FINANCIAL ACCOUNTING AND FINANCIAL ANALYSIS

Introduction:

As you are aware, every trader generally starts business for purpose of earning profit. While establishing business, he brings own capital, borrows money from relatives, friends, outsiders or financial institutions. Then he purchases machinery, plant, furniture, raw materials and other assets. He starts buying and selling of goods, paying for salaries, rent and other expenses, depositing and withdrawing cash from bank. Like this he undertakes innumerable transactions in business.

!.1 Meaning ofAccounting:

Thus, book-keeping is an art of recording the business transactions in the books of original entry and the ledges. Accountancy begins where Book-keeping ends. Accountancy means the compilation of accounts in such a way that one is in a position to know the state of affairs of the business. The work of an accountant is to analyze, interpret and review the accounts and draw conclusion with a view to guide the management in chalking out the future policy of the business.

!.2 Definition ofAccounting:

American Institute of Certified Public Accountants (AICPA): "The art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events, which are in part at least, of a financial character and interpreting the results thereof."

Smith and Ashburne: "Accounting is a means of measuring and reporting the results of economicactivities."

R.N. Anthony: "Accounting system is a means of collecting summarizing, analyzing and reporting in monetary terms, the information about thebusiness.

Thus, accounting is an art of identifying, recording, summarizing and interpreting business transactions of financial nature. Hence accounting is the Language of Business.

!.3 Branches ofAccounting:

The important branches of accounting are:

1. ***Financial Accounting:*** The purpose of accounting is to ascertain thefinancial results i.e.profit or loss in the operations during a specific period. It is also aimed at knowing the financial position, i.e.assets, liabilities and equity position at the end ofthe period. It

   also provides other relevant information to the management as a basic for decision-making for planning and controlling the operations of the business.
2. ***Cost Accounting:*** The purpose of this branch of accounting is to ascertain the cost of a product / operation / project and the costs incurred for carrying out various activities. It also assists the management in controlling the costs. The necessary data and

information are gatherr4ed form financial and other sources.

3. ***Management Accounting:*** Its aim to assist the management in taking correct policy decision and to evaluate the impact of its decisions and actions. The data required for this purpose are drawn accounting andcost-accounting.
4. ***Inflation Accounting:*** It is concerned with the adjustment in the values of assest and of profit in light of changes in the price level. In a way it is concerned with the overcoming of limitations that arise in financial statements on account of the cost assumption (i.e recording of the assets at their historical or original cost) and the assumption of stable monetaryunit.
5. ***Human Resource Accounting:*** It is a branch of accounting which seeks to report and emphasize the importance of human resources in a company's earning process and total assets. It is concerned with the process of identifying and measuring data about human resources and communicating this information to interested parties. In simple words, it is accounting for people as organizationalresources.

2.4 FUNCTIONS OF ANACCOUNTANT:

The job of an accountant involves the following types of accounting works:

- **Designing Work:** It includes the designing of the accounting system, basis for identification and classification of financial transactions and events, forms, methods, procedures,etc.
- **Recording Work:** The financial transactions are identified, classified and recorded in appropriate books of accounts according to principles. This is "Book Keeping". The recording of transactions tends to be mechanical andrepetitive.
- **Summarizing Work:** The recorded transactions are summarized into significant form according to generally accepted accounting principles. The work includes the preparation of profit and loss account, balance sheet. This phase is called preparation of final accounts
- **Analysis and Interpretation Work:** The financial statements are analyzed by using ratio analysis, break-even analysis, funds flow and cash flowanalysis.
- **Reporting Work:** The summarized statements along with analysis and interpretation are communicated to the interested parties or whoever has the right to receive them. For Ex. Shareholders. In addition, the accou8nting departments have to prepare and send regular reports so as to assist the management in decision making. This isReporting.
- **Preparation of Budget:** The management must be able to reasonably estimate the future requirements and opportunities. As an aid to this process, the accountant has to prepare budgets, like cash budget, capital budget, purchase budget, sales budget etc. this isBudgeting.

- **Taxation Work:** The accountant has to prepare various statements and returns pertaining to income-tax, sales-tax, excise or customs duties etc., and file the returns with the authoritiesconcerned.
- **Auditing:** It involves a critical review and verification of the books of accounts statements and reports with a view to verifying their accuracy. This is auditing this is what the accountant or the accounting department does. A person may be placed in any part of Accounting Department or MIS (Management Information System) Department or in small organization; the same person may have to attend to all thiswork.

SERS OF ACCOUNTING INFORMATION

Different categories of users need different kinds of information for making decisions. The users of accounting can be divided in two board groups

(1). Internal users and

(2). External users.

iternal Users:

Managers: These are the persons who manage the business, i.e. management at

- TopLevel,
- Middle Leveland
- Lowerlevels.

xternal Users:

- Investors
- Creditors
- Workers
- Customers
- Government
- Public
- Researchers

ASIC ACCOUNTING CONCEPTS

Accounting is a system evolved to achieve a set of objectives. In order to achieve the goals, we need a set of rules or guidelines. These guidelines are termed here as "BASIC ACCOUNTING ONCEPTS". The term concept means an idea or thought. Basic accounting concepts are the fundamental ideas or basic assumptions underlying the theory and profit of FINANCIAL ACCOUNTING. These concepts help in bringing about uniformity in the practice of accounting. In accountancy following concepts are quite popular.

1) **Business Entity Concept:** In this concept "Business is treated as separate from the proprietor". All the Transactions recorded in the book of Business and not in the books of proprietor. The proprietor is also treated as a creditor for the Business.

2) **Going Concern Concept:** This concept relates with the long life of Business. The

assumption is that business will continue to exist for unlimited period unless it is dissolved due to some reasons or theother.

3) **Money Measurement Concept:** In this concept "Only those transactions are recorded in accounting which can be expressed in terms of money, those transactions which cannot be expressed in terms of money are not recorded in the books ofaccounting".

4) **Cost Concept:** Accounting to this concept, can asset isrecorded at its cost in the books of account. i.e., the price, which is paid at the time of acquiring it. In balance sheet, these assets appear not at cost price every year, but depreciation is deducted and they appear at the amount, which is cost, lessclassification.

5) **Accounting Period Concept:** every Businessman wants to know the result of his investment and efforts after a certain period. Usually one-year period is regarded as an ideal for this purpose. This period is called Accounting Period. It depends on the nature of the business and object of the proprietor ofbusiness.

6) **Dual Accept Concept:** According to this concept "Every business transaction has two aspects", one is the receiving benefit aspect another one is giving benefit aspect. The receiving benefit aspect is termed as "DEBIT", whereas the giving benefit aspect is termed as "CREDIT". Therefore, for every debit, there will be correspondingcredit.

7) **Matching Cost Concept:** According to this concept "The expenses incurred during an accounting period, e.g., if revenue is recognized on all goods sold during a period, cost of those good sole should also Be charged to thatperiod.

8) **Realization Concept:** According to this concept revenue is recognized when a sale is made. Sale is Considered to be made at the point when the property in goods possess to the buyer and he becomes legally liable topay.

ACCOUNTING CONVENTIONS

Accounting is based on some customs or usages. Naturally accountants here to adopt that usage or custom. They are termed as convert conventions in accounting. The following are some of the important accounting conventions.

1) **Full Disclosure:** According to this convention accounting reports should disclose fully and fairly the information. They purport to represent. They should be prepared honestly and sufficiently disclose information which is if material interest to proprietors, present and potential creditors and investors. The companies ACT, 1956 makes it compulsory to provide all the information in the prescribedform.
2) **Materiality**: Under this convention the trader records important factor about the commercial activities. In the form of financial statements if any unimportant information is to be given for the sake of clarity it will be given asfootnotes.
3) **Consistency:** It means that accounting method adopted should not be changed from

year to year. It means that there should be consistent in the methods or principles followed. Or else the results of a year cannot be conveniently compared with that ofanother.

4) **Conservatism:** This convention warns the trader not to take unrealized income in to account. That is why the practice of valuing stock at cost or market price, whichever is lower is in vague. This is the policy of "playing safe"; it takes in to consideration all prospective losses but leaves all prospectiveprofits.

The following three different rules have been laid down for the three classes of accounts:

- **Personal Accounts:** The account of the person receiving benefit (receiver) is to be debited and the account of the person giving the benefit (given) is to be credited.

Rule: "Debit ------TheReceiver

Credit ---TheGiver"

- **Real Accounts:** When an asset is coming into the business, account of that asset is tobe debited .When an asset is going out of the business; the account of that asset is to be credited.

Rule: "Debit ------What comesin

Credit ---What goesout"

- **Nominal Accounts:** When an expense is incurred or loss encountered, the account representing the expense or loss is to be debited. When any income is earned or gain made, the account representing the income of gain is to becredited.

Rule: "Debit ------All expenses andlosses

Credit ---All incomes andgains"

The perform of Journal is given below:

Date	Particulars	LF	Dr. (Amount Rs.)	Cr. (Amount Rs.)

LEDGER:

All the transactions in a journal are recorded in a chronological order. After a certain period, if we want to know whether a particular account is showing a debit or credit balance it becomes very difficult. So, the ledger is designed to accommodate the various accounts maintained the trader. It contains the final or permanent record of all the transactions in duly classified form. "A ledger is a book which contains various accounts." The process of transferring entries from journal to ledger is called"POSTING".

Posting is the process of entering in the ledger the entries given in the journal. Posting into ledger is done periodically, may be weekly or fortnightly as per the convenience of thebusiness.

The following are the guidelines for posting transactions in the ledger.

- After the completion of Journal entries only posting is to be made in theledger.
- For each item in the Journal a separate account is to be opened. Further, for each new item a new account is to beopened.
- Depending upon the number of transactions space for each account is to be determined in the ledger.
- For each account there must be a name. This should be written in the top of the table. At the end of the name, the word "Account" is to beadded.
- The debit side of the Journal entry is to be posted on the debit side of the account, by starting with"TO".
- The credit side of the Journal entry is to be posted on the debit side of the account, by starting with"BY".

Performa for ledger: LEDGER BOOK:

Dr. Cr.

Date	Particulars	JF	Amount Rs.		Date	Particulars	JF	Amount Rs.

SUBSIDIARY BOOKS:

In a small business concern, the numbers of transactions are limited. These transactions are first recorded in the journal as and when they take place. Subsequently, these transactions are posted in the appropriate accounts of the ledger. Therefore, the journal is known as "Book of Original Entry" or "Book of Prime Entry" while the ledger is known as main book ofaccounts.

On the other hand, the transactions in big concern are numerous and sometimes even run into thousands and lakhs. It is inconvenient and time-wasting process if all the transactions are going to be managed with ajournal.

Therefore, a convenient device is made. Smaller account books known as subsidiary books or subsidiary journals are disturbed to various sections of the business house. As and when transactions take place, they are recorded in these subsidiary books simultaneously without delay. The original journal (which is known as Journal Proper) is used only occasionally to record those transactions which cannot be recorded in any of the subsidiary books.

TYPES OF SUBSIDIARY BOOKS: -- Subsidiary books are divided into eight types. They are,

1. ***Purchases Book:*** - This book records all credit purchases only. Purchase of goods for cash and purchase of assets for cash. Credit will not be recorded in this book. Purchases book is otherwise called Purchases Day Book, Purchases Journal or PurchasesRegister.
2. ***Sales Book***: - This book is used to record credit sales only. Goods are sold for cash and sale of assets for cash or credit will not be recorded in this book. This book is otherwise called Sales Day Book, Sales Journal or Sales Register.
3. ***Purchase Returns Book***: - This book is used to record the particulars of goods returned to the suppliers. This book is otherwise called Returns OutwardBook.
4. ***Sales Returns Book***: - This book is used to record the particulars of goods returned by the customers. This book is otherwise called Returns InwardBook.
5. *Cash Book:* - All cash transactions, receipts and payments are recorded in this book. Cash includes cheques, money ordersetc.
6. ***Bills Receivables Book***: - This book is used to record all the bills and promissory notes are received from thecustomers.
7. ***Bills Payable Book***: - This book is used to record all the bills or promissory notes accepted to thesuppliers.
8. ***Journal Proper***: - This is used to record all the transactions that cannot be recorded in any of the above-mentioned subsidiarybooks.

TRAIL BALANCE:

The first step in the preparation of final accounts is the preparation of trail balance. Inthe double entry system of book keeping, there will be credit for every debit and there will not be any debit without credit. When this principle is followed in writing journal entries, the total amount of all debits is equal to the total amount allcredits.

A trail balance is a statement of debit and credit balances. It is prepared on a particular date with the object of checking the accuracy of the books of accounts. It indicates that all the transactions for a particular period have been duly entered in the book, properly posted and balanced. The trail balance doesn't include stock in hand at the end of the period. All adjustments required to be done at the end of the period including closing stock are generally given under the trailbalance.

DEFINITIONS: *SPICER AND POGLAR: A trail balance is a list of all the balances standing on the ledger accounts and cash book of a concern at any given date.*

J.R.B ATLIBOI: A trail balance is a statement of debit and credit balances extracted from the ledger with a view to test the arithmetical accuracy of thebooks.

Thus, a trail balance is a list of balances of the ledger accounts and cash book of a business concern at any given date.

PROFORMA FOR TRAIL BALANCE:

Trail balance for the Year Ending Mr.. as on ....

Particulars	Debit Balances Rs	Credit Balances Rs
Debit Balances:		XXX
1) Debtors		
2) Assets suchas		
Plant and Machinery		
Land and Buildings		
Furniture		
3) Expenses such as		
Rent		
Insurance		
Office expenses		
4) Losses Suchas		
Stock destroyed by fire		
Loss on sale of Assets		
5) Purchase		
6) Sales Returns		
7) Drawings		
Credit Balance:		
1) Creditors		
2) Liabilities Such as		
Capital		
Debentures		
Long termLoan		
3) Incomes		
4) Gains		
5) Profit		
6) BankOverdraft		
7) PurchaseReturns		
8) Sales account		
9) Provision account such as		
Provision for DoubtfulDebts		
Provision for discount on debtors		
10) Reserves andSurplus		

Final Accounts:

The process of preparing final accounts is two stages:

1) Trading and Profit and Loss accountand
2) Balance sheet

The first step in the preparation of final account is the preparation of trading account. The main purpose of preparing the trading account is to ascertain gross profit or gross loss as a result of buying and selling the goods.

Trading account of MR…………………… for the year ended ……………………

Particulars	Amount	Particulars	Amount
To opening stock	Xxxx	By sales xxxx	
To purchases xxxxLess:returns xx	Xxxx	Less: returns xxx	Xxxx
		By closing stock	Xxxx
To carriage inwards	Xxxx		
Towages	Xxxx		
Tofreight	Xxxx		
To customs duty	Xxxx		
To gas, fuel, coal, Water	Xxxx		
To factory expenses	Xxxx		
To other man. Expenses	Xxxx		
To productive expenses	Xxxx		
To gross profit c/d	Xxxx		
	Xxxx		Xxxx

PROFIT AND LOSS ACCOUNT

The business man is always interested in knowing his net income or net profit. Net profit represents the excess of gross profit plus the other revenue incomes over administrative, sales, Financial and other expenses. The debit side of profit and Credit side of loss account. shows the expenses in debit side and the incomes in credit side. If the total of the credit side is more, it will be the net profit. And if the debit side is more, it will be net loss.

PROFIT AND LOSS A/C OF MR……………………..FOR THE YEAR ENDED………..

PARTICULARS	AMOUNT	PARTICULARS	AMOUNT
TO office salaries	Xxxxxx	**By Gross profit b/d**	Xxxxx
TOrent,rates,taxes	Xxxxx	By Interest received	Xxxxx
TO Printing and stationery	Xxxxx	By Discount received	Xxxx
TO Legalcharges		By Commission received	Xxxxx
Audit fee	Xxxx	By Income from investments	
TOInsurance	Xxxx	By Dividend on shares	Xxxx
TO General expenses	Xxxx	By Miscellaneous investments	Xxxx
TO Advertisements	Xxxxx	By Rent received	Xxxx
TO Baddebts	Xxxx		
TO Carriage outwards	Xxxx		Xxxx
TO Repairs	Xxxx		
TO Depreciation	Xxxxx		
TO interestpaid	Xxxxx		
TO Interest on capital	Xxxxx		
TO Interest on loans	Xxxx		
TO Discount allowed	Xxxxx		
TO Commission	Xxxxx		
TONet profit-------→ (transferred to capital a/c)	Xxxxx		
	Xxxxx		Xxxx

BALANCE SHEET

The second point of final accounts is the preparation of balance sheet. It is prepared often in the trading and profit; loss accounts have been compiled and closed. A balance sheet may be considered as a statement of the financial position of the concern at a given date.

DEFINITION: A balance sheet is an item wise list of assets, liabilities and proprietorship of a business at a certain state.

J.R.botliboi: A balance sheet is a statement with a view to measure exact financial position of a business at a particular date.
On the left-hand side of this statement, the liabilities and the capital are shown. On the right-hand side all the assets are shown. Therefore, the two sides of the balance sheet should be equal. Otherwise, there is an error somewhere.

BALANCE SHEET OF .... AS ON ....

Liabilities and capital		Amount	Assets	Amount
Creditors		Xxxx	Cash in hand	Xxxx
Bills payable		Xxxx	Cash at bank	Xxxx
Outstanding Expenses		Xxxx	Bills receivable	Xxxx
Bank overdraft		Xxxx	Debtors	Xxxx
Loans		Xxxx	Closing stock	Xxxx
Mortgage		Xxxx	Investments	Xxxx
Reserve& Surplus fund			Furniture and fittings	Xxxx
Capital	xxxxxx		Plats&machinery	
Add:			Land & buildings	Xxxx
NetProfit	xxxx		Patents,Trade Mark	Xxxx
	-------		copyrights	Xxxx
	xxxxxxx		Goodwill	
	--------		Prepaidexpenses	Xxxx
Less:			Outstanding incomes	Xxxx
Drawings	xxxx	Xxxxxxx		Xxxx

-				
		XXXX		XXXX

FINAL ACCOUNTS – ADJUSTMENTS:

1.*CLOSING STOCK*:-

(i) *If closing stock is given in Trail Balance*: It should be shown only in the balance sheet "Assets Side".

(ii) *If closing stock is given asadjustment*:

1. First, it should be posted at the credit side of "TradingAccount".
2. Next, shown at the asset side of the "BalanceSheet".

2.*OUTSTANDING EXPENSES*:-

(i) *If outstanding expenses given in Trail Balance*: It shouldbeonly on the liability side of Balance Sheet.

(ii) *If outstanding expenses given as adjustment*:

1. First, it should be added to the concerned expense at the debit side of profit and loss account or TradingAccount.
2. Next, it should be added at the liabilities side ofthe Balance Sheet.

3. *PREAPID EXPENSES*:-

(i) *If prepaid expenses given in Trial Balance*: It should be shown only in assets side of the Balance Sheet.

(ii) *If prepaid expense givenasadjustment* :

1. First, it should be deducted from the concerned expenses at the debit side of profit and loss account or TradingAccount.
2. Next, it should be shown at the assets side of the BalanceSheet.

4. *INCOME EARNED BUT NOT RECEIVED [OR] OUTSTANDING INCOME [OR] ACCURED INCOME*:-

(i) *If incomes given in Trial Balance*: It should be shown only on the assets side of the Balance Sheet.

(ii) *If incomes outstanding given asadjustment*:

1. First, it should be added to the concerned income at the credit side of profit and loss account.
2. Next, it should be shown at the assets side of the Balancesheet.

5. *INCOME RECEIVED IN ADVANCE: UNEARNED INCOME*:-

(i) *If unearned incomes given in Trail Balance*: It should be shown only on the liabilities side of the BalanceSheet.

(ii) *If unearned income givenasadjustment* :

1. First, it should be deducted from the concerned income in the credit side of the profit and lossaccount.
2. Secondly, it should be shown in the liabilities side of the Balance Sheet.

6. *DEPRECIATION*:-

(i) *If Depreciation given in Trail Balance*: It should be shown only on the debit side of the profit and lossaccount.

(ii) If Depreciation given asadjustment

1. First, it should be shown on the debit side of the profit and lossaccount.
2. Secondly, it should be deduced from the concerned asset in the Balance sheet assetsside.

7. *INTEREST ON LOAN [OR] CAPITAL*: -

(i) *If interest on loan (or) capital given in Trail balance*: It should be shown only on debit side of the profit and lossaccount.

(ii) *If interest on loan (or)capital given as adjustment:*

1. First, it should be shown on debit side of the profit and lossaccount.
2. Secondly, it should add to the loan or capital in

the liabilities side of the BalanceSheet.

8.*BAD DEBTS*: -

(i) *If bad debts given in Trail balance: It* should be shown on the debit side of the profit and loss account.

(ii) *If bad debts given asadjustment*:

1. First, it should be shown on the debit side of the profit and lossaccount.
2. Secondly, it should be deducted from debtors in the assets side of the BalanceSheet.

9.*INTEREST ON DRAWINGS*:-

(i) *If interest on drawings given in Trail balance*: It should be shown on the credit side of the profit and lossaccount.

(ii) *If interest on drawings given as adjustments*:

1. First, it should be shown on the credit side of the profit and lossaccount.
2. Secondly, it should be deducted from capital on liabilities side of the BalanceSheet.

10.*INTEREST ON INVESTMENTS*:-

(i) *If interest on the investments given in Trail balance*: It should be shown on the credit side of the profitandloss account.

(ii) *If interest on investments givenasadjustments*:

1. First, it should be shown on the credit side of the profit and lossaccount.
2. Secondly, it should be added to the investments on assets side of the BalanceSheet.

RATIO ANALYSIS

Introduction: Ratio analysis is a commonly used tool of financial statement analysis. Ratio is a mathematical relationship between one number to another number. Ratio is used as an index for evaluating the financial performance of the business concern. An accounting ratio shows the mathematical relationship between two figures, which have meaningful relation with each other.

Ratio can be classified into various types. Classification from the point of view of financial management is as follows:

- LiquidityRatio
- ActivityRatio
- SolvencyRatio
- ProfitabilityRatio

Objectives of Ratio Analysis:

- To determine liquidity (Short teamsolvency)
- To determine long termSolvency.

- To determine operatingefficiently.
- To determine profitability with respect to revenues from operations andInvestments.
- To compare intra firmposition
    - Evaluating the financialposition
    - Performance of the enterprise in the industry over a period attime.
    - Identify strong and weak areas for theenterprise.
    - To compare inter firm position within particularindustry.

Managerial Uses:

- It is useful to takedecisions
- Financialforecasting
- Helps incommunications
- Helps in Co –ordinations
- Useful toshareholders
- Useful tocreditor
- Useful toemployees
- Useful toGovt.

Classification of Ratio Analysis:

- LiquidityRatio
- ActivityRatio
- SolvencyRatio
- ProfitabilityRatio

Liquidity Ratio

It is also called as short-term ratio. This ratio helps to understand the liquidity in a business which is the potential ability to meet current obligations. This ratio expresses the relationship between current assets and current assets of the business concern during a particular period.

The following are the major liquidity ratio:

- CurrentRatio
- Quick Ratio (or) Liquid Ratio (or) Acid testRatio.
- Absolute Liquidity or Cash Ratio

Activity / Turnover Ratio:

It is also called as turnover ratio. This ratio measures the efficiency of the current assets and liabilities in the business concern during a particular period. This ratio is helpful to understand the performance of the business concern. Some of the activity ratios are givenbelow:

- Finished Goods or Stock TurnoverRatio
- Debtors TurnoverRatio
- Creditors Turnover Ratio

- Working Capital T/ORatio
- Fixed Assets T/ORatio
- Capital TurnoverRatio

Leverage or Capital Structure Ratio

It is also called as leverage ratio, which measures the long-term obligation of the business concern. This ratio helps to understand, how the long-term funds are used in the business concern. Some of the solvency ratios are givenbelow:

- Debt to Total FundsRatio
- Equity to Total FundsRatio
- Debt – Equity Ratio
- Capital GearingRatio
- ProprietaryRatio
- Fixed Assets to Long Term FundsRatio
- Debt Service CoverageRatio
- Interest coverageRatio
- Preference Dividend CoverageRatio

Profitability Ratio

Profitability ratio helps to measure the profitability position of the business concern. Some of the major profitability ratios are given below.

- Gross ProfitRatio
- Operating ProfitRatio
- Net ProfitRatio
- ContributionSales
- Ratio (or) Profit VolumeRatio
- Return on Investment (or) Return on Capital Employed(ROCE)
- Return on Equity (ROE) (or) Return on Net Worth(RONW)
- Return onAssets
- Earnings Per Share(ESP)
- Dividend Per Share(DPS)
- Price Earnings Ratio (PERatio)
- Dividend Yield(%)
- Book Value PerShare
- Market Value to BookValue