuring.

Going Concern Concept:

Under this concept, the transactions are recorded assuming that the business will exist for a longer period of time, i.e., a business unit is considered to be a going concern and not a liquidated one. Keeping this in view, the suppliers and other companies enter into business

transactions with the business unit. This assumption supports the concept of valuing the assets at historical cost or replacement cost. This concept also supports the treatment of prepaid expenses as assets, although they may be practically unsaleable.

Dual Aspect Concept:

According to this basic concept of accounting, every transaction has a two-fold aspect, Viz., 1.giving certain benefits and 2. Receiving certain benefits. The basic principle of double entry system is that every debit has a corresponding and equal amount of credit. This is the underlying

assumption of this concept. The accounting equation viz., Assets = Capital + Liabilities or Capital = Assets – Liabilities, will further clarify this concept, i.e., at any point of time the total assets of the business unit are equal to its total liabilities. Liabilities here relate both to the outsiders and the owners. Liabilities to the owners are considered as capital.

Periodicity Concept:

Under this concept, the life of the business is segmented into different periods and accordingly the result of each period is ascertained. Though the business is assumed to be continuing in future (as per goingconcern concept), the measurement of income and studying the financial position of the business for a shorter and definite period will help in taking corrective steps at the appropriate time. Each segmented period is called "accounting period" and the same is normally a year. The businessman has to analyse and evaluate the results ascertained periodically. At the end of an accounting period, an Income Statement is prepared to ascertain the profit or loss made during that accounting period and Balance Sheet is prepared which depicts the financial position of the business as on the last day of that period. During the course of preparation of these statements capital revenue items are to be necessarily distinguished.

Historical Cost Concept:

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

Matching Concept:

The essence of the matching concept lies in the view that all costs which are associated to a particular period should be compared with the revenues associated to the same period to obtain the net income of the business. Under this concept, the accounting period concept is relevant and it is this concept (matching concept) which necessitated the provisions of different adjustments

for recording outstanding expenses, prepaid expenses, outstanding incomes, incomes received in advance, etc., during the course of preparing the financial statements at the end of the accounting period.

Realisation Concept:

This concept assumes or recognizes revenue when a sale is made. Sale is considered to be complete when the ownership and property are transferred from the seller to the buyer and the consideration is paid in full. However, there are two exceptions to this concept, viz., 1. Hire purchase system where the ownership is transferred to the buyer when the last instalment is paid and 2. Contract accounts, in which the contractor is liable to pay only when the whole contract is completed, the profit is calculated on the basis of work certified each year.

Accrual Concept:

According to this concept the revenue is recognized on its realization and not on its actual receipt. Similarly the costs are recognized when they are incurred and not when payment is made. This assumption makes it necessary to give certain adjustments in the preparation of income statement regarding revenues and costs. But under cash accounting system, the revenues and costs are recognized only when they are actually received or paid. Hence, the combination of both cash and accrual system is preferable to get rid of the limitations of each system.

Objective Evidence Concept:

This concept ensures that all accounting must be based on objective evidence, i.e., every transaction recorded in the books of account must have a verifiable document in support of its, existence. Only then, the transactions can be verified by the auditors and declared as true or otherwise. The verifiable evidence for the transactions should be free from the personal bias, i.e., it should be objective in nature and not subjective. However, in reality the subjectivity cannot be avoided in the aspects like provision for bad and doubtful debts, provision for depreciation, valuation of inventory, etc., and the accountants are required to disclose the regulations followed.

Manufacturing Account:

Manufacturing concerns which convert raw material into finished product is required to prepare manufacturing account and then prepare trading and profit and loss account. This is necessary because they have to ascertain cost of goods manufactured, gross profit and net profit.

Trading account:

Trading account is prepared for an accounting period to find the trading results or gross margin of the business i.e., the amount of gross profit the concern has made from buying and selling during the accounting period. The difference between the sales and cost of sales is gross profit.

For the purpose of computing cost of sales, value of opening stock of finished goods, purchases, direct expenses on purchasing and manufacturing are added up and closing stock of finished goods is reduced. The balance of this account shows gross profit or loss which is transferred to the profit and loss account.

Profit and Loss Account:

In the words of Prof. Carter "Profit and loss account is an account into which all gains and losses are collected in order to ascertain the excess of gains over the losses or vice versa."

Balance sheet:

"Balance sheet is a screen picture of the financial position of a going business concern at a certain moment" - Francis.

Asset:

Any physical thing or right owned that has a money value is an asset. In other words, an asset is that expenditure which results in acquiring of some property or benefits of a lasting nature.

They are classified on the basis of their nature. Different types of assets are as under:

(i) Fixed assets: Fixed assets are the assets which are acquired and held permanently and used in the business with the objective of making profits. Land and building, Plant and machinery, Furniture and Fixtures are examples of fixed assets.

(ii) Current assets: The assets of the business in the form of cash, debtors bank balances, bill receivable and stock are called current assets as they can be realised within an operating cycle of one year to discharge liabilities.

(iii) Tangible assets: Tangible assets have definite physical shape or identity and existence; they can be seen, felt and have volume such as land, cash, stock etc. Thus tangible assets can be both fixed assets and current assets.

(iv) Intangible assets: The assets which have no physical shape which cannot be seen or felt but have value are called intangible assets. Goodwill, patents, trade marks and licences are examples of intangible assets. They are usually classified under fixed assets.

(v) Fictitious assets: Fictitious assets are not real assets. Past accumulated losses or expenses which are capitalised for the time being, expenses for promotion of organisations (preliminary expenses), discount on issue of shares, debit balance of profit and loss account etc. are the examples of fictitious assets.

Liability:

It means the amount which the firm owes to outsiders that is, excepting the proprietors. In the words of Finny and Miller, "Liabilities are debts; they are amounts owed to creditors; thus the claims of those who ate not owners are called liabilities".

In simple terms, debts repayable to outsiders by the business are known as liabilities.

Long term Liabilities: Liabilities repayable after specific duration of long period of time are called long term liabilities.

Current liabilities: Liabilities which are repayable during the operating cycle of business, usually within a year, are called short term liabilities or current liabilities

FINANCIAL STATEMENT ANALYSIS

Financial Statement : A financial statement is an organized collection of data according to logical and consistent accounting procedures

Purpose: To understand the financial aspects of a business form.

Financial Statement

Income Statement   Balance Sheet   Statement of retained earnings   Statement of changes in financial position

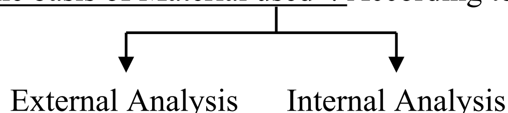
Analysis : Methodical Classification of data given in the financial statements in simplified form.

Interpretation: Explaining the meaning and significance of data so simplified.

Financial statement Analysis: To analyze the firm's profitability & financial soundness

The following are the types of Financial Statement Analysis.

1.On the basis of Material used : According to the material used.



External Analysis   Internal Analysis

External Analysis: This analysis is done by the outsiders like Investors /Credit agencies/Government agencies and other Creditors.

Internal Analysis: This analysis is done by the internal executives / employees of the organization.

2.On the basis of modus operandi : According to the method of operation followed in the analysis.

Dynamic / Horizontal Analysis Static / Vertical Analysis

Dynamic / Horizontal Analysis: This analysis refers to the financial data of a company for several years. The figures of various years are compared with the base year. It helps to focus attention on items that have changed significantly during the period under review. Changes in different elements of cost and sales over no. of years.

Tools employed are comparative statements and trend percentages.

Static / Vertical Analysis: A study is made of the quantitative relationship of the various items in the financial statements in a particular date.
Percentage of each element of cost to sales.
Tools employed are common-size financial statements and financial ratios.

Ex: Item based
Particular period and in the same company

One division – FMCG goods
Another division – Medicines than
So the ratio is measured & compared the performance of one division to another division

Particular period and with different companies

One company – FMCG goods
Another company – FMCG goods
So the ratio is measured and compared the performance of one company to another company.

Methods and Devices of Financial Analysis:

A number of methods or devices are used to study the relationship between different statements and to analyze the position of the enterprise.

The following are the methods:
1.Comparative statements
2.Trend Analysis
3.Common-size statements
4.Funds Flow Analysis
5.Cash Flow Analysis
6.Ratio Analysis
7.Cost-Volume-Profit Analysis

Comparative Statements:

The comparative financial statements are statements of the financial position at different periods, of time. The elements of financial position are shown in a comparative form so as to give an idea of financial position at two or more periods. The following are the two types of comparative statements.

1.Comparative Balance Sheet : The analysis is the study of the trend of the same items, groups of items and computed items in two or more balance sheets of the same business enterprise on different dates. The changes in periodic balance sheet items reflect the conduct of a business. It has four columns and the fourth column is used for giving percentages of increases or decreases.

Guidelines for interpretation : Interpreter is expected to study the following aspects
-Current financial position and liquidity position
-Long-term financial position
-Profitability of the concern
-For studying current financial position or short-term financial position of a concern, should see the working capital in both the years.

2.Comparative Income Statement: The income statement gives the results of the operations of a business. It gives an idea of the progress of a business over a period of time. Like comparative balance sheet it also has 4 columns and the fourth column is used to show increase or decrease in figures, in absolute amounts and percentages respectively.

Guidelines for interpretation : Interpreter is expected to study the following aspects
-The increase or decrease in sales should be compared with the increase or decrease in cost of goods sold.
-To analyze the study of operational profits.
-The increase or decrease in net profit will give an idea about the overall profitability of the concern.
-Should mention whether the overall profitability is good or not.

Trend Analysis:

The financial statements may be analyzed by computing trends of series of information. This method determines the direction upwards or downwards and involves the computation of the percentage relationship that each statement item bears to the same item in base year.

Procedure for calculating trends.
-One year is taken as a base year. Generally the first or the last is taken as base year.
-The figures of base year are taken as 100.
-Trend percentages are calculated in relation to base year. If a figure in one year is less than the figure in base year the trend percentage will be less than 100 and it will be more than 100 if figure is more than base year figure. Each year’s figure is divided by the base year’s figure.

COMMON-SIZE STATEMENT ANALYSIS:

The common-size statements, balance sheet and income statement are shown in analytical and percentages. The figures are shown as the percentage of total assets, total liabilities and total sales. These statements are also known as components percentage or 100 percent statement.
1.The total of assets or liabilities are taken as 100.
2.The individual assets are expressed as percentage of total assets.
Ex: Total assets = Rs.5,00,000, Inventory value = Rs.50,000
If total assets are taken as 100

Calculation: $\frac{50000 \times 100}{5,00,000} = 10\%$

Common-size Balance sheet: A statement in which balance sheet items are expressed as the ratio of each asset to total assets and the ratio of each liabilities to total liabilities is called common-size balance sheet.

Common-size Income Statement: The items in income statement can be shown as percentage of sales to show the relation of each item to sales. A significant relationship can be established between items of income statement and volume of sales.
Sales increases selling expenses increases - there will be no affect on other administrative expenses
Sales decreases selling expenses decreases - there will be no affect on other administrative expenses
If sales increase to a considerable extent then administrative and financial expenses go up.
So a relationship is established between sales and other items in income in evaluating operational activities of the enterprise.

Funds Flow Statement: The term flow means movement and includes both inflow and outflow. The term flow of funds means transfer of economic values from one asset to another.

Source of funds: If the effect of transaction results in the increase of funds, it is called a source of funds.

Application of funds: If the effect of transaction results in the decrease of funds, it is called application of funds.

Cash Flow Statement: Cash flow statement is a statement which describes the inflows and outflows of cash and cash equivalents in an enterprise period of time.

Cash: Cash comprises cash on hand and demand deposits at bank.

Cash Equivalents: Cash Equivalents are short term, high liquid investments that are readily convertible into known as amount of cash.

Cash flow: Cash flows are inflows and outflows of cash and cash equivalents.

Cash flows from operating activities: Operating activities are the principal of revenue-producing activities of the enterprise and other activities that are not investing or finance activities.

Cash flow from investing activities: The cash flow represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Cash flows from financing activities: Financial activities are activities that result in changes in the size and composition of the owner's capital and borrowings of the enterprise.

Cost-volume-profit analysis: Cost-Volume-Profit (CVP) analysis is a managerial accounting technique that is concerned with the effect of sales volume and product costs on operating profit of a business. It deals with how operating profit is affected by changes in variable costs, fixed costs, selling price per unit and the sales mix of two or more different products.

CVP analysis has following assumptions:

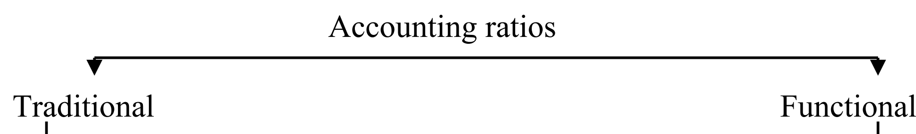
-All cost can be categorized as variable or fixed.
-Sales price per unit, variable cost per unit and total fixed cost are constant.
-All units produced are sold.

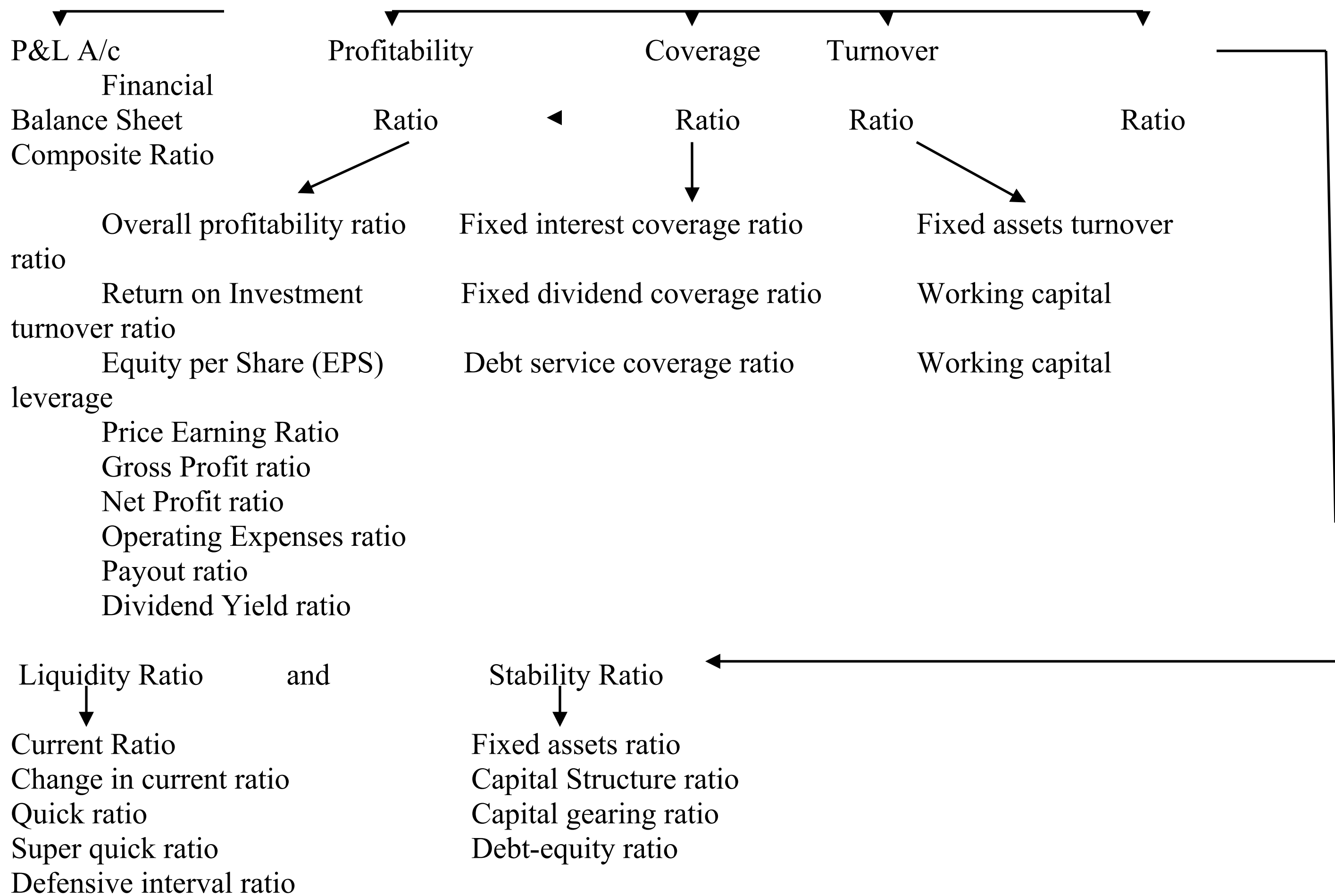
RATIONALE:

Explanation of the logical reasons or principles employed in consciously arriving at a decision or estimate rationales usually document
why a particular choice was made,
how the basis of its selection was developed,
why and how the particular information or assumptions were relied on and
why the conclusion is deemed credible or realistic.

RATIO ANALYSIS :

It is a technical of analysis and interpretation of financial statements. It is the process of establishing and interpreting various ratios for helping in making the certain decisions.
According to Accountants' Handbook of Wixon, Kell and Bedford a ratio is an
"Expression of the quantitative relationship between two numbers".





CLASSIFICATION, CALCULATION AND INTERPRETATION OF RATIOS

SL NO	RATIO	CLASSIFICATION		COMPUTATION FORMULA	PURPOSE
		Traditional	Functional		
1	Gross Profit Ratio	P&L A/c or Revenue Statement Ratio	Probability Ratio	$\frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$	Indicates the efficiency of the production / trading operations
2	Net Profit Ratio	"	"	Net Profit	Indicates net margin on sales

				——— x100 Net Sales	
3	Operating or Expenses ratio	"	"	Operating cost ——— x100 Net Sales	A measure of management's ability to keep operating expenses properly controlled fo level of sales achieved
4	Net Profit to Total Assets	Composite Ratio	"	Net profit after tax + Interest ——— x100 Total assets	A measure of productivity of Total Assets
5	Return on Shareholders' funds	"	"	Profit available for equity shareholders ——— x100 Average equity shareholders's funds	Shows the amount of earnings attributable to each equity share
6	Earning per equity share	"	"	Profit available for equity shareholders ——— x100 No. of Equity Shares	Shows the amount of earnings attributes to each equity share.
7	Dividend yield	"	"	Dividend per share ——— x100 Market price per share	Shows the rate of return to shareholders in the form of dividends based on the market price of the share.
8	Price Earning ratio	"	"	Market price of a share ——— x100 Earning per share	A measure for determining the value of a share. May also be used to measure the rate of retu expected by investors.
9	Fixed Interest Cover	P&L or Revenue Statement Ratio	Profitability Ratio	Operating Income ——— Annual Interest Expense	Shows the margin of coverage interest requirements
10	Fixed Dividend Cover	"	"	Net Income ——— Annual Preference Dividends	Shows the extent to which curr earnings are available to pay dividends on preference shares.
11	Inventory Turnover	"	Turnover or Efficiency ratio	Cost of goods sold ——— Average Inventory	Evaluation of the liquidity of inventory and adequacy of inventory controls.
12	Accounts Receivable Turnover	Composite ratio	"	Net Sales on Credit ——— Average Receivable	Measures liquidity of accounts receivable and the effectivenes of credit policy.
13	Current ratio	Balance sheet ratio	Financial ratio	Current Assets ——— Current Liabilities	Measures short-term debt payir ability.

14	Quick (Acid Test) ratio	"	"	(i) Quick Assets / Current Liabilities (ii) Quick Assets / Quick Liabilities	A refined measure of the short-term debt paying ability by measuring short-term liquidity.
15	Proprietary ratio	"	"	Total Shareholders' Funds / Total Tangible Assets	Measures conservatism of capit structure and shows the extent o shareholders' funds in the total assets employed in the business
16	Debt-Equity ratio	"	ʻʼ	(i) External Equities / Internal Equities (ii) Total Long-term Debt / Total Lon-term Funds	Indicates the percentage of func being financed through borrowings; a measure of the extent of trading on equity.

UTILITY OF RATION ANALYSIS:

Ratios are of immense importance in the analysis and interpretation of financial statements as they bring strength or weaknesses of the firm.
The following are the types of utility of ratio analysis.

1.Managerial uses of ratio analysis: This analysis helps in decision making through information provided in financial statements, financial forecasting and planning like looking ahead and ratios calculated are used as a guide for future , helps in communication like understanding financial strengths and weaknesses, co-ordination helps in effective business management, control like comparing actual with standards & other uses like budgetary control and standard costing.

2.Utility to Shareholders / Investors: Ratio analysis is used in making up investor mind whether present financial position of the concern, warrants further investment or not.

3.Utility to Creditors: Ratio analysis is used to know whether current assets are quite sufficient to current liabilities.

4.Utility to Employees: Profitability of financial statements like Gross-profit, Net-profit, Operating-profit will enable the employees to put forward their view point for the increase of their wages and benefits.

5.Utility to Government: Government also interested to know overall strength of the industry . So the ratio act as an indicator to know the overall strength of the public and private sector.

6. Tax-audit requirements: Ratios are used to analyze the Gross-profit/turnover, Net-profit/turnover, Stock-in-trade/turnover and material consumed/finished goods product.