**UNIT – V**

INTRODUCTION TO FINANCIAL ACCOUNTING AND FINANCIAL ANALYSIS

**HISTORY OF ACCOUNTING:**

Accounting based on the principles of Double Entry System came into existence in 17th Century. Fra Luka Paciolo, a Fransiscan monk and mathematician published a book *De computicetscripturies*in 1494 at Venice in Italyl. This book was translated into English in 1543. In this book he covered a brief section on ‘book-keeping’.

**ORIGIN OF ACCOUNTING IN INDIA:**

Accounting was practiced in India thousand years ago and there is a clear evidence for this. In his famous book *Arthashastra*Kautilya dealt with not only politics and economics but also the art of proper keeping of accounts. However, the accounting on modern lines was introduced in India after 1850 with the formation joint stock companies in India.

Accounting in India is now a fast developing discipline. The two premier Accounting Institutes in India viz., chartered Accountants of India and the Institute of Cost and Works Accountants of India

**BOOK-KEEPING AND ACCOUNTING**

First stage is called Book-Keeping and the second one is accounting.

**Book – Keeping:** Book – Keeping involves the chronological recording of financial transactions in a set of books in a systematic manner.

**Accounting:** Accounting is concerned with the maintenance of accounts giving stress to the design of the system of records, the preparation of reports based on the recorded date and the interpretation of the reports.

**MEANING OF ACCOUNTING**

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 compilations of accounts in such a way that one is in a position to know the state of affairs of the business.

**Definition of Accounting:**

**Smith and Ashburne:** “Accounting is a means of measuring and reporting the results of economic activities.”

**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.”

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

**BRANCHES OF ACCOUNTING:**

The important branches of accounting are:

1. **Financial Accounting:** The purpose of Accounting is to ascertain the financial 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 of the 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 and cost-accounting.

**FUNCTIONS OF AN ACCOUNTANT**

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

1. **Designing Work:** It includes the designing of the accounting system, basis for identification and classification of financial transactions and events, forms, methods, procedures, etc.
2. **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 and repetitive.
3. **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’
4. **Analysis and Interpretation Work:** The financial statements are analysed by using ratio analysis, break-even analysis, funds flow and cash flow analysis.
5. **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. Share holders. In addition, the accou8nting departments have to prepare and send regular reports so as to assist the management in decision making. This is ‘Reporting’.

1. **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 is ‘Budgeting’.
2. **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 authorities concerned.
3. **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’

**USERS 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.

1. **Internal Users:**

**Managers:** These are the persons who manage the business, i.e. management at him top, middle and lower levels. Their requirements of information are different because they make different types of decisions.

Accounting reports are important to managers for evaluating the results of their decisions. In additions to external financial statements, managers need detailed internal reports either branch division or department or product-wise. Accounting reports for managers are prepared much more frequently than external reports.

Accounting information also helps the managers in appraising the performance of subordinates. As such Accounting is termed as “the eyes and ears of management.”

2. **External Users:**

**1. Investors:**  Those who are interested in buying the shares of company are naturally interested in the financial statements to know how safe the investment already made is and how safe the proposed investments will be.

**2. Creditors:** Lenders are interested to know whether their load, principal and interest, will be paid when due. Suppliers and other creditors are also interested to know the ability of the firm to pay their dues in time.

**3. Workers:** In our country, workers are entitled to payment of bonus which depends on the size of profit earned. Hence, they would like to be satisfied that he bonus being paid to them is correct. This knowledge also helps them in conducting negotiations for wages.

**4. Customers:** They are also concerned with the stability and profitability of the enterprise. They may be interested in knowing the financial strength of the company to rent it for further decisions relating to purchase of goods.

**5. Government:** Governments all over the world are using financial statements for compiling statistics concerning business which, in turn, helps in compiling national accounts. The financial statements are useful for tax authorities for calculating taxes.

**6. Public :**The public at large interested in the functioning of the enterprises because it may make a substantial contribution to the local economy in many ways including the number of people employed and their patronage to local suppliers.

**7. Researchers:**The financial statements’, being a mirror of business conditions, is of great interest to scholars undertaking research in accounting theory as well as business affairs and practices.

**ADVANTAGES FROM ACCOUNTING**

The role of accounting has changed from that of a mere record keeping during the 1st decade of 20th century of the present stage, which it is accepted as information system and decision making activity. The following are the advantages of accounting.

1. **Provides for systematic records:** Since all the financial transactions are recorded in the books, one need not rely on memory. Any information required is readily available from these records.
2. **Facilitates the preparation of financial statements:** Profit and loss accountant and balance sheet can be easily prepared with the help of the information in the records. This enables the trader to know the net result of business operations (i.e. profit / loss) during the accounting period and the financial position of the business at the end of the accounting period.
3. **Provides control over assets:**Book-keeping provides information regarding cash in had, cash at bank, stock of goods, accounts receivables from various parties and the amounts invested in various other assets. As the trader knows the values of the assets he will have control over them.
4. **Provides the required information:** Interested parties such as owners, lenders, creditors etc., get necessary information at frequent intervals.
5. **Comparative study:** One can compare the present performance of the organization with that of its past. This enables the managers to draw useful conclusion and make proper decisions.
6. **Less Scope for fraud or theft:** It is difficult to conceal fraud or theft etc., because of the balancing of the books of accounts periodically. As the work is divided among many persons, there will be check and counter check.
7. **Tax matters:** Properly maintained book-keeping records will help in the settlement of all tax matters with the tax authorities.
8. **Ascertaining Value of Business:** The accounting records will help in ascertaining the correct value of the business. This helps in the event of sale or purchase of a business.
9. **Documentary evidence:** Accounting records can also be used as evidence in the court to substantiate the claim of the business. These records are based on documentary proof. Every entry is supported by authentic vouchers. As such, Courts accept these records as evidence.
10. **Helpful to management:** Accounting is useful to the management in various ways. It enables the management to asses the achievement of its performance. The weakness of the business can be identified and corrective measures can be applied to remove them with the helps accounting.

**LIMITATIONS OF ACCOUNTING** .

1. **Does not record all events:**  Only the transactions of a financial character will be recorded under book-keeping. So it does not reveal a complete picture about the quality of human resources, locational advantage, business contacts etc.
2. **Does not reflect current values:** The data available under book-keeping is historical in nature. So they do not reflect current values. For instance, we record the value of stock at cost price or market price, which ever is less. In case of, building, machinery etc., we adopt historical cost as the basis. Infact, the current values of buildings, plant and machinery may be much more than what is recorded in the balance sheet.
3. **Estimates based on Personal Judgment:** The estimate used for determining the values of various items may not be correct. For example, debtors are estimated in terms of collectibility, inventories are based on marketability, and fixed assets are based on useful working life. These estimates are based on personal judgment and hence sometimes may not be correct.
4. **Inadequate information on costs and Profits:** Book-keeping only provides information about the overall profitability of the business. No information is given about the cost and profitability of different activities of products or divisions.

**BASIC ACCOUNTING CONCEPTS**

Accounting has been evolved over a period of several centuries. During this period, certain rules and conventions have been adopted. These rules and conventions are termed as **Generally Accepted Accounting Principles.** These principles are also referred as standards, assumptions, concepts, conventions doctrines, etc. Thus, the accounting concepts are the fundamental ideas or basic assumptions underlying the theory and practice of financial accounting. They are the broad working rules for all accounting activities developed and accepted by the accounting profession.

# BASIC 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 CONCEPTS”. 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 CONEPT*: 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 the other.

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 can not be expressed in terms of money are not recorded in the books of accounting”.

4. *COST CONCEPT*: Accounting to this concept, can asset is recorded 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, less classification.

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 of business.

6. *DUAL ASCEPT CONCEPT*: According to this concept “Every business transactions has two aspects”, one is the receiving benefit aspect another one is giving benefit aspect. The receiving benefit aspect is termed as

“DEBIT”, where as the giving benefit aspect is termed as “CREDIT”. Therefore, for every debit, there will be corresponding credit.

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 alsoBe charged to that period.

8. *REALISATION 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 posses to the buyer and he becomes legally liable to pay.

**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 prescribed form.

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 as footnotes.

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 of another.

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, which ever is lower is in vague. This is the policy of “playing safe”; it takes in to consideration all prospective losses but leaves all prospective profits.

**CLASSIFICATION OF BUSINESS TRANSACTIONS**

All business transactions are classified into three categories:

1. Those relating to persons

2. Those relating to property (Assets)

3. Those relating to income & expenses

Thus, three classes of accounts are maintained for recording all business transactions. They are:

1. Personal accounts

2. Real accounts

3. Nominal accounts

1*. Personal Accounts*: Accounts which are transactions with persons are called “Personal Accounts”.

A separate account is kept on the name of each person for recording the benefits received from, or given to the person in the course of dealings with him.

E.g.: Krishna’s A/C, Gopal’s A/C, SBI A/C, NagarjunaFinanaceLtd.A/C, ObulReddy& Sons A/C , HMT Ltd. A/C, Capital A/C, Drawings A/C etc.

2. *Real Accounts*: The accounts relating to properties or assets are known as “Real Accounts” .Every business needs assets such as machinery, furniture etc, for running its activities .A separate account is maintained for each asset owned by the business.

E.g.: cash A/C, furniture A/C, building A/C, machinery A/C etc.

3.*NominalAccounts: Accounts* relating to expenses, losses, incomes and gains are known as “Nominal Accounts”. A separate account is maintained for each item of expenses, losses, income or gain.

E.g.: Salaries A/C, stationery A/C, wages A/C, postage A/C, commission A/C, interest A/C, purchases A/C, rent A/C, discount A/C, commission received A/C, interest received A/C, rent received A/C, discount received A/C.

Before recording a transaction, it is necessary to find out which of the accounts is to be debited and which is to be credited. The following three different rules have been laid down for the three classes of accounts….

1. *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----The Receiver

Credit---The Giver”

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

***Rule***: “Debit----What comes in

Credit---What goes out”

3. *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 be credited.

***Rule***: “Debit----All expenses and losses

Credit---All incomes and gains”

**JOURNAL**

The first step in accounting therefore is the record of all the transactions in the books of original entry viz., Journal and then posting into ledges.

*JOURNAL:* The word Journal is derived from the Latin word ‘journ’ which means a day. Therefore, journal means a ‘day Book’ in day-to-day business transactions are recorded in chronological order.

Journal is treated as the book of original entry or first entry or prime entry. All the business transactions are recorded in this book before they are posted in the ledges. The journal is a complete and chronological (in order of dates) record of business transactions. It is recorded in a systematic manner. The process of recording a transaction in the journal is called “JOURNALISING”. The entries made in the book are called “Journal Entries”.

The proforma of Journal is given below.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Date Date | Particulars | L.F. no | Debit  RS. | Credit  RS. |
| 1998 Jan 1 | Purchases account to cash account(being goods purchased for cash) |  | 10,000/- | 10,000/- |

***Note: Problems to be solved on journal***

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

1. After the completion of Journal entries only posting is to be made in the ledger.
2. For each item in the Journal a separate account is to be opened. Further, for each new item a new account is to be opened.
3. Depending upon the number of transactions space for each account is to be determined in the ledger.
4. 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 be added.
5. The debit side of the Journal entry is to be posted on the debit side of the account, by starting with “TO”.
6. The credit side of the Journal entry is to be posted on the debit side of the account, by starting with “BY”.

*Proforma for ledger:*

***LEDGER BOOK***Particulars account

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Date | Particulars | Lfno | Amount | Date | Particulars | Lfno | amount |
|  |  |  |  |  |  |  |  |

Sales account

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Date | Particulars | Lfno | Amount | Date | Particulars | Lfno | amount |
|  |  |  |  |  |  |  |  |

Cash account

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Date | Particulars | Lfno | Amount | Date | Particulars | Lfno | amount |
|  |  |  |  |  |  |  |  |

**TRAIL BALANCE**

The first step in the preparation of final accounts is the preparation of trail balance. In the 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 all credits.

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 trail balance.

*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.BATLIBOI:*

A trail balance is a statement of debit and credit balances extracted from the ledger with a view to test the arithmetical accuracy of the books.

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 MR…………………………………… as on …………

|  |  |  |  |
| --- | --- | --- | --- |
| NO | NAME OF ACCOUNT  (PARTICULARS) | DEBIT AMOUNT (RS.) | CREDIT AMOUNT (RS.) |
|  |  |  |  |

***Note: Problems to be solved on trail balance***

**FINAL ACCOUNTS**

In every business, the business man is interested in knowing whether the business has resulted in profit or loss and what the financial position of the business is at a given time. In brief, he wants to know

(I)The profitability of the business and

(ii) The soundness of the business.

The trader can ascertain this by preparing the final accounts. The final accounts are prepared from the trial balance. Hence the trial balance is said to be the link between the ledger accounts and the final accounts. The final accounts of a firm can be divided into two stages. The first stage is preparing the trading and profit and loss account and the second stage is preparing the balance sheet.

**TRADING ACCOUNT**

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  To purchases xxxx  Less: returns xx  To carriage inwards  To wages  To freight  To customs duty, octroi  To gas, fuel, coal,  Water  To factory expenses  To other man. Expenses  To productive expenses  To gross profit c/d | Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx | By sales xxxx  Less: returns xxx  By closing stock | Xxxx  Xxxx |
| Xxxx |

Finally, a ledger may be defined as a summary statement of all the transactions relating to a person, asset, expense or income which have taken place during a given period of time. The up-to-date state of any account can be easily known by referring to the ledger.

**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 loss account shows the expenses and the credit side the incomes. 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  TO rent,rates,taxes  TO Printing and stationery  TO Legal charges  Audit fee  TO Insurance  TO General expenses  TO Advertisements  TO Bad debts  TO Carriage outwards  TO Repairs  TO Depreciation  TO interest paid  TO Interest on capital  TO Interest on loans  TO Discount allowed  TO Commission  TO Net profit-------🡪  (transferred to capital a/c) | Xxxxxx  Xxxxx  Xxxxx  Xxxx  Xxxx  Xxxx  Xxxxx  Xxxx  Xxxx  Xxxx  Xxxxx  Xxxxx  Xxxxx  Xxxx  Xxxxx  Xxxxx  Xxxxx | By gross profit b/d  Interest received  Discount received  Commission received  Income from investments  Dividend on shares  Miscellaneous investments  Rent received | Xxxxx  Xxxxx  Xxxx  Xxxxx  Xxxx  Xxxx  xxxx |
| xxxxxx | Xxxxxx |

**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.

Thus, Balance sheet is defined as a statement which sets out the assets and liabilities of a business firm and which serves to as certain the financial position of the same on any 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  Bills payable  Bank overdraft  Loans  Mortgage  Reserve fund  Capital xxxxxx  Add:  Net Profit xxxx  -------  xxxxxxx  --------  Less:  Drawings xxxx  --------- | Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx | Cash in hand  Cash at bank  Bills receivable  Debtors  Closing stock  Investments  Furniture and fittings  Plats&machinery  Land & buildings  Patents, tm ,copyrights  Goodwill  Prepaid expenses  Outstanding incomes | Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx  Xxxx |
| XXXX | XXXX |

*Advantages:* The following are the advantages of final balance.

1. It helps in checking the arithmetical accuracy of books of accounts.
2. It helps in the preparation of financial statements.
3. It helps in detecting errors.
4. It serves as an instrument for carrying out the job of rectification of entries.
5. It is possible to find out the balances of various accounts at one place.

**FINAL ACCOUNTS -- ADJUSTMENTS**

We know that business is a going concern. It has to be carried on indefinitely. At the end of every accounting year. The trader prepares the trading and profit and loss account and balance sheet. While preparing these financial statements, sometimes the trader may come across certain problems .The expenses of the current year may be still payable or the expenses of the next year have been prepaid during the current year. In the same way, the income of the current year still receivable and the income of the next year have been received during the current year. Without these adjustments, the profit figures arrived at or the financial position of the concern may not be correct. As such these adjustments are to be made while preparing the final accounts.

The adjustments to be made to final accounts will be given under the Trial Balance. While making the adjustment in the final accounts, the student should remember that “every adjustment is to be made in the final accounts twice i.e. once in trading, profit and loss account and later in balance sheet generally”. The following are some of the important adjustments to be made at the time of preparing of final accounts:-

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 as adjustment:*

1. First, it should be posted at the credit side of “Trading Account”.
2. Next, shown at the asset side of the “Balance Sheet”.

2. *OUTSTANDING EXPENSES*:-

(i)*If outstanding expenses given in Trail Balance*: It should be only 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 Trading Account.
2. Next, it should be added at the liabilities side of the

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 given as adjustment*  :

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

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 as adjustment*:

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 Balance sheet.

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 Balance Sheet.

(ii)*If unearned income given as adjustment* :

1. First, it should be deducted from the concerned income in the credit side of the profit and loss account.
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 loss account.

(ii)*If Depreciation given as adjustment*

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

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 loss account.

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

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

The liabilities side of the Balance Sheet.

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 as adjustment*:

1. First, it should be shown on the debit side of the profit and loss account.
2. Secondly, it should be deducted from debtors in the assets side of the Balance Sheet.

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 loss account.

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

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

Side of the Balance Sheet.

10. *INTEREST ON INVESTMENTS*:-

(I)*If interest on the investments given in Trail balance: It* should be shown on the credit side of the profit and loss account.

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

1. First, it should be shown on the credit side of the profit and loss account.
2. Secondly, it should be added to the investments on assets side of the Balance Sheet.

***Note: Problems to be solved on final accounts***

**KEY WORDS IN BOOK-KEEPING**

1. *TRANSACTIONS*: Any sale or purchase of goods of services is called the transaction.

Transactions are two types.

[A]. cash transaction: cash transaction is one where cash receipt or payment is involved in the exchange.

[b]. Credit transaction: Credit transaction will not have cash, either received or paid, for something given or received respectively.

2. *GOODS*: Fill those things which a firm purchases for resale are called goods.

3. *PURCHASES*: Purchases means purchase of goods, unless it is stated otherwise it also represents the Goods purchased.

4. *SALES*: Sales means sale of goods, unless it is stated otherwise it also represents these goods sold.

5. *EXPENSES*: Payments for the purchase of goods as services are known as expenses.

6. *REVENUE*: Revenue is the amount realized or receivable from the sale of goods or services.

7. *ASSETS*: The valuable things owned by the business are known as assets. These are the properties Owned by the business.

8. *LIABILITIES*: Liabilities are the obligations or debts payable by the enterprise in future in the term of money or goods.

9*. DEBTORS*: Debtors means a person who owes money to the trader.

10. *CREDITORS*: A creditor is a person to whom something is owned by the business.

11. *DRAWINGS*: cash or goods withdrawn by the proprietor from the Business for his personal or Household is termed to as “drawing”.

12. *RESERVE*: An amount set aside out of profits or other surplus and designed to meet contingencies.

13. *ACCOUNT*: A summarized statements of transactions relating to a particular person, thing, Expense or income.

14. *DISCOUNT*: There are two types of discounts...

1. Cash discount: An allowable made to encourage frame payment or before the expiration of the period allowed for credit.
2. Trade discount: A deduction from the gross or catalogue price allowed to traders who buys them for resale.

**UNIT-VIII**

**FINANCIAL ANALYSIS THROUGH RATIOS (RATIO ANALYSIS)**

**RATIO ANALYSIS**

Ratio analysis is the process of determining and interpreting numerical relationships based on financial statements. By computing ratios, it is easy to understand the financial position of the firm. Ratio analysis is used to focus on financial issues such as liquidity, profitability and solvency of a given firm.

**WHAT IS A RATIO?**

Ratio is simply a number expressed in terms of another. It refers to the numerical or quantitative relationship between two variables which are comparable. It is an expression derived by dividing one variable by the other. It is a statistical measure that provides an insight into the relationships between two variables. Ratios used rightly may even develop understanding and stimulate thinking. Ratios can be expressed in terms of percentages, proportions, and quotients also.

**INTERPERTATION:**

Interpretation refers to evaluating the ratio in terms of the laid out standards or norms; nature of the industry/sector; and identifying the possible cause for improvement or decline in the performance of the company. An insight into the logical functioning of business and the knowledge of cause and effect relationship among the given variables in the micro- and macro-business environment will enhance the quality of interpretation. Interpretation is to be made with meticulous care because future decisions are based on the results of interpretation.

**USES OR ADVANTAGES OR IMPORTANCE OF RATIO ANALYSIS**

**Useful in financial position analysis:** Accounting reveals the financial position of the concern. This helps banks, insurance companies and other financial institution in lending and making investment decisions.

**Useful in simplifying accounting figures**: Accounting ratios simplify, summaries and systematic the accounting figures in order to make them more understandable and in lucid form.

**Useful in assessing the operational efficiency:** Accounting ratios helps to have an idea of the working of a concern. The efficiency of the firm becomes evident when analysis is based on accounting ratio. This helps the management to assess financial requirements and the capabilities of various business units.

**Useful in forecasting purposes**: If accounting ratios are calculated for number of years, then a trend is established. This trend helps in setting up future plans and forecasting.

**Useful in locating the weak spots of the business**: Accounting ratios are of great assistance in locating the weak spots in the business even through the overall performance may be efficient.

**Useful in comparison of performance**: Managers are usually interested to know which department performance is good and for that he compare one department with the another department of the same firm. Ratios also help him to make any change in the organisation structure.

LIMITATIONS OF RATIO ANALYSIS:

These limitations should be kept in mind while making use of ratio analyses for interpreting the financial statements. The following are the main limitations of ratio analysis.

**False results if based on incorrect accounting data**: Accounting ratios can be correct only if the data (on which they are based) is correct. Sometimes, the information given in the financial statements is affected by window dressing, i. e. showing position better than what actually is.

**No idea of probable happenings in future:** Ratios are an attempt to make an analysis of the past financial statements; so they are historical documents. Now-a-days keeping in view the complexities of the business, it is important to have an idea of the probable happenings in future.

**Variation in accounting methods:** The two firms’ results are comparable with the help of accounting ratios only if they follow the some accounting methods or bases. Comparison will become difficult if the two concerns follow the different methods of providing depreciation or valuing stock.

**Price level change**: Change in price levels make comparison for various years difficult.

**Only one method of analysis:** Ratio analysis is only a beginning and gives just a fraction of information needed for decision-making so, to have a comprehensive analysis of financial statements, ratios should be used along with other methods of analysis.

**No common standards:** It is very difficult to by down a common standard for comparison because circumstances differ from concern to concern and the nature of each industry is different.

**Different meanings assigned to the some term:** Different firms, in order to calculate ratio may assign different meanings. This may affect the calculation of ratio in different firms and such ratio when used for comparison may lead to wrong conclusions.

**TYPES OF RATIO:**

Based on their nature, the ratios can broadly be classified into four categories:

Liquidity ratios

Activity ratios

Capital structure ratios

Profitability ratios

LIQUIDITY RATIOS:

Liquidity ratios express the ability of the firm to meet its short-term commitments as and when they become due. Creditors are interested to know whether the firm will be in a position to meet its commitments on time or not.

If the firm is not in a position to meet its short-term commitments such as payment of taxes, wages and salaries, and so on, then it cannot continue in business for long despite its strong capital base. Liquidity ratios help in identifying the danger signals for the firm in advance.

Apart from the firm itself, all the financing companies offering short-term finances are interested in there ratios.

Liquidity ratios can be classified into two types:

1. CURRENT RATIO:

2. QUICK RATIO

**1. CURRENT RATIO:**

Current ratio is the ratio between current assets and current liabilities. The firm is said to be comfortable in its liquidity position if the current ratio is 2:1. It is almost considered as a yardstick to assess short-term liquidity. However, it may vary from one industry sector to the other. In other words, for every rupee of current liability, there should be two rupees worth current assets. The interests of the creditors are safeguarded if the current ratio is at least 2:1.

**CURRENT RATIO= CURRENT ASSETS/ CURRENT LIABILITES**

**2. QUICK RATIO:**

Quick ratio is also called acid test ratio. It measures the firm’s ability to convert its current assets quickly into cash in order to meet its current liabilities. It is the ratio between liquid assets and liquid liabilities. It supplements the information given by current ratio.

**QUICK RATIO = QUICK ASSETS/ CURRENT LIABILITIES**

Where Quick assets = Current assets – (Stock + Prepaid expenses)

Quick assets are those assets that can be converted into cash quickly. These are also called liquid assets. Since stock can be sold quickly, it is not included in the list of quick assets. All current assets except stock and prepaid expenses, if any, are called quick or liquid assets.

**ACTIVITY RATIOS**:

Activity ratios express how active the firm is in terms of selling its stocks, collecting its receivables and paying its creditors. These are three types:

Inventory Turnover Ratio

Debtors Turnover Ratio

**INVENTORY TURNOVER RATIO:**

It is also called stock turnover ratio. It indicates the number of times the average stock is being sold during a given accounting period. It establishes the relation between the cost of goods sold during a given period and the average amount of inventory outstanding during that period. The higher the inventory turnover ratio, the better is the performance of the firm in selling its stocks.

It helps in determining the liquidity of the firm by giving the rate at which inventories are converted into sales and then to cash. It also helps the financial manager to design an appropriate inventory policy so as to avoid piling of inventories. It is calculated as given below:

**INVENTORY TURNOVER RATIO = COST OF GOODS SOLD/ AVERAGE INVETORY**

Where cost of goods sold = Sales – Gross profit;

Average inventory is the average of opening stock at the beginning of the year and the closing stock at the end of the year, that is,

**AVERAGE STOCK = OPENING STOCK + CLOSING STOCK / 2**

A high inventory turnover ratio implies the efficiency of the firm whereas a low inventory turnover ratio indicates that the firm is not in a position a clear its stocks.

From inventory turnover ratio, we can also determine the inventory holding period. It is determined as given below:

**INVENTORY HOLDING PERIOD = 364 DAYS/ INVENTORY TURNOVER RATIO**

**DEBTORS TURNOVER RATIO:**

Debtor’s turnover ratio reveals the number of times the average debtors are collected during a given accounting period. In other words, It shows how quickly the firm is in a position to collect its debts. It is necessary to keep close monitoring of realization of debts because it directly affect the working capital position. In case, the firm is not in a position to collect its debts, to meet the working capital requirements, it has to borrow paying interest. This further erodes the profitability. The successful companies maintain the aged list of the debtors showing the details of when to collect, how much to collect and from which debtor.

Debtor’s turnover ratio is calculated as given below:

**DEBTORS TURNOVER RATIO = CREDIT SALES/ AVEREGE DEBTORS**

Where credit sales refer to goods sold on credit. Average debtors are the average of opening and closing balances of debtors for the given accounting period.

A higher debtor’s turnover ratio explains that the firm is efficient in collecting its debts whereas lower ratio signifies its inefficiency.

**DEBT COLLECTION PERIOD:**

Debt collection period refers to the time taken to collect the debts. From debtors turnover ratio, we can find out the debt collection period as follows.

**DEBT COLLECTION PERIOD = 365 DAYS/ DEBTORS TURNOVER RATIO**

The lesser the time, more is the efficiency of the firm and vice versa.

**CAPITAL STRUCTURE RATIOS (LEVERAGE RATIOS):**

Capital structure or leverage ratio is defined as ‘the financial ratio, which focuses on the long-term solvency of the firm. The long-term solvency of the firm is always reflected in its ability to meet its long-term commitments such as payment of interest periodically without fail, repayment of principal as and when due.

DEBT-EQUITY (D/E) RATIO

INTEREST COVERAGE RATIO

**DEBT-EQUITY (D/E) RATIO:**

Debt-equity ratio is the ratio between outsider’s funds (debt) and insiders fund (equity). This is used to measure the firm’s obligations to creditors in relation to the owner’s funds. It is a measure of solvency. The yardstick for this ratio is 1:1. In other words, for every rupee of debt, there should be one rupee worth internal funds.

This is also industry/sector specific ratio. Depending upon the industry, the standard for the debt-equity ratio differs. For instance, in case of capital intensive industries such as shipping companies or steel manufacturing companies, the D/E ratio can be as high as 20:1. So this ratio has to be interpreted considering the nature of industry and competitors D/E ratios.

Debt-equity ratio is calculated as follows:

**DEBT-EQUITY RATIO = (DEBT/EQUITY) OR (OUTSIDERS FUNDS/INSIDERS OR SHAREHOLDERS FUNDS)**

**INTEREST COVERAGE RATIO:**

Interest coverage ratio is calculated to judge the firm’s capacity to pay the interest on debt it borrows. It gives an idea of the extent the firm’s earnings may contract before it is unable to pay interest payments out of current earnings. It is a very important ratio for the financial institutions to judge the ability of the borrower to service the load from the current year’s profits. The higher the ratio, better it is. In other words, a higher ratio implies that the company has no problems in paying interest.

Interest coverage ratio is calculated as follows:

**INTEREST COVERAGE RATIO = (NTE PROFIT BEFORE INTEREST AND TAXES/ FIXED INTEREST CHARGES)**

The more the number of times of coverage, the better is the solvency position of the borrower.

**PROFITABILITY RAITOS**:

Profitability ratios throw light on how well the firm is organizing its activities in profitable manner. The owners expect reasonable rate of return on their investment. The firm should generate enough profits not only to meet the expectations of the owners, but also to finance the expansion activities.

**1. GROSS PROFIT RATIO:**

Gross profit ratio is the ratio between gross profits to sales during a given period. It is expressed in terms of percentage. Gross profit is the difference between the net sales and the cost of goods sold.

GROSS PROFIT RATIO = (GROSS PROFIT/SALES) \* 100

**2. NET PROFIT RATIO**:

Net profit ratio is the ratio between net profits after taxes and net sales. It indicates what portion of sales is left to the owners after operating expenses. Non-operating income such as interest on investments, gain on sale of fixed assets and so on are added to the operating profit and non-operation expenses such as loss on sale of fixed assets and so on are deducted from such profit. This is the net profit after adjusting non-operating income and non-operation expenses;

NET PROFIT RATIO = (NET PROFIT AFTER TAXES/NET SALES) \* 100

3**. OPERATING RATIO:**

Operation ratio is the ratio between costs of goods sold plus operating expenses and the net sales. This is expressed as a percentage to net sales. The higher the operating ratio, the lower is the profitability and vice versa.

OPERATING RATIO = (OPERATING EXPENSES/NET SALES)\*100

Where Operating expenses = (Cost of goods sold + Administrative expenses + Selling and distribution expenses)

**4. EARNINGS PER SHARE (EPS):**

EPS is the relationship between net profits and the number of shares outstanding at the end of the given period. This can be compared with previous years to provide a basis for assessing the company’s performance.

EPS = (NET PROFIT AFTER TEXES/NUMBER OF SHARES OUTSTANDING)

DUPONT CHART:

The elements that go into computation of earning power have been built into the following chart by Du Pont Company for the first time and hence it is called Du Pont Chart.

It can be seen that the earning power is dependent on many variables. Any change in these factors will affect the earning power. If the selling price increases, it will increase the profits and vice versa. If the cost of goods sold increases, the profit margin declines. The earnings power will improve only if turnover or net profit or both increases.

Earning power is an important ratio that can be used to evaluate and compare the performances of departments as well as the firm as a whole. It is a valuable tool for inter-firm comparison also.

Working capital + Non-current assets

Sales/Investment

Investment turnover

Earning power

ROI

Net

Profit/sales

Profit margin

Cost of goods sold + selling & Adm. Expenses

Sales minus expenses

*\*\*\*\*\*ALL THE BEST\*\*\*\*\**