Unit 6
Financial Accounting and Ratio Analysis

FINANCIAL ACCOUNTING

INTRODUCTION TO FINANCIAL ACCOUNTING

Definition

Financial Accounting is the systematic process of recording, classifying, summarizing, and interpreting financial transactions to ascertain the financial performance and position of a business.

Objectives

- To determine the profit or loss during a specific period.
- To understand the financial position of the business (assets, liabilities, equity).
- To maintain systematic and permanent records of financial transactions.
- To provide financial information to stakeholders like owners, creditors, investors, and government.

Branches of Accounting

1. *Financial Accounting* – External reporting of historical financial data.
2. *Cost Accounting* – Analysing production costs and operations.
3. *Management Accounting* – Assisting internal decision-making with forward-looking reports.

PRINCIPLES AND CONCEPTS OF ACCOUNTING

Accounting Principles (Fundamental Assumptions)

1. *Business Entity Concept:* The business is treated as a separate entity from the owner.
2. *Money Measurement Concept:* Only measurable (monetary) transactions are recorded.
3. *Going Concern Concept:* The business is assumed to continue indefinitely.
4. *Cost Concept:* Assets are recorded at their original purchase cost.
5. *Dual Aspect Concept:* Every transaction affects two accounts (debit and credit).
6. *Accrual Concept:* Revenues/expenses are recognized when they occur, not when cash is received or paid.
7. *Matching Concept:* Expenses are recorded in the same period as the related revenues.

Accounting Conventions

1. *Consistency:* Same methods must be used year to year for comparison.
2. *Conservatism:* Anticipate no profits, but provide for all losses.
3. *Materiality:* Only significant items are disclosed.
4. *Full Disclosure:* All relevant facts must be disclosed in financial statements.

TYPES OF ACCOUNTS AND RULES OF DEBIT AND CREDIT

Type of Account	Debit Rule	Credit Rule
Personal	Debit the Receiver	Credit the Giver
Real	Debit what comes in	Credit what goes out
Nominal	Debit all expenses and losses	Credit all incomes and gains

JOURNAL

Definition

The Journal is a book of original entry in which all transactions are recorded in chronological order with debit and credit.

Format

Date	Particulars	L.F.	Debit (₹)	Credit (₹)

Example

Transaction: Bought goods for ₹1,000 in cash.

Entry: Purchases A/c Dr. ₹1,000
To Cash A/c ₹1,000
(Being goods purchased for cash)

LEDGER

Definition

The Ledger is the principal book of accounts where journal entries are classified account-wise.

Format

Date	Particulars	Debit (₹)	Credit (₹)

Features

- Shows the cumulative effect of all transactions.
- Helps in preparing trial balance and final accounts.

TRIAL BALANCE

Definition

A Trial Balance is a statement of all ledger balances on a particular date to check the arithmetic accuracy of the books.

Format

Account Title	Debit (₹)	Credit (₹)

Purpose

- Verifies the equality of debits and credits.
- Used as a base for preparing the final accounts.

FINAL ACCOUNTS

A) Trading Account

- Calculates Gross Profit/Loss.
- Formula:
  Gross Profit = Sales – (Opening Stock + Purchases + Direct Expenses – Closing Stock)

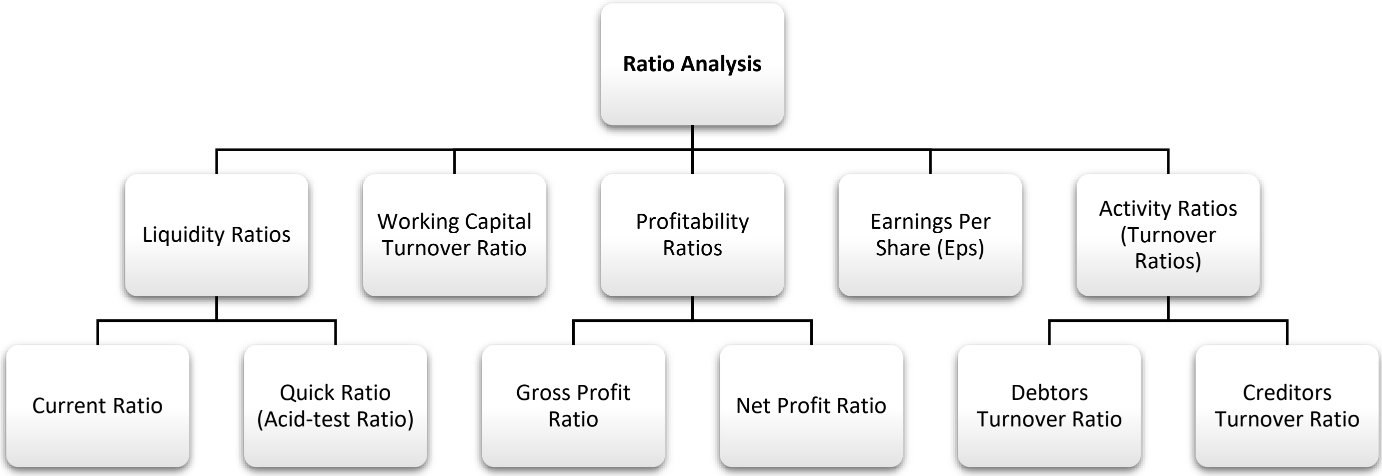
B) Profit and Loss Account

- Determines Net Profit/Loss after indirect expenses.
- Formula:
  Net Profit = Gross Profit – Indirect Expenses + Indirect Incomes

C) Balance Sheet

- Presents Assets, Liabilities, and Owner's Equity at a particular date.
- Formula:
  Assets = Liabilities + Capital

RATIO ANALYSIS



LIQUIDITY RATIOS

a) Current Ratio

- Formula:
  Current Ratio = Current Assets / Current Liabilities
- *Ideal Ratio:* 2:1
- Measures short-term financial strength.

b) Quick Ratio (Acid-Test Ratio)

- Formula:
  Quick Ratio = Quick Assets / Current Liabilities
  where, Quick Assets = Current Assets – Inventory – Prepaid Expenses
- *Ideal Ratio:* 1:1
- Measures immediate liquidity.

WORKING CAPITAL TURNOVER RATIO

- Formula:
  Working Capital Turnover = Net Sales / Working Capital
- Working Capital = Current Assets – Current Liabilities
- Measures efficiency in using working capital to generate sales.

PROFITABILITY RATIOS

a) Gross Profit Ratio

- Formula:
  Gross Profit Ratio = (Gross Profit / Net Sales) × 100
- Indicates production & pricing efficiency.

b) Net Profit Ratio

- Formula:
  Net Profit Ratio = (Net Profit / Net Sales) × 100
- Measures overall profitability after expenses.

EARNINGS PER SHARE (EPS)

- Formula:
  EPS = (Net Profit after Tax – Preference Dividend) / Number of Equity Shares
- Indicates return on equity investment.
- Higher EPS = More attractive to investors.

ACTIVITY RATIOS (TURNOVER RATIOS)

a) Debtors Turnover Ratio

- Formula:
  Debtors Turnover = Net Credit Sales / Average Debtors
- Higher ratio = Efficient collection.

b) Creditors Turnover Ratio

- Formula:
  Creditors Turnover = Net Credit Purchases / Average Creditors
- Measures how quickly dues are paid to suppliers.

LIMITATIONS OF RATIO ANALYSIS

- Based on historical data.
- Ignores qualitative aspects (brand, reputation).
- Different firms may use different accounting policies.
- Ratios vary across industries.
- Not useful unless compared over time or with benchmarks.