



INSTITUTE OF AERONAUTICAL ENGINEERING

(Autonomous)

DUNDIGAL, HYDERABAD – 500043

Power Point Presentation

ON

ACCOUNTING FOR MANAGEMENT

MBA I semester

(Autonomous-R18)

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UNIT-I

INTRODUCTION TO FINANCIAL ACCOUNTING

Meaning of Book-keeping

Book-keeping is the art and science of recording, classifying and summarizing business transactions in money or money's worth accurately and systematically so that the businessman may be able to know his profit/loss during a specified period and also financial position on a particular date. Book-keeping is thus the recording of business transactions in a systematic manner.

Definitions of Book-keeping

According to Carter, “Book-keeping is the science and art of correctly recording in the books of accounts all those transactions that result in the transfer of money or money's worth”.

According to Vickery, “Book-keeping is an art of recording day-to-day business transactions in a set of books in the most scientific manner”.

BOOK-KEEPING TERMS

1. BUSINESS: It is an establishment for the conduct of trade or commerce. It denotes activities of a person or a group of persons undertaken to exchange goods and /or services with a view to earn profit. From the accounting point of view, a business is different from its proprietor. Therefore, it owns assets and also accepts claims against it.

2. PROPRIETOR: He is the owner of the business. He invests capital in the business with the object of earning profits. He enjoys all the incomes and profits and bears all expenses and losses, if any.

3. TRANSACTION: Transaction refers transfer of money or money's worth from one person to another person. Transactions are the result of transfer of money or money's worth. Every transaction affects two accounts in the opposite direction.

4. BUSINESS TRANSACTION: Every business operation deals with exchange of cash, goods and services. This results in change in the financial position of the business concern. Hence, a business transaction may be defined as an activity that brings a change in the aspects of the business. Suppose, the trader purchases a building for Rs. 50,000. He acquire a new assets (i.e., Building) worth Rs.50,000 and parts with cash Rs.50,000. This transaction affects two accounts (viz., Cash A/c and Buildings A/c) in the opposite direction. The value of the asset Building increases and cash balance decreases.

BOOK-KEEPING TERMS

Transaction may be classified into three categories.

a) Cash Transaction:

Cash transaction is one where cash receipt or cash payment is involved in the exchange. Cash transactions are those in which cash is involved in the exchange. Cash receipts and cash payments are called as cash transactions.

Eg. Cash Receipts: Capital, Cash Sales, Cash received from individual, cash withdrawn from Bank, Sale of Fixed Assets for cash, Loan taken from Bank/Individual, Incomes received, Profits received.

Eg. Cash Payments: Drawings, Cash Purchases, Cash paid to an Individual, Cash deposited into Bank, Purchase of Fixed Assets, Loan given to Individual, Expenditure paid, Losses incurred.

BOOK-KEEPING TERMS

b) Credit Transaction:

Credit transactions will not have cash, either received or paid, for some thing given or received, respectively. Credit transactions give rise to debtor and creditor relationship. Credit transactions are those in which cash is not paid immediately. The settlement is postponed to later date.

Eg. Goods sold to an Individual, Goods purchased from an Individual, Asset sold to an Individual, Asset purchased from an individual.

c) Non-Cash Transactions: It is a transaction where the question of cash receipt or payment does not arise at all.

Eg. Depreciation, Return of goods etc.,

BOOK-KEEPING TERMS

5. ASSETS:

Assets are the properties or possessions, which belong to a trader. They help the trade in carrying on his business. Assets are those which

are essential and beneficial for running the business operations. Asset mean conglomeration of benefits. There are four types of Assets.

Fixed Assets: Fixed Assets are those assets which are acquired/purchased only for use and not for sale. Fixed assets are those which provide long-term benefits for running the business. Change in the value of these assets is minimum.

For instance, Plant and Machinery, Land and Buildings, Furniture and Fixtures, Long term Investments etc.

BOOK-KEEPING TERMS

b) Current Assets: Current Assets are those which can be converted into cash as

soon as possible. Current assets are also known as Floating Assets. Floating assets are those which dedicate their benefits for running the business and which change in value within a short span of time.

Eg. Cash in hand, Cash at Bank, Stock/ Inventory, Debtors, Short term investments etc.,

c) Intangible Assets: Intangible Assets are those having no physical existence.

Eg. Goodwill, Copyrights, Trademarks, Patents.

d) Tangible Assets: Tangible assets are those having physical existence. Fixed

Assets and Current assets are also called as Tangible Assets.

6. LIABILITIES: The debts owed by a trader to outsiders and also to the investors i.e., Owners on different Accounts in the course of business are called Liabilities.

Eg. Creditors, Bills Payable, Bank Overdraft, Loan taken etc.,

$$\text{Liabilities} = \text{Assets} - \text{Capital}$$

7. EQUITY: Any right or claim to asset or any interest in property or in a business is known as equity. An equity holder may be a creditor, part owner or proprietor. Therefore liabilities are creditor's equity and capital is owner's equity.

8. CAPITAL: This is the amount of money or property with which a trader starts business. This is known as the net worth or net assets.

The amount invested by the owner for running the business is called Capital. This can be in the form of Goods or cash. In other words, the excess of assets over liabilities is known as capital.

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

BOOK-KEEPING TERMS

9. ACCOUNTING EQUATION: It is a mathematical form of saying that always the total assets equal owner's equity and creditor's equity.

Assets = Owner's Equity + Creditors equity

Assets = Capital + Liabilities

10. DEBTOR: Debtor is a person who owes money to the trader. The person who receives benefit from the trader is called Debtor. 'Dr' is an abbreviation of Debtor.

11. CREDITOR: A creditor is a person to whom something is owed by the business. He is a person to whom some amount is payable for loan taken, services obtained or goods bought. 'Cr' is an abbreviation of Creditor. The person who gives benefit to others is also known as creditor.

12. DRAWINGS: It is the value of cash or goods withdrawn from the business by the owner or proprietor for his personal or domestic use. It is treated as loan taken by the proprietor from the business.

BOOK-KEEPING TERMS

13. BALANCE SHEET:

It is a statement of financial position of a business at any given time. It discloses the position of Assets, Liabilities and Capital. In this statement all assets are shown on the right hand side and Liabilities and Capital on the left hand side. It is a statement form of the accounting equation. This is a statement showing the assets and liabilities of a trader. This shows financial position of the business on a particular date.

14. OPENING AND CLOSING STOCKS:

Stock of goods at the commencement of a trading period is called opening stock. Stock of goods at the end of the trading period represents closing stock.

BOOK-KEEPING TERMS

15. GOODS: It is a general term used for the articles in which the business deals. This is, commodities bought bought for the purpose of resale are termed as goods. Goods are those with which the business concern does business. If a commodity is produced or purchased for the purpose of sale, it is called 'goods'. The furniture purchased for the office use to run the business is not goods. The furniture will be goods, if it is purchased by the business concern for the sake of sale.

16. ENTRY: Entry is a record of the transaction either in the journal or in the ledger.

17. JOURNAL: This is a book of first entry or original entry. Business transactions are first entered in this book before they are taken to the appropriate accounts in the ledger. The word Journal is derived from the Latin word 'Journ' which means a day. Hence, Journal is also termed as a day book where in the day to day transactions are recorded in chronological order.

BOOK-KEEPING TERMS

18. LEDGER: This is the main book of account. This is a book in which all accounts are kept. The entries recorded in the journal are posted into the accounts opened in the ledger and their balances are found. It is a set of accounts.

19. ACCOUNT: Account is a classified record of business transactions relating to a particular person or item or thing. It is a statement of a particular matter or series of dealings expressed in words and figures. The matter and figures are set forth in an Account in such a manner that the result of them may be readily seen.

Account is a summarized statement of debit and credit. It is vertically divided into two parts in T shape. The left hand side of the part is called Debit side and right hand side of the part is known as Credit side. The benefits received by that account are recorded on the debit side and the benefits given by that account are recorded on the credit side of this account.

BOOK-KEEPING TERMS

20. INCOME: Income is an earning of the business. It increases the profit. Eg. Rent received, commission received, interest received etc.,

The amount earned by a firm out of its business transaction during a period is called income. Income may be classified into two types. They are Capital Gain and Revenue Income.

CAPITAL GAIN: Capital Gain is the excess amount received over the book value of the asset owned by the firm. For example, profit received on sale of Machinery.

REVENUE INCOME: Revenue Income is the income received during business transactions or sale and purchase of goods or on services rendered to outsiders.

For example, Interest and commission received.

BOOK-KEEPING TERMS

21. EXPENDITURE: It is money spent in conducting the business activities. It is the expenditure in return for which some benefit is received. Eg. Salaries paid, Rent paid, Wages paid, Insurance paid, Transport paid, Taxes paid, Advertisements paid, selling expenses paid etc.,

Amount spent for acquiring goods and services for running the business is known as expenditure. It may be Capital expenditure and Revenue expenditure.

CAPITAL EXPENDITURE: The amount spent for the acquisition of fixed assets which have long life and which are useful for the long term benefit of the business is known as Capital Expenditure. For example Machinery, Furniture, Land, Building etc.,

REVENUE EXPENDITURE: All expenses incurred for running the business for the current year is known as Revenue Expenditure. For example Salaries, Rent, Interest etc.,

22. LOSS: It is decrease in value of any asset without resulting in any revenue or benefit. Eg. Depreciation on Fixed Asset, Loss on sale of Asset etc.,

23. PROFIT: The difference between the selling price and the cost price is called Gross profit. It does not include any allowance for the traders office and other trading expenses are deducted from the gross profit the amount of profit then remaining is called the Net profit. In other words, excess of income over expenditure during a given period is called profit.

24. DEBIT AND CREDIT: A transaction affects two accounts in the opposite direction. The account which receives the benefit is debited and the account which gives the benefit is the credited. Debit represents the receiving aspect of the transaction and Credit represents the giving aspect of a transaction. Debit is the left hand side of the account and is indicated as 'Dr'. Credit is the right hand side of the account and is indicated as 'Cr'.

25. SOLVENT: If a trader's assets are equal or exceed his liabilities he is able to pay all his debts. Then he is said to be solvent. Therefore, a person is said to be solvent, when his assets exceed or equal to his liabilities.

26. INSOLVENT: If a trader's liabilities exceed his assets then he cannot pay all his debts. Then he is said to be insolvent. Therefore, a person is said to be insolvent when his liabilities exceed his assets.

27. CASTING: This means totaling and balancing of accounts.

28. POSTING: Entering of transactions from Journal to the Ledger is called Posting.

29. ACCOUNTING PERIOD: It is a period of twelve months for which the accounts are usually department.

30. JOURNAL ENTRY: The process of recording the business transaction in the journal is known as journalizing. To divide business transactions into two aspects and recording in the journal is called Journal Entry. The first one is debit aspect and the second one is

31. CHEQUE: A cheque is an instrument, by means of which a depositor can order the bank to pay a certain sum of money only to the order of a person or to the bearer of the instrument.

32. INVOICE: Invoice is a statement sent by the seller to the purchaser which contains the details of the quantity of goods sold and price of the goods/product, terms and conditions of payment particulars.

33. TRIAL BALANCE: This is the list of the balances of the accounts appearing in a trader's ledger. The trial balance is a statement containing the balances of all ledger accounts, as at any given date, arranged in the form of debit and credit columns side by side and prepared with the object of checking the arithmetical accuracy of the ledger postings. In other words, the Trial Balance is a connecting link between the ledger accounts and final accounts.

34. VOUCHER: It is documentary evidence in support of a transaction recorded in the books of account.

35. BAD DEBTS: These are the debts due to a trader which will never be paid.

The amount of debt which is unrealizable from a debtor is called Bad Debts.

36. TRADE DISCOUNT: Trade discount is an allowance given by the seller to the buyer on the list price at the time of sale. Trade discount is not recorded in the books but it must be deducted from the list price.

DEFINITIONS OF FINANCIAL ACCOUNTING

1. According to Smith and Ashburne,

“Accounting is the science of recording and classifying business transactions and events, primarily of financial character and art of making significant summaries, analysis and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgements”.

2. According to committee on terminology of American Institute of Certified Public Accountants (AICPA),

“Accounting is 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 financial character and interpreting the results thereof.”

DEFINITIONS OF FINANCIAL ACCOUNTING

3. Another definition given by the same professional body, namely, AICPA stated that

“Accounting is the collection, measurement, recording, classification and communication of economic data relating to an enterprise for the purpose of reporting, decision making and control.

4. In 1966, the American Accounting Association defined accounting as follows:

“Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of the information.”

CHARACTERISTICS/NATURE OF FINANCIAL ACCOUNTING

1. It is a Science and an Art:

Accounting is a science because it has some objects. In other words Accounting is a science because every business transaction is recorded in a systematic manner. This is done first in the Journal which is the primary book of Accounting/ Business. Accounting is an art because it prescribes the process through which the objects can be achieved.

2. It is the art of recording business transactions:

First, all transactions should be recorded in the journal or the books of original entry known as subsidiary books as and when they take place so that a complete record of financial transactions is available.

CHARACTERISTICS/NATURE OF FINANCIAL ACCOUNTING

3. It is the art of classifying business transactions

All entries in the journal or subsidiary books should be classified by posting them to the appropriate ledger accounts to find out at a glance the total effect of all such transactions in a particular account.

For example, all transactions relating to shyam Sundar's Account in the journal or various subsidiary books will be posted to shyam Sundar's Account. It may be noted that business transactions are recorded and classified in such a way that it may be possible to determine profit or loss made by the business and its financial position on a specified date.

4. Recording of Transactions of Financial Nature:

Transactions or events which are of financial or economic nature are only recorded in accounting. Transactions or Events which cannot be measured in terms of money, are not at all recorded in financial accounting. For example, a quarrel between production manager and financial manager may be affecting the business but it cannot be measured in terms of money and thus will not be recorded in the books of accounts. Another example is efficiency or honesty of the employees cannot be recorded because it cannot be measured in terms of money though it affects the total profits of business.

5. It is the art of summarizing financial transactions:

After recording and classifying financial transactions next stage is to prepare the trial balance and final accounts with a view to ascertaining the profit or loss made during a trading period and financial position of the business on a particular date.

6. It is an art of analysis and interpretation of these financial transactions:

The accounting information must be analyzed and interpreted by calculating various ratios and percentages or other relationship in order to evaluate the past performance of the business and to make sound plans for the future. As we know that the purpose of accounting is not only recording of transactions but also of analyzing and interpreting data for taking certain important future decisions. This is also known as future forecasting. Thus we see the definition of accounting is changing rapidly because of increase in its functions. i.e., recording of transactions to interpreting of economic events.

7. The results of such analysis must be communicated to the persons who are to make decisions or form judgments:

All information must be provided in time and presented to the different categories of the persons so that appropriate decisions may be taken at the right time.

OBJECTIVES OF FINANCIAL ACCOUNTING

1. Maintaining proper/systematic record of Business Transactions:

Accounting replaces the limitations of human memory. The main purpose of accounting is to identify business transactions of financial nature and enter them into appropriate books of accounts. Accounting helps to keep record of all financial transactions and events systematically in proper books of accounts.

2. To ascertain the financial results of the enterprise: One of the main objects of accounting is to ascertain or calculate the profit or loss of the business enterprise. Income statements are prepared with the help of trial balance (prepared with the balances of ledger accounts). At the end of the accounting period, we prepare trading account and ascertain gross profit or gross loss. Afterwards profit and loss account is prepared to ascertain net profit or net loss.

OBJECTIVES OF FINANCIAL ACCOUNTING

3. To ascertain financial position or financial health of the business: At the end of the accounting period, we prepare position statement. Balance sheet is a statement of assets and liabilities of the business on a particular date and serves as a parameter to measure the financial health of the business.

4. To help in decision making: Accounting serves as an information system for helping to arrive at rational decisions. American Accounting Association also stresses upon this point while defining the term Accounting as “the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of the information. Accounting keeps systematic record of all transactions and events which are used to assist the management in its function of decision making and control.

OBJECTIVES OF FINANCIAL ACCOUNTING

5. **Providing Effective Control over the Business:**

Accounting reveals the actual performance of the business in terms of production, sales, profit, loss, cost of production and the book value of the sundry assets. The actual performance can be compared with the planned and or desired performance of the business. It can also be compared with the previous performance. Comparison reveals deviation in terms of weaknesses and plus points.

6. Making Information to various groups: Accounting makes information available to all these interested parties. Proprietors have interest in profit or dividend, debenture holders, lenders and investors are concerned with the safety of money advanced by them to the business and interest thereon. The object of the accounting is to provide meaningful information to all these interested parties.

Meaning of an Account:

An account is a classified summary of business transactions relating to a particular person or property or an income or an expense.

It is vertically divided into two halves/parts.

It is prepared in the form of alphabet T.

The left side of this account is known as Debit side and right side of the account is known as Credit side.

The word Dr should be written at the top left hand corner side of the account.

The word Cr should be written at the top right hand corner side of the account.

The title or name of the account should be written at the top in the middle of the account.

The word 'To' should be written on the debit side of an account in the particulars column.

The word 'By' should be written on the credit side in the particulars column of an account. All the receiving aspects are entered on the debit side and all the giving aspects are entered on the credit side of the account in the particulars column.

All accounts are maintained in Ledger. So they are called "Ledger accounts".

PROFORMA OF ACCOUNT

Name of Account

Dr DATE	PARTICULARS	J.F	Amount Rs.	DATE	PARTICULARS	J.F	Cr Amount Rs.
	To Particulars of benefits received		xxxxx		By Particulars of Benefits given		xxxxx

- An account contains 1) Date column 2) Particulars column 3) Journal Folio column 4) Amount column on the both sides. The format or ruling of an account is given as above.
- **Classification of Accounts:**
- Broadly speaking accounts are classified into two types. They are I. Personal Accounts II. Impersonal Accounts. Impersonal accounts are again divided into Real Accounts and Nominal Accounts. Thus accounts are of Three types.
 1. Personal Accounts
 2. Real Accounts
 3. Nominal Accounts
- Real and Nominal Accounts are collectively called “Impersonal Accounts”.

1. Personal Accounts:

These are accounts of persons and institutions with whom the business deals. A separate account is kept for each person. Personal accounts can be classified into three categories:

They are i) Natural personal accounts ii) Artificial Personal accounts iii) Representative Personal accounts.

I) Natural Personal Accounts: The term Natural Persons means who are creations of Gods. For example Ravi Account, Rani Account, Raghu account Nagarjuna Account etc., are called as Natural Personal Accounts.

II) Artificial Personal Accounts: These accounts include accounts of corporate bodies or institutions which are recognized as persons in business dealings. The account of a Limited Company, the accounts of co-operative society, the accounts of clubs, the account of Government, the account of insurance company, the account of Colleges, Schools, Universities and Hotels etc., are examples of Artificial Personal Accounts.

Personal Accounts:

- **III) Representative Personal Accounts:** These are accounts which represent a certain person or group of persons. For example, Outstanding expenses A/c, Prepaid expenses A/c, Income Receivable A/c and Income received in advance A/c, Drawings A/c and Capital A/c are termed as Representative Accounts.
- **Principle/ Rule of Personal Account:**
- **Debit the receiver and**
- **Credit the giver.**
- For example, if cash has been paid to Raja, the account of Raja will have to be debited. Similarly, if cash received from Meena, the account of Meena will have to be credited.

- **2. Real Account:**

- Accounts relating to properties or assets or possessions of the firm are called Real Accounts. Every business firm needs Fixed Assets such as Land and Buildings, Plant and Machinery, Furniture and Fixtures etc for running its business. A separate account is maintained for each asset. There are Four types of Assets. They are
- **Fixed Assets:** Those assets which are acquired for long term use by the business concern are known as Fixed assets. For example Land and Buildings, Plant and Machinery, Furniture and Fixtures etc are called as Fixed Assets.
- **Current Assets:** Those assets which are possible to convert into cash are known as known as Current assets. For example cash in hand, cash at Bank, Stock in trade, Debtors, Bills Receivable etc., are called as current assets.
- **Tangible Assets:** Tangible assets are those which relate to such things which can be touched, felt, measured etc., Tangible assets have physical existence. Hence these assets may be transferred from one place to another place.Fixed assets and Current assets are the examples of Tangible assets.
- **Intangible Assets:** These accounts represent such things which cannot be touched. Of course, they can be measured interms of money. Intangible assets haven't any physical existence. Goodwill, copy rights, patents and trademarks are the examples of Intangible assets.

2. Principle of Real Account:

i) Debit what comes into the business and

ii) Credit what goes out of the business.

- For example, if machinery has been purchased for cash, machinery account should be debited since it is coming into the business, while cash account should be credited since cash is going out of the business.
- If furniture is sold for cash, cash account should be debited since cash is coming into the business, while Furniture account should be credited since furniture is going out of the business.

3. Nominal Account:

- Nominal accounts include accounts of all expenses, losses, incomes and gains. The examples of such accounts are salaries, wages, rent, taxes, lighting charges, transport charges, travelling charges, coolie charges, warehouse rent, insurance, advertisement paid, Bad debts, commission paid, Discount allowed, interest paid, interest paid on capital, rent received, interest received, commission received, discount received, dividend received, interest on investment received, bad debts recovered etc.,
- These accounts are opened in the books to simply explain the nature of the transactions. They do not really exist. For example, in a business when salary is paid to the manager, commission is paid to the salesmen, rent is paid to landlord, cash goes out of the business and it is something real, while salary, commission, or rent as such does not exist. The accounts of these items are opened simply to explain how the cash has been spent. In the absence of such information, it may be difficult for the cashier to explain how the cash at his disposal was utilized. Nominal accounts are also called Fictitious Accounts.

- **Principle or Rule of Nominal Account:**

1. Debit all expenses and losses and

2. Credit all incomes and gains.

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- For example when salaries paid in cash, salaries account should be debited since it is an expense to the business, while cash account should be credited since cash is going out of the business. If Rent received in cash, Cash account should be debited since cash is coming into the business, while rent account should be credited since it is an income to the business.

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- The principle of Nominal account is quite opposite to the principles of personal account and real account. As per the principle of Nominal account receiving aspects (Incomes and profits) are credited and giving aspects (expenses and losses) are debited. But as per the principles of personal account and real account, receiving aspect is debited and giving aspect is credited. Hence the rule of Nominal account is different from the principles of Real account and Nominal account.

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Functions / Scope of Financial Accounting

- **1. Systematic record of business transactions / Recording:**
Recording is the basic function of accounting. Accounting records business transactions in terms of money. It is essentially concerned with ensuring that all business transactions of financial nature are properly recorded. Recording is done in Journal or subsidiary books in chronological order. To keep systematic record of transactions, post them into ledger and ultimately to prepare the final accounts is the first function of accounting.
- **2. Classifying:**
- Accounting also facilitates classification of all business transactions recorded in the journal. Items of similar nature are classified under appropriated heads. It deals with classification of recorded transactions so as to group similar transactions at one place. The work of classification is done in a book called the Ledger, where similar transactions are recorded at one place under individual account heads. Eg. In sales account all sale of goods are recorded. In purchases account all purchase of goods are recorded.

Functions / Scope of Financial Accounting

3. **Summarizing:** It involves presenting classified transactions in a manner useful to both its internal and external users. It involves preparation of financial statements i.e profit & loss account and Balance sheet etc., Accounting summarizes the classified information. This process leads to the preparation of Trial balance, Income statement and balance sheet.
- **4. Analyzing:** The recorded data in financial statement is analyzed to make useful interpretation. The figures given in financial statements need to be put in a simplified manner. Eg. All items relating to fixed assets are placed at one place while long term liabilities are placed at one place.
- **5. Interpretation:** It deals with explaining the meaning and significance of the data simplified. The accountants should interpret the statements in a manner useful to the users. Interpretation of data helps management, outsiders and shareholders in decision making. It aims at drawing meaningful conclusions from the information. Different parties can make meaningful judgments about the financial condition and profitability of business operations.

Functions / Scope of Financial Accounting

- **6. Communicating Results to Interested Parties:**
 - Accounting also serves as an information system. It is the language of the business. It supplies the meaningful information about the financial activities of the business to various parties i.e., owners, creditors, investors, employees, government, public, research scholars and managers at the right time. It is a service function. It is not an end itself but a means to an end. It involves preparation and distribution of reports to the users to make decisions.
- **7. Compliance with legal requirements:** The accounting system must aim at fulfilling the requirements of law. Under the provisions of law, the business man has to file various statements such as income-tax returns, sales tax returns etc.
- **8. Protecting the property of the business:** For performing this function the accountant is required to devise such a system of recording information so that assets of the business are not put to wrong use and a complete record of the assets of the concern is available without any difficulty.

ADVANTAGES/ IMPORTANCE OF FINANCIAL 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 really available from these records.
- **2. Facilitates the preparation of financial statements:** Profit and Loss Account 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 the business operations. During the accounting period and financial position of the business at the end of the accounting period.
- **3. Provides control over assets:** Book-keeping provides information regarding cash in hand, 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. Assistance to various parties:** It provides information to various parties i.e., owners, money lenders, creditors, investors, government, managers, research scholars, public and employees and financial position of a business concern from their own view point.

ADVANTAGES/ IMPORTANCE OF FINANCIAL ACCOUNTING

- **5. Assistance to the insolvent person:** If a person is maintaining proper accounts and unfortunately he becomes insolvent (i.e., when he is unable to pay to his creditors), he can explain many things about the past with help of accounts and can start a fresh life.
- **6. Comparative study:** One can compare the present performance of the organization with that of its past. This enables the managers to draw useful conclusions and make proper decisions.
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- **7. 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.
- **8. Settlement of Taxation Liability:** If accounts are properly maintained, it will be of great help to the businessman in settling the income tax and sales tax liability otherwise tax authorities may impose any amount of tax which the businessman will have to pay.

ADVANTAGES/ IMPORTANCE OF FINANCIAL ACCOUNTING

- 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 assess the achievement of its performance. The weaknesses of the business can be identified and corrective measures can be applied to remove them with of the accounting.
- 11. Replacement of memory:** In a large business it is very difficult for a business man to remember all the transactions. Accounting provides records which will furnish information as and when desired and thus it replaces human memory.

LIMITATIONS / DISADVANTAGES OF FINANCIAL ACCOUNTING

- **1. Records only monetary transactions:** Accounting records only those transactions which can be measured in monetary terms. Those transactions which can not be measured in monetary terms as conflict between production manager and marketing manager , office management etc., may be very important for concern but not recorded in the business books.
- **2. Effect of price level changes not considered:** Accounting transactions are recorded at cost in the books. The effect of price level changes is not brought into the books with the result that comparison of various years becomes difficult. For example, the sales to total assets in 2007 would be much higher than in 2003 due to rising prices, fixed assets being shown at cost and not at market price.
- **3. No realistic information:** Accounting information may not be realistic as accounting statements are properly prepared by following basic concepts and conventions. For example, going concern concept gives us an idea that the business will continue and assets are to be recorded at cost but the book value which the asset is showing may not be actually realizable. Similarly, by following the principles of conservation the financial statements will not reflect the true position of the business.

LIMITATIONS / DISADVANTAGES OF FINANCIAL ACCOUNTING

- **4. No real test of managerial performance:** Profit earned during an accounting period is the test of managerial performance. Profit may be shown in excess by manipulation of accounts by suppressing such costs as depreciation, advertisement and research and development or taking excess value of closing stock. Consequently real idea of managerial performance may not be available by manipulated profit.
- **5. Historical in nature:** Usually accounting supplies information in the form of Profit and Loss Account and Balance Sheet at the end of the year. So, the information provided is of historical interest and only gives post-mortem analysis of the past accounting information. For control and planning purposes management is interested in quick and timely information which is not provided by financial accounting.
- **6. Personal bias / judgement of Accountant affects the accounting Statements:** Accounting statements are influenced by the personal judgement of the accountant. He may select any method of depreciation, valuation of stock, amortization of fixed assets and treatment of deferred revenue expenditure. Such judgment based on integrity and competency of the accountant will definitely affect the preparation of accounting statements.

LIMITATIONS / DISADVANTAGES OF FINANCIAL ACCOUNTING

- 7. Permits alternative treatments:** Accounting permits alternative treatments within generally accepted accounting concepts and conventions. For example, method of charging depreciation may be straight line method or diminishing balance method or some other method. Similarly, closing stock may be valued by FIFO(First-in-First Out) or LIFO(Last in First Out) or Average Price Method. Application of different methods may give different results and results may not be comparable.

ADVANTAGES OF DOUBLE ENTRY SYSTEM

- **MEANING OF DOUBLE ENTRY SYSTEM**
- Double entry system is a scientific way of presenting accounts. As such all the business concerns feel it convenient to prepare the accounts under double entry system. The taxation authorities also compel the businessmen to prepare the accounts under Double Entry System.
- Under dual aspect the Account deals with the two aspects of business transaction i.e., (1) receiving aspect and (2) giving aspect. Receiving aspect is known as Debit aspect and giving aspect is known as Credit aspect. Under which system these two aspects of transactions are recorded in chronological manner in the books of the business concern is known as Double Entry System. In Double Entry System these two aspects are recorded facilitating the preparation of Trial Balance and the Final Accounts there from.

ADVANTAGES OF DOUBLE ENTRY SYSTEM

- **PRINCIPLE OF DOUBLE ENTRY SYSTEM**
- Every business transaction has got two accounts, where one account is debited and the other account is credited. If one account receives a benefit, there should be another account to impart the benefit. The principle of Double Entry is based on the fact that there can be no giving without receiving nor can there be receiving without something giving. The receiving account is debited (i.e., entered on the debit side of the account) and the giving account is credited (i.e., entered on the credit side of the account).
- The principle under which both debit and credit aspects are recorded is known as the principle of double entry. According to this principle every debit must necessarily have a corresponding credit and vice versa.

ADVANTAGES OF DOUBLE ENTRY SYSTEM

- 1. Scientific system:** Double entry system records, classifies and summarizes business transactions in a systematic manner and, thus, produces useful information for decision makers. It is more scientific as compared to single entry of book-keeping.
- 2. Full Information:** Full and authentic information can be had about all transactions as the trader maintains the ledger with all types of accounts.
- 3. Assessment of Profit and Loss:** The businessman/trader will be able to know correctly whether he had earned profit or sustained loss. It facilitates the trader to take such steps so as to increase the efficiency of the firm.
- 4. Knowledge of Debtors:** The trader will be able to know exactly what amounts are owed by different customers to the firm. If any amount is pending for a long time from any customer, he may stop credit facility to that customer.

ADVANTAGES OF DOUBLE ENTRY SYSTEM

- 5. Knowledge of Creditors:** The trader is also knows the exact amounts owed by the firm to others and he will be able to arrange prompt payment to obtain cash discount.
- 6. Arithmetical Accuracy:** The arithmetical accuracy of the books can be proved by the trial balance.
- 7. Assessment of Financial Position:** The trader will be able to prepare the Balance Sheet which will help the interested parties to know fully about the financial position of the firm.
- 8. Comparison of Results:** It facilitates the comparison of current year results with those of previous years.
- 9. Maintenance according to Income Tax Rules:** Proper maintenance of books will satisfy the tax authorities and facilitates accurate assessment. In India Joint stock companies should maintain accounts under double entry system.
- 10. Detection of Frauds:** The systematic and scientific recording of business transactions on the basis of this system minimizes the chances of embezzlement and frauds or errors. The frauds or errors can be easily detected by vouching, verification and auditing of accounts.

DISADVANTAGES/ LIMITATIONS OF DOUBLE ENTRY SYSTEM

- **1. Not Practical to All Concerns:** This system requires the maintenance of a number of books of accounts which is not practical in small concerns.
- **2. Costly system:** This system is costly because of a number of records are to be maintained.
- **3. No guarantee of Absolute Accuracy of the Books of Account:** There is no guarantee of absolute accuracy of the books of account inspite of agreement of the trial balance because of there are some errors like errors of principles, errors of omission, compensating errors etc., which remain understand inspite of agreement of trial balance.
- **4. Errors of Omission:** In case the entire transaction is not recorded in the books of accounts, the mistake cannot be detected by accounting. The Trial Balance will tally inspite of the mistakes.

DISADVANTAGES/ LIMITATIONS OF DOUBLE ENTRY SYSTEM

- **5. Errors of Principle:** Double entry is based upon the fact that every debit has its corresponding credit and vice versa. It will not be able to detect the mistake such as debiting Ram's account instead of Rao's account or Building account in place of Repairs account.
- **6. Compensating Errors:** If Rahim's account is by mistake debited with Rs. 15 lesser and Mohan's account is also by mistake credited with Rs.15 lesser, the Trial Balance will tally but mistake will remain in accounts.

ACCOUNTING CONCEPTS

- Account is a system evolves to achieve a set of objectives. In order to achieve the goals, we need a set of rules or guide lines. These guide lines are termed as “Basic accounting concepts”. The term concept means an idea or thought. Basic accounting concepts are the fundamental ideas or basic assumptions underlying theory and practice of financial accounting.
- These concepts are termed as “generally accepted accounting principles”. These are broad working rules of accounting activity. They are evolved over a period in response to changing business environment. They are developed and accepted by accounting profession. The concepts guide the identification of events and transactions to be accounted for.

- The concepts help in bringing about uniformity in the practice in accounting. In accountancy following concepts are quite popular.
- **1. Business Entity Concept:**
- Business is treated separate from the proprietor. All the transactions are recorded in the books of the proprietor. The proprietor is also treated as a creditor for the business. When he contributes capital, he is treated as a person who has invested his amount in the business. Therefore, capital appears in the liabilities of balance sheet of the proprietor.
- **Effects of this Concept:**
- Financial position of the business can be easily found out.
- Earning position of the business can be easily ascertained.
-

- **2. Going Concern Concept:** This concept relates with the long life of the business. The assumption is that business will continue to exist unlimited period unless it is dissolved due to some reason or the other. When final accounts are prepared, record is made for outstanding expenses and prepaid expenses because of the assumption that business will continue. Going concern concept helps other business undertaking to make contracts with specific business unit for business dealing in future.
- **Effects of this concept:**
 - i) Working life of asset is taken into consideration for writing of depreciation because of this concept. (ii) Accountant always remains hopeful about continuity of the business. Therefore, he does not stop writing transactions even though the condition of business is deteriorating.

- **3. Money Measurement Concept:**

- Only those transactions are recorded in accounting which cannot be expressed in terms of money. The transactions which cannot be expressed in money fall beyond the scope of accounting. One serious short coming of this concept is that the money value of that date is recorded on which transaction has taken place. It does not recognize the changes in the purchasing power of monetary unit.

- **Effects of this concept:**

(i) In the absence of this concept, it would have not been possible to add various possessions. For example : A proprietor has 40 chairs, 50 tables, 15 machines and 20 acres of land. He cannot add them. But total amount of all these possessions can be easily found out by finding out their value in money

(ii) It fails to keep any record of such matters which cannot be expressed in terms of money. For example: ability of the board of directors, quality of the articles produced and efficiency of workers cannot be recorded.

4. Cost Concept: According to this concept, an 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 depreciation. Under this concept, all such events are ignored which affect the business but have no cost. For example, if an important and influential director dies, then the earning capacity and position of the business will be affected. But this event has no cost. Hence it will not be recorded in account books.

Effects of the cost concept:

- (i) Under this concept market price is ignored. Balance sheet indicates financial position on cost and expired cost less.**
- (ii) This concept is mainly for fixed assets. Current assets are not affected by it. Current assets appear in balance sheet at cost or market price whichever is lower. But both these assets are acquired at cost price.**

5. Account 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. The life of the business is considered to be indefinite, but the measurement of income cannot be postponed for a very long period of time. Therefore, it is necessary to have a period for which the operational results are assessed for external reporting. Hence a period of one year i.e., twelve months is considered as accounting period. It may be a calendar year (January to December or any period of one year.) In India, the accounting period begins on 1st April every year and ends on 31st March every year. This concept implies that at the end of each accounting period, financial statements i.e., profit & loss account and balance sheet are to be prepared. It is mandatory under Income Tax Act to assess profit of the business every year and determine tax liability.

Effects of Accounting Period concept:

- (i) Financial position and earning capacity of one year maybe compared with another year.
- (ii) These comparisons help the management in planning and increasing the efficiency of business.

- **6. Dual Aspect Concept:** Under this concept, every transaction has got a twofold aspects i.e., (i) receiving aspect/ receiving benefit and (ii) giving aspect/ giving of benefit. For instance, when a firm acquires an asset (receiving of the benefit), it must have to pay cash (giving of benefit).
- Therefore, two accounts are to be passed in the books of accounts. One for the receiving benefit and the other for the giving of benefit. Thus, there will be a double entry for every transaction – debit for receiving the benefit and credit for giving the benefit.

Effects of Dual aspect concept:

- (i) This concept is of great help in indicating the true position of the business.
- (ii) This concept helps in detecting the errors of employees and in having strict control over them.
- (iii) The accounting equation, i.e., $\text{Assets} = \text{Equities (or liabilities + capital)}$ is based on this concept.

7. Matching Concept: Every businessman is eager to make maximum profit at minimum cost. Hence, he tries to find out revenue and cost during the accounting period. An accountant records all expenses of a year (whether they are paid in cash or are outstanding) and all revenues of a year (whether they are received in cash or accrued).

- Expenses, which are incurred during a particular accounting period for earning the revenue of.

- All expenses incurred during the accounting period must not be taken. Only relevant cost should be deducted from the revenue of a period for periodic income statement. The related period, are to be considered to revenue is called “Matching process”. While ascertaining profit, other appropriate cost which are not directly related to cost of goods sold are to be taken into consideration. Example, rent paid, interest paid, depreciation etc., Thus appropriate costs have to be matched against the appropriate revenues for the accounting period.
- **Effects of this Concept:**
 - (i) Proprietor can easily know about his profit or loss.
 - (ii) On the basis of this concept, he can make efforts to create economy, increasing efficiently and increasing his income.

8. Realization Concept:

This concept is also known as “revenue recognition concept”. Revenue results out of sale of goods and services. According to this concept revenue is realized when a sale is made. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. No profit or income will arise without the realization of sales. Likely sales and anticipated revenues are not to be recorded in account books. The realization concept is important in ascertaining the exact profit earned during a period in a business concern. According to this concept, the revenue should be considered only when it is realized. Any business transaction should be recorded only after it actually taken place. Production of goods does not mean that the total production is sold, it should be recorded only when they are sold and cash realized or obligation created.

9. Objectivity Concept: This concept implies that all accounting records should be supported by proper documents. Cash memos, invoices, correspondence, agreements, vouchers, etc., are examples of business documents. These documents supply the information. They form the basis for record of entries in the books of account. Accounting record based on documentary evidence is readily and objectively verifiable.

10. Accrual Concept: This concept implies that revenue is recognized in the period in which it is earned irrespective of the fact whether it is received or not during the period. For example, commission Rs.2,000 earned in the year 2008, but received in cash in the year 2009, then the commission is to be taken as income for the year 2008 only, not as income of the year 2009.

ACCOUNTING CONVENTIONS

- In accounting, convention means a custom or tradition, used as a guide for the preparation of accounting statement. The following are the accounting conventions:

1. Convention of Full Disclosure: Accounting to this convention, accounts should be prepared honestly and they should disclose all materials and significant information. Every company shall keep proper books of accounts. Auditor records expenses, incomes, profits, losses, assets and liabilities. The essential items to be disclosed in the Profit and Loss Account are given. There is legal form for the balance sheet.

ACCOUNTING CONVENTIONS

- **2. Convention of Consistency:** In every business, the management draws important conclusion from the financial statements, regarding working of the concern, for this purpose in preparing the final accounts.
- The same principle and practices should be followed from year to year.
- **3. Convention of Conservation:** This is very important in preparing final accounts. This term suggests caution. All prospective profits should be ignored. All outstanding expenses should be taken into account. Adequate reserves or provisions should be provided for. This means that there should be no window dressing and secret reserves.

ACCOUNTING CONVENTIONS

4. Convention of Materiality:

This is also called the convention of reasonable degree of accuracy. According to this, the information given in the accounts should be reasonable accurate. All the entries should be exact. Fraction of a rupee is avoided.

5. Convention of Relevance:

As per this convention, the firm should give relevant accounting information whenever required with documentary evidence like, purchases or sales invoices, vouchers etc., as documentary proof of a transaction.

ADVANTAGES OF JOURNAL

- **1. Availability of Full information/Complete Record:**
- All business transactions date-wise will be recorded in the Journal As such the total information for every transaction can be obtained very easily without late. So Journal serves as a complete record. It provides a chronological record of all transactions and hence provides permanent record.
- **2. Posting becomes easy:**
- When once the transactions are entered in the Journal, recording the same in the relevant accounts in the ledger can be made easily. The businessman can have an understanding on debit and credit principles in the beginning itself. It provides information of debit and credit in an entry and an explanation to make it understandable properly.

ADVANTAGES OF JOURNAL

- 3. Explanation of the transaction:** Every Journal entry will be briefly explained with a narration. Narration helps in proper understanding of the entry.
- 4. Location of the errors easy:** Journal helps to locate the errors easily. Both debit and credit aspects of a transaction are recorded in the journal. Since the amount recorded in debit amount column and credit amount column must be equal. Therefore, the possibility of committing errors is reduced and the detection of errors, if any, committed becomes easy.
- 5. Chronological order:** Transactions are recorded in a chronological order in the Journal. Hence, when any information is required, the information can be traced out quickly and easily.

ADVANTAGES OF JOURNAL

- **6. Eliminates the need for reliance on memory:** It eliminates the need for a reliance on memory of the accounts keeper. Some transactions are of a complicated nature and without the journal, the entries may be difficult, if not impossible.
- **7. Journal provides information relating to the following aspects:**
 - (a) Credit sale and purchase of fixed assets, investment or any thing else not dealt in by the firm.
 - (b) Special allowances received from suppliers or given to the customers.
 - (c) Writing off extra-ordinary losses viz. losses due to fire, earth quakes, theft etc., and bad debts.

ADVANTAGES OF JOURNAL

- (d) Recording in the reduction of the assets i.e., depreciation.
- (e) Receipt and issue of bills of exchange, promissory notes, hundies and their dishonour, renewal etc.,
- (f) Transactions with Bank(unless bank column added to the cash book)
- (g) Income earned but not received in cash.
- (h) Expenses incurred but not yet paid for in cash and other similar adjusting entries.
- (i) Transfer entries viz. posting total of subsidiary books to the respective impersonal accounts in the ledger at the end of every month, transfer of gross profit or loss to the Profit & Loss A/c and net profit or net loss and also drawings A/c to the Capital A/c at the end of the trading period.
- (j) Closing entries-entries to close the books at the time of preparing trading and profit & loss account.

LIMITATIONS OF JOURNAL

The following are the main limitations of the journal.

1. The Journal will be too long and becomes unwieldy if all transactions are recorded in the journal.
2. The Journal is unable to ascertain daily cash balance. That is why cash transactions are directly recorded in a separate cash book so that daily cash balances may be available.
3. It becomes difficult in practice to post each and every transaction from the Journal to the ledger. Hence in order to make the accounting easier and systematic, transactions are recorded in total in different books.

THE LEDGER

- The second stage in the accounting cycle is ledger posting it means posting transactions entered in the journal into their respective accounts in the ledger. It is the book of final entry. The Ledger is designed to accommodate the various accounts maintained by a trader. It contains the final and permanent record of all transactions in duly classified form. A ledger is a book which contains various accounts. The process of transferring the entries from the journal into the ledger is called posting.
- 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 and shows their net effect. The up to date state of any account can be easily known by referring to the ledger.

FEATURES OF LEDGER

- i. Ledger contains all the accounts-personal, real and nominal accounts.
- ii. It is a permanent record of business transactions.
- iii. It provides a means of easy reference.
- iv. It provides final balance of the accounts.
- Ledger is the principal book of accounts because it helps us in achieving the objectives of accounting. It gives answers to the following pertinent questions.
 1. How much amount is due from others to the business?
 2. How much amount is owed to others?
 3. What are the total sales to an individual customer and what are the total purchases from an individual supplier?
 4. What is the amount of profit or loss made during a particular period?
 5. What is the financial position of the firm on a particular date?

ADVANTAGES OF LEDGER

The following are the main utilities of Ledger

1. It provides complete information about all accounts in one book.
2. It is easy to ascertain how much money is due to suppliers (trade creditors from creditors' ledger) and how much money is due from customers (trade debtors from debtors' ledger).
3. It enables to ascertain, what are the main items of revenues/incomes (Nominal accounts).
4. It enables to ascertain, What are the main items of expenses(Nominal accounts)
5. It enables to know the kind of assets the enterprise holds and their respective values(Real Accounts)
6. It facilitates preparation of trial balance and thereafter preparation of financial statements i.e., profit and loss account and balance sheet.

DIFFERENCES BETWEEN JOURNAL AND LEDGER

POINT OF DIFFERENCE	JOURNAL	LEDGER
1. Nature	It is a book of original entry	It is a book of final entry
2. Object	It is prepared to record all the transactions.	It is prepared to know the net effect of various transactions affecting a particular account.
3. Basis of preparation	It is prepared on the basis of source document (voucher) of transaction.	It is prepared on the basis of journal.
4. Stage of recording	Recording in the journal is the first stage.	Recording in the ledger is the second stage.
5. Balancing	Journal is not balanced.	All ledger accounts are balanced.
6. Narration	Narration is written for each entry.	No narration is given.
7. Format	In journal there are five columns viz., date, particulars, ledger folio, debit and credit.	In the ledger there are four columns on debit and credit side viz., date, particulars, journal folio and amount.
8. Name of the process of recording entries	The process of recording in journal is called journalizing.	The process of recording in the ledger is called posting.
9. Basis for Preparation of final accounts	Journal directly does not serve as basis for preparation of Final accounts.	Ledger serves as basis for preparation of Trial Balance and Final Accounts.

TRIAL BALANCE

Trial Balance is a statement in which debit and credit balances of all ledger accounts are shown to test the Arithmetical accuracy of the books of account. Trial Balance is not conclusive proof of accuracy of books of accounts.

Definitions of Trial Balance:

- 1. According to J.R.Batliboi,** “ A Trial Balance is a statement of Debit and Credit balances extracted from the various accounts in the ledger with a view to test the arithmetical accuracy of the books.”
- 2. According to Spicer and Peglar,** “ A Trial Balance is a list of all the balances standing on the ledger accounts and cash book of a concern at any given date.”

FEATURES OF TRIAL BALANCE

1. It is not an account., it is only a statement which is prepared to verify the arithmetical accuracy of ledger accounts.
2. It contains debit and credit balances of ledger account.
3. It is prepared on a particular date generally at the end o f business year.
4. Trial Balance helps in preparing final accounts.
5. As it is prepared by taking up the ledger account balances, both debit and credit side of a Trial Balance are always equal.
6. The preparation of Trial Balance is not compulsory. There is no hard fast rule in this regard.

IMPORTANCE OF TRIAL BALANCE

- 1. Proof of Arithmetical accuracy:** It helps in checking the arithmetical accuracy of books of accounts.
- 2. Preparation of financial statements:** It helps in the preparation of final accounts i.e., Trading Account, Profit & Loss Account and Balance Sheet.
- 3. Detection of Errors:** It will help in detection of errors in the books of accounts and in their rectification.
- 4. Rectification of Errors:** It serves as instrument for carrying out the job of rectification of errors.
- 5. Easy Checking:** It is possible to find out the balances of various accounts at one place.

LIMITATIONS OF TRIAL BALANCE

1. Trial balance can be prepared only in those concerns where double entry system of accounting is adopted. This system is very costly and time consuming. It cannot be adopted by the small business concerns.
2. Though Trial Balance gives arithmetical accuracy of the books of accounts but there are certain errors which are not disclosed by Trial Balance. That is why it is said that Trial balance is not a conclusive proof of the accuracy of the books of accounts.
3. If Trial Balance is not prepared correctly then the final accounts prepared will not reflect the true and fair view of the state of the affairs/financial position of the business. Whatever conclusions and decisions are made by the various groups of persons will not be correct and will mislead such persons.
5. Trial Balance tallies even though errors are existing in the books of accounts.
6. Even some transactions are omitted the Trial Balance tallies.

OBJECTIVES OF TRIAL BALANCE

The following are the main objectives of preparing the Trial Balance.

- 1. To have balances of all the accounts of the ledger in order to avoid the necessity of going through the pages of the ledger to find it out.**
- 2. To have a proof that the double entry of each transaction has been recorded because of its agreement.**
- 3. To have arithmetical accuracy of the books of accounts because of the agreement of the Trial Balance.**
- 4. To have material for preparing the profit or loss account and balance sheet of the business.**

METHODS FOR PREPARING TRIAL BALANCE

- 1. Totals Method:** Under this method the total of debits and credits of all ledger accounts are shown in the debit and credit side of the Trial Balance. The Trial Balance prepared under this method is known as gross Trial Balance.
- 2. Balances Method:** Under this method all the balances of each and every account will be shown against the debit or credit side of the Trial Balance. If an account has no balance then it will not be shown in the Trial Balance. This method is more convenient and commonly used.
- 3. Totals and Balances Method / Compound Method:** Under this method, the above two methods are combined. Under this method statement of trial balance contains seven columns instead of two columns.
- 4. Elimination of Equal Totals Method:** Under this method equal totals of accounts will be eliminated from the trial balance.

TRADING ACCOUNT

This account is prepared to know the trading results or gross margin on trading of business, i.e., how much gross profit of the business has earned from buying and selling during a particular period. The difference between the sales and cost of goods sold is gross profit. This is a nominal account in its nature hence all the trading expenses should be debited where as all the trading incomes should be credited to Trading Account. The balance of trading account will be considered as Gross Profit (credit balance) or Gross Loss (debit balance) and will be transferred to profit and loss A/c. While preparing the trading A/c the following equations also can be used.

- $\text{Sales less returns} - \text{Cost of goods sold} = \text{Gross Profit or Gross Loss}$
- $\text{Sales} = \text{Total cash sales} + \text{credit sales.}$
- $\text{Cost of goods sold} = \text{Opening stock} + \text{purchases less purchase returns} + \text{Direct expenses} - \text{Closing stock of goods.}$

IMPORTANCE OF TRADING ACCOUNT

1. Information of Gross profit or Gross Loss:

- Trading Account provides information regarding gross profit and sets the upper limit within which indirect expenses are to be incurred. Indirect expenses should be much less than the gross profit so that a good amount of profit may be earned. If trading account discloses gross loss, it is better to close the business rather than running at a gross loss because gross loss will further increase when indirect expenses are added to it.
- **Gross Profit Ratio:** This ratio is calculated as follows:
- **Gross profit Ratio = $\frac{\text{Gross Profit}}{\text{Sales}} \times 100$**
- Higher the ratio, it is better condition. Gross profit ratio can be calculated with the help the Trading account year after year and comparison of performance of year after year can be made. A low ratio indicates unfavorable trend in the form of reduction in selling prices not accompanied by the proportionate decrease in cost of goods purchased or increase in cost of production.

2. Comparison of Closing Stock with Opening Stock :

- Comparison of stock figures of one period with another period will be helpful in avoiding overstocking. Investment in stock should be reasonable so that production and sales go on smoothly.
- 3. Fixation of selling price:** In case of a new product, the selling price can be easily fixed by adding in the cost of purchases or cost of goods manufactured the desired percentage of gross profit.
4. It enables the comparison of sales, purchases and direct expenses of one period with another period. The comparative study helps the management to control the affairs of the business and take sound decisions.
5. It helps to check the direct expenses. 6. It gives us the information about the proportion of gross profit or gross loss to the direct expenses. This study helps the management in arresting the unnecessary expenditure on any time.

PROFIT AND LOSS ACCOUNT

This account is prepared to calculate the net profit or net loss of the business concern.

There are certain items of incomes and expenses of the business which must be taken into consideration for calculating net profit or net loss of the business concern.

These are of indirect nature i.e., the whole business and relating to various activities which are done by the business for the purpose of making the goods available to the customers.

Indirect expenses may be administrative expenses or management expenses, selling and distribution expenses, financial expenses and extra-ordinary losses and expenses to maintain the assets into working order.

This account is prepared from nominal accounts and its balance is transferred to capital account as the whole the profit or loss will be that of the owner and it will increase or decrease the capital.

IMPORTANCE OF PROFIT AND LOSS

ACCOUNT

- 1. Information of Net profit or Net loss:** One of the important objectives of maintains the accounts are to see whether the business has earned profit or suffered loss during the accounting period. Profit and Loss A/c provides information regarding this important objective because it gives information about the profitability or otherwise of the business.
- 2. Comparison of current profit with the last year profit:** Profit and Loss A/c affords comparison of the current year's net profit with those of the past years. With this comparison it can be ascertained whether net profit of the business is showing a rising trend or down ward trend.
- 3. Comparison of expenses:** Comparison of various expenses included in the profit and loss account with expenses of the previous period helps in taking effective steps for control of unnecessary expenses.

IMPORTANCE OF PROFIT AND LOSS

ACCOUNT

- 4. Helpful in preparation of Balance Sheet:** Net profit or Net loss disclosed by the profit and loss A/c is transferred to capital Account and Capital Account appears on the liabilities side of the Balance Sheet. Without taking net profit or net loss, the balance sheet cannot be completed. Thus, the profit and loss account helps in the preparation of the balance sheet.
- 5. Helpful in future Growth of business:** On the basis of their profit figures of the current and previous period, estimates about the profits in the years to come can be made and projections about the expansion of the business can be made.

BALANCE SHEET

A Balance Sheet a statement prepared with a view to measure the financial position of a business on a certain fixed date. The financial position of a concern is indicated by its assets on a given date and its liabilities on that date. Excess of assets over liabilities represent the capital and is indicative of the financial soundness of a company.

A Balance sheet is also described as a “statement showing the sources and application of the capital”. It is a statement and not an account and prepared from real and personal accounts. Sources or liabilities are shown on the left hand side of the Balance Sheet. Application of funds (Assets) is shown on the right hand side of the Balance Sheet.

CHARACTERISTICS OF BALANCE SHEET

Characteristics of Balance Sheet:

1. It is prepared on a particular date and not for a particular period.
2. It is prepared after preparation of the Trading and Profit & Loss A/c.
3. As assets must be equal to the total liabilities. The two sides of the Balance must have the same total.
4. It shows the financial position of a business as a going concern.
5. It is a statement of assets and liabilities and not an account.

IMPORTANCE OF BALANCE SHEET

Information that Balance Sheet convey to Outsiders (Importance):

- 1. The nature and the value of assets.**
- 2. It shows the nature and extent of liabilities.**
- 3. It shows the owner's equity (i.e., $\text{assets} - \text{liabilities} = \text{capital}$)**
- 4. It tells about the creditworthiness and solvency of the firm.**
- 5. It reflects the liquidity of a firm.**
- 6. It reveals other information required to changes in economic reserves and obligations.**

FINANCIAL STATEMENTS

- Though financial statements are relevant and useful for the concern, still they do not present a final picture of the concern.
- The utility of these statements is dependent upon a number of factors.
- The analysis and interpretation of these statements should be done very carefully otherwise misleading conclusions may be drawn.

LIMITATIONS OF FINANCIAL STATEMENTS

1. Only Interim Reports: These statements do not give a final picture of the concern. The data given in the statements is only approximate. The actual position can only be determined when the business is sold or liquidated. However, the statements have to be prepared for different accounting periods, generally one year, during the life time of the concern. The costs and incomes be apportioned to different periods with a view to determine profits etc. the allocation of expenses and incomes will depend upon the personal judgment of the account. The existence of contingent assets and liabilities also makes the statements imprecise. So financial statements do not give the final picture and they are at the most interim reports.

LIMITATIONS OF FINANCIAL STATEMENTS

- **2. Do not give Exact Position:** The financial statements are expressed in monetary values. So, they appear to give final and accurate position. The value of fixed assets in the balance sheet neither represents the value for which fixed assets can be sold nor the amount which will be required to replace these assets.
- The balance sheet is prepared on the presumption of a going concern. The concern is expected to continue in the future. So fixed assets are shown at cost less accumulated depreciation. There are certain assets in the balance sheet such as preliminary expenses, goodwill and discount on issue of shares which will realize nothing at the time of liquidation though they are shown in the balance sheet.

LIMITATIONS OF FINANCIAL STATEMENTS

- **3. Historical Costs:**

The financial statements are prepared on the basis of historical costs or original costs. The value of assets decreases with the passage of time current price changes are not taken into account. The statements are not prepared keeping in view the present economic conditions.

- The balance sheet loses the significance of being an index of current economic realities. Similarly, the profitability shown by the income statement may not represent the earning capacity of the concern. The increase in profits may be due to an increase in prices or due to some abnormal causes and not due to increase in efficiency. The conclusion drawn from financial statements may not give a fair picture of the concern.

LIMITATIONS OF FINANCIAL STATEMENTS

- **4. Impact of Non-Monetary Factors Ignored:**

There are certain factors which have a bearing on the financial position and operating results of the business but they do not become a part of these statements because they cannot be measured in monetary terms.

Such factors may include the reputation of the management, credit worthiness of the concern, sources and commitments for purchases and sales, co-operation of the employees, etc. The financial statements only show the position of the financial accounting for business and not the financial position.

LIMITATIONS OF FINANCIAL STATEMENTS

5. No Precision:

- The precision of financial statement data is not possible because the statements deal with matters which cannot be precisely stated.
- The data are recorded by conventional procedures followed over the year. Various conventions, postulates, personal judgements etc., are used for developing the data.

UNIT-III

INVENTORY VALUATION

- According to Kohler's Dictionary for Accountants, inventory is defined as "raw materials and supplies, goods finished and in process of manufacture and merchandise on hand, in transit and owned, in storage or consigned to other at the end of an accounting period."
- According to Accounting Standards-A(AS-2) 'INVENTORIES' mean tangible property held
- For sale.
- In the process of production for sale.
- For computation in the production of goods or services for sale, inventories are normally classified in the financial statements as current assets as under:
- Raw materials and components,
- Work-in-progress.
- Finished goods.
- Stores and spares.

• **Objectives of Inventory Control:**

- To determine the cashment income.
- To present true and correct view of financial affairs.
- To compute the ratios.
- **Methods of Valuation of Inventory:**
- **First in First Out Method (FIFO):**
- Under this method materials are first issued from the earliest consignment on hand and priced at the cost at which that consignment was placed in stores.
- In other words, materials received first are issued first.
- The units in the opening stock of materials are treated as if they are issued first.
- The units from the first purchase issued next and so on until the units left in the closing stock of materials are valued at the latest cost of purchases.
- It follows that unit costs are apportioned to cost of production according to their chronological order of receipts in the store.
- This method is the most suitable in times of falling prices because the issue price of materials to jobs or works orders will be high while the cost of replacement of materials will be low.

- But in case of rising prices this method is not suitable because the issue price of materials to production will be low while the cost of replacement of materials will be high.
- Two points should be noted (i) materials are charged at the actual cost price and at the oldest price of materials in stock. (ii) Stock of materials in hand is valued at the latest purchase prices.
- **Advantages of FIFO Method:**
- The main advantage of FIFO method is that it is simple to understand and easy to operate.
- Closing stock valuation is at cost as well as at the latest market prices.
- Materials are issued at actual cost. Thus, no unrealised profit / loss results from the use of this method.
- This method is based on a realistic assumption that materials which are received first are issued first.

- **It is a logical method because it takes into consideration the normal procedure of utilising first those materials which are received first. Materials are issued in order of purchases, so materials received first are utilised first.**
- **Under this method, materials are issued at the purchase price; so the cost of jobs or work orders is correctly ascertained so far as cost of materials is concerned. Thus, this method recovers the cost price of materials.**
- **This method is suitable when prices are falling.**
- **Closing stock of raw materials will be valued at the market price as the closing stock under this method would consist of recent purchase of materials.**
- **This method is also useful when transactions are not too many and prices of materials are fairly steady.**

• **Disadvantages of FIFO Method:**

- **Materials are not charged at the current market prices. Therefore, in times of rising prices, charge to production is unduly low.**
- **This method sometimes produces unfair results as between one job and another job.**
- **When transactions are large in number and the price fluctuates very frequently, the method involves more calculations and increases the possibility of errors.**
- **This method increases the possibility of clerical errors, if consignments are received frequently at fluctuating prices as every time an issue of materials is made, the store ledger clerk will have to go through this record to ascertain the price to be charged.**

- **In case of fluctuations in price of materials, comparison between one job and the other becomes difficult because one job started a few minutes later than another of the same nature may be issued materials at different prices, merely because the earlier job exhausted the supply of the lower priced materials in stock.**
- **For pricing one requisition more than one price has often to be taken.**
- **When prices rise, the issue price does not reflect the market price as materials are issued from the earliest consignments. Therefore, the charge to production is low because the cost of replacing the material consumed will be higher than the price of issue.**

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- **Last in First Out Method (LIFO):**

- As against the First in First Out method the issues under this method are priced in the reverse order of purchase i.e., the price of the latest available consignment is taken.
- This method is sometimes known as the replacement cost method because materials are issued at the current cost to jobs or work orders except when purchases were made long ago.
- This method is suitable in times of rising prices because material will be issued from the latest consignment at a price which is closely related to the current price levels.
- Valuing materials issues at the price of the latest available consignment will help the management in fixing the competitive selling prices of the products.
- This method was first introduced in the U.S.A. during the Second World War to get the advantage of rising prices.
- Two important points in this method are (i) issues are priced at actual cost and at the latest prices paid. (ii) Closing stock is valued at the older prices and is completely out of line with current prices.

- **Advantages of LIFO Method:**

- The value of materials issued is closely related to current market prices.
- 2. As materials are issued at actual cost, it does not result in any unrealised profit or loss.
- 3. When prices are rising, the higher prices of the most recent purchases are charged to production. This reduces profit figure and results in Income tax saving.
- 4. Like FIFO method, this is simple to operate and is useful when transactions are not too many and the prices are fairly steady.
- 5. like FIFO method, this method recovers cost from production because actual cost of material is charged to production.
- 6. Production is charged at the recent prices because materials are issued from the latest consignment. Thus, effect of current market prices of materials is reflected in the cost of sales provided the materials are recently purchased.
- 7. in times of rising prices, LIFO method of pricing issues is suitable because materials are issued at the current market prices which are high. This method thus helps in showing a lower profit because of increased charge to production during periods of rising prices and lower profit produces burden of income tax.

- **Disadvantages of LIFO Method:**

- **1. Although stock is valued at cost, the price is that of the earliest materials purchased , so that stock value does not represent its current value.**
- **This method is not realistic as it does not conform to the physical flow of materials.**
- **Like FIFO, in this method also, the material cost of similar jobs may differ simply because the prior job exhausted the supply of lower priced stock. This renders comparisons between jobs different.**
- **When prices fluctuate very often, the calculations complicate the stores account and increase the possibility of clerical errors.**
- **5. Like FIFO method, this may lead to clerical errors as every time an issue is made, the stores ledger clerk will have to go through the record to ascertain the price to be charged.**
- **6. Like FIFO method, comparison between one job and the other job will become difficult because one job started a few minutes after another of the same type may bear a different charge for materials consumed, merely because the earlier job exhausted the supply of the lower priced or higher priced materials in stock.**
- **7. For pricing a single requisition, more than one price has often to be adopted.**
- **8. the stock in hand is valued at price which does not reflect current market price. Consequently, closing stock will be understated or overstated in the Balance Sheet.**

- **Average Price Method:**

- These methods are based on the assumption that when materials purchased in different lots is stored together, their identity is lost, and therefore, these should be charged at an average price. Basically average prices of two types. They are (i) Simple Average Price method (ii) Weighted Average Price Method.

- **Simple Average Price Method**

- Simple average price is calculated by adding all the different prices and dividing by the number of such prices. It does not take into account quantities of materials while computing average price.
- For instance, when 100 units are purchased @Rs.9 per unit and 900 units are purchased @Rs.7 per unit, the simple average price will be = $9+7 / 2 = \text{Rs.}8$

- **Advantages:**

- The only advantage of this method is that it is simple to understand and easy to operate.

- **Disadvantages:**

- Materials are not charged out at actual cost. Thus, unrealised profit or loss will usually arise out of pricing.
- This method is unscientific and usually produces unsatisfactory results. The value of closing stock may be a negative figure which is quite absurd.

- **Weighted Average Price Method**

- This method gives due weight to the quantities held at each price when calculating the average price.
- The weighted average price is calculated by dividing the total cost of materials in stock from which the materials to be priced could have been drawn, by that total quantity of materials in that stock.
- The simple formula is that weighted average price at any time is the balance value figure divided by the balance units figure. Thus

- Weighted Average Price =

- $$\frac{\text{Total cost of Materials in stock}}{\text{Total quantity of materials in stock}}$$

- **Advantages of Weighted Average Price Method:**
- This method is rational, systematic and not subject to manipulation. It is representative of the prices that prevailed during the entire period rather than of the price at the beginning, end or at one point of issue during the period because it is based on the average of the material costs of the various lots available in the store.
- This method evens out the effect of widely varying prices of different purchases.
- The new issue price is calculated only at the time of each new purchase and not at the time of each issue. This reduces the work of making calculations.
- No unrealised profit or loss arises.
- This method recovers the cost of materials from production.
- Issue prices are not to be calculated each time issues are made, issue prices are changed only when new lot of materials is received.
- Average price method is considered to be the best method when prices fluctuate considerably because this method tends to smooth out fluctuations in prices.
- This method maintains the issue prices as near to the market price possible.

- **Disadvantages:**

- Where receipts are numerous, this method requires a good deal of calculations.
- Issue prices generally run to a number of decimal points.
- Materials are not issued at the current market prices.
- Closing stock is not valued at current cost.
- Issue price of materials does not represent actual cost price of materials issued but it represents average cost of materials in stores. At the time of rising prices, it overstates profit but not as much as FIFO because average price is lower than the most recent price.
- A fresh rate calculation will have to be made as soon as a new lot of materials is purchased which may involve tedious calculations. Thus, there are chances of clerical errors.

- **Inflated Price Method**

- There are some materials which are subjected to natural wastage. Examples are
 - i) Materials lost due to loading and unloading and
 - ii) Timber lost due to seasoning. In such cases, the materials are issued at an inflated price (a price higher than the actual cost) so as to recover the cost of natural wastage of materials from the production. In this way, the total cost of the material is recovered from the production.

- **Specific Price/ Identification Method**

- Under this method, materials issued to production are priced at their purchase prices.
- The basic assumption in following this method is that materials in the stores are capable of being identified as belonging to specific lots.
- Identification can be made by placing some distinguishing mark usually price tag on every lot.
- When materials are issued, price tags are removed and forwarded to the costing department for ascertaining the material cost of production. This method is simple in its mechanism and operation.

• **Base Stock Method**

- Each concern always maintains a minimum quantity of material in stock.
- This minimum quantity is known as safety or base stock and this should be used only when an emergency arises.
- The base stock is created out of the first lot of the material purchased and , therefore, it is always valued at the cost price of the first lot and is carried forward as a fixed asset.
- This method works with some other method and is generally used with FIFO or LIFO method.
- Therefore, the advantages or disadvantages of the method (with which the base stock is used) will arise.
- Any quantity over and above the base stock is issued in accordance with the other method which is used in conjunction with this method.
- The objective of this method is to issue the material according to the current prices.
- This objective will be achieved only when the LIFO method is used together with Base stock method.
- **Highest in First Out Method (HIFO)**
- This method is based on the assumption that the closing stock of materials should always remain at the minimum value; so the issues are priced at highest value of the available consignments in the store.
- **Price Method**
- There are some materials which are subjected to natural wastage. Examples are
 - i) Materials lost due to loading and unloading and
 - ii) Timber lost due to seasoning. In such cases, the materials are issued at an inflated price (a price higher than the actual cost) so as to recover the cost of natural wastage of materials from the production. In this way, the total cost of the material is recovered from the production.
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- Identification can be made by placing some distinguishing mark usually price tag on every lot.
- When materials are issued, price tags are removed and forwarded to the costing department for ascertaining the material cost of production. This method is simple in its mechanism and operation.

- This method is not popular as it always undervalues the stock which amounts to creating a secret reserve.
- This method is mainly used in case of cost plus contracts or monopoly products as it is helpful in increasing the price of the contract or products.
- **Market Price Method**
- Market price can either be the replacement price or the realisable price.
- The replacement price is used in case of the items which are held in stock for use in production while realisable price is used in respect of the items which are kept in stock for sale.
- Under this method, materials are issued at a price at which they can be replaced.
- Therefore, cost of the materials issued is not considered but materials are issued at the market price prevailing on the date of issue.
- This method is considered to be the best method where quotations have to be sent because quotations sent would reflect the latest competitive conditions so far as materials are concerned.
- This method discloses whether the buying is efficient or inefficient.
- There will be efficiency in buying if the market price is higher than the cost price and inefficiency if reverse is the case.

Stock Levels

- There are five levels of stocks should be calculated under valuation of inventory.

They are 1. Re-Order Level

2. Maximum Stock Level

3. Minimum Stock Level

4. Average Stock Le

5. Danger Level

- 1. Re-Order Level:
 - This is that level of material to be reordered should be calculated as follows:
 - Re-ordering Level =
 - Maximum Consumption X Maximum Re-order Period

UNIT-IV

FINANCIAL STATEMENTS-I

FUNDS FLOW STATEMENT

Funds Flow Statement is a statement showing sources and uses of funds for a period of time.

Foulke defines this statement as:

“ A statement of sources and applications of funds is a technical device designed to analyze the changes in the financial condition of a business enterprise between two dates.”

In the words of Anthony, “ The funds flow statement describes the sources from which additional funds were derived and the use to which these sources were put.”

Uses, significance and Importance of Funds Flow Statement

1.It helps in the analysis of financial Operations:

- The financial statements reveal the net effect of various transactions on the operational and financial position of a concern.
- The balance sheet gives a static view of the resources of a business and the uses to which these resources have been put at a certain point of the time.
- But it does not disclose the causes for changes in the assets and liabilities between two different points of time.

- The funds flow statement explains causes for such changes and also effect of these changes on the liquidity position of the company.
- Some times a concern may operate profitably and yet its cash position may become more and more worse.
- The Funds Flow Statement gives a clear answer to such a situation explaining what has happened to the profits of the firm?

2. It throws light on many Perplexing/Confusing questions of general interest:

- Why were the net current assets lesser in spite of higher profits and vice-versa?
- Why more dividends could not be declared in spite of available profits?
- How was it possible to distribute more dividends than the present earnings?
- What happened to the net profit? Where did they go?
- What happened to the proceeds of sale of fixed assets or issue of shares, debentures etc.,?

➤ What are the sources of repayment of debts?

➤ How was the increase in working capital financed and how will it be financed in future?

3. It helps in the formation of a realistic dividend policy:

➤ Some times a firm has sufficient profits available for distribution as dividend but yet it may not be advisable to distribute dividend for lack of liquid or cash resources.

➤ In such cases, a funds flow statement helps in the formation of a realistic dividend policy.

4. It helps in the proper allocation of resources:

- The resources of a concern are always limited and it wants to make the best use of these resources.
- A projected funds flow statement constructed for the future helps in making managerial decisions.
- The firm can plan the deployment/use of resources and allocate them among various applications.

5. It acts as future guide:

- A projected funds flow statement also acts as a guide for future to the management.
- The management can come to know the various problems, it is going to face in near future for want of funds.
- The firm's future needs of funds can be projected well in advance and also the timing of these needs.
- The firm can arrange to finance these needs more effectively and avoid future problems.

6. It helps in appraising the use of working capital:

A funds flow statement helps in explaining how efficiently the management has used its working capital and also suggests ways to improve working capital position of the firm.

7. It helps knowing overall creditworthiness of a firm:

- The financial institutions and banks such as State Financial Institutions, Industrial Development Corporation, Industrial Finance Corporation of India, Industrial Development Bank of India etc., all ask for funds flow statement constructed for a number of years before granting loans to know the creditworthiness and paying capacity of the firm.
- Hence a firm seeking financial assistance from these institutions has no alternative but to prepare funds flow statements.

LIMITATIONS OF FUNDS FLOW STATEMENT

1. It should be remembered that a funds flow statement is not a substitute of an income statement or a balance sheet. It provides only some information as regards changes in working capital.
2. It cannot reveal continuous changes.
3. It is not an original statement but simply are arrangement of data given in the financial statements.
4. It is essentially historic in nature and projected funds flow statement cannot be prepared with much accuracy.
5. Changes in cash are more important and relevant for financial management than the working capital.

Differences between Funds Flow and Cash Flow Statements

Point of Difference	Funds Flow Statement	Cash Flow Statement
1. Basis of concept	Funds flow statement is based on wider concepts of funds i.e, working capital	Cash flow statement is based on narrower concepts of funds i.e, cash only.
2. Object	The funds flow statement is prepared to know the changes in firms working capital position between the dates of two balance sheets.	Cash flow statement is prepared to analyze changes in the firms cash position between dates of two balance sheets.
3. Basis of Accounting	It is based on accrual basis of accounting.	It is based on cash basis of accounting.
4. Preparation of Schedule	In the case of funds flow statement a schedule of changes in working capital is prepared.	In cash flow statement no such schedule is prepared.

Point of Difference	Funds Flow Statement	Cash Flow Statement
5. Techniques	No opening and closing balances appear in funds flow statement.	Cash flow statement is prepared with opening balance as stating point and ends with closing balance.
6. Finance	Funds flow statement as a tool of financial analysis is more useful to the management.	Cash flow statement as a tool of financial analysis is useful in short term financing.
7. Nature	Funds flow statement deals with all the components of working capital.	Cash flow statement deals only with cash.
8. Sources and Applications	Funds flow statement reveals the sources and applications of funds. The difference represents net increase or net decrease in working capital.	Cash flow statement is prepared by taking inflows and outflows of cash. All inflows are added to opening cash balance. From this total outflows are deducted. The difference represents the closing balance of cash.

Advantages of Cash Flow Statement

1. Cash flow statement reveals the causes of changes in cash balances between two dates of balance sheets.
2. This statement helps the management to evaluate its ability to meet its obligations i.e., payments to creditors. The payment of bank loan, payment of interest, taxes, dividend etc.
3. it throws light on causes for poor liquidity in spite of good profits and excessive liquidity in spite of heavy losses.

4. It helps the management in understanding the past behavior of cash cycle and in controlling the use of cash in future.

5. Cash flow statement helps the management in planning repayment of loans, replacement of assets etc.

6. This statement is helpful in short-term financial decisions relating to liquidity.

7. This statement helps the management in preparing cash budgets properly.

8. This statement helps the financial institution who lend advances to business concerns in estimating their repaying capacities.

9. Cash flow statement helps in evaluating financial policies of the management.

10. Cash flow statement discloses the complete story of cash movement. The increase in, or decrease of cash and the reason therefore can be known.

11. Cash flow statement provides information of all activities such as operating, investing and financial activities.

12. Since cash flow statement provides information regarding the sources and utilizations of cash during a particular period. It is easy for the management to plan carefully for the cash requirements in the future, for the pose of redeeming long-term liabilities or /and replacing some fixed assets.

LIMITATIONS OF CASH FLOW STATEMENT

1. A cash flow statement only reveals the inflow and outflow of cash. The cash balance disclosed by the cash flow statement may not represent the real liquid position of the concern.
2. Cash flow statement is not suitable for judging the profitability of a firm as non-cash changes are ignored while calculating cash flows from operating activities.

3. Cash flow statement is not a substitute for income statement or funds flow statement.

- Each of them has separate function to perform.
- Net cash flow disclosed by cash flow statement does not necessarily show net income of the business, because net income is determined by taking into account both cash and non-cash items.

4. Cash flow statement is based on cash accounting. It ignores the basic accounting concept of accrual basis.

5. Cash flow statement reveals the movement of cash only. In preparation it ignores most liquid current assets like Sundry Debtors, Bills Receivables etc.,

6. It is difficult to precisely define the term cash. There are controversies among accountants over a number of near cash items like cheques, stamps, postal orders etc., to be included in cash.

7. Cash flow statement does not give a complete picture of financial position of the concern.

FUNDS FLOW STATEMENT

Funds Flow Statement is a statement showing sources and uses of funds for a period of time.

Foulke defines this statement as:

“ A statement of sources and applications of funds is a technical device designed to analyze the changes in the financial condition of a business enterprise between two dates.”

In the words of Anthony, “ The funds flow statement describes the sources from which additional funds were derived and the use to which these sources were put.”

Meaning of Cash Flow Statement

- Cash Flow Statement is a statement which describes the inflows(sources) and outflows(uses) of cash and cash equivalents in an enterprise during a specified period of time.
- A Cash Flow Statement summarizes the causes of changes in the cash position of a business enterprise between two Balance Sheets.

(i) Statement of Schedule of Changes in Working Capital

particulars	Previous year	Current year	Effect on Working Capital	
			Increase	Decrease
<u>Current Assets</u>				
Cash in Hand	XXX	XXXX	XXX	
Cash at Bank	XXXX	XXX		XXX
Bills Receivables	XXXX	XXX		XXX
Sundry Debtors	XXX	XXXX	XXX	
Temporary Investments	XXXX	XXX		XXX
Closing stock	XXXX	XXXXX	XXX	
Prepaid Expenses	XXX	XXXX	XXX	
Accrued Income	XXX	XXXX	XXX	
Total Current Assets	XXXXX	XXXXX		

particulars	Previous Year	Current Year	Effect on Working Capital	
			Increase	Decrease
<u>Current Liabilities</u>				
Bills Payables	xxx	xxxx		xxx
Sundry Creditors	xxx	xxxx		xxx
Outstanding Expenses	xxxx	xxx	xxx	
Bank Overdraft	xxxx	xxx	xxx	
Short Term Advances	xxxx	xxx	xxx	
Dividends Payable	xxx	xxxx		xxx
Proposed Dividends	xxxx	xxx	xxx	
Provision for Taxation	xxxx	xxx	xxx	
Total Current Liabilities	xxxxx	xxxxx		
Working Capital(C.A –C.L)	xxxx	xxxx		
Net Increase or Decrease in working Capital	xxx	xxx		

ii) Calculation of Funds from operations:

Adjusted Profit and Loss Account

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Depreciation on Fixed Assets	xxxx	By Opening Balance of P&L A/c	xxxx
To Goodwill, Copy rights, Patents , Trade Marks and Preliminary Expenses written off	xxxx	By Transfers from excess provisions	xxxx
To Appropriation of Retained earnings such as: Transfers to General Reserve, Dividend Equalization Fund, Sinking Fund	xxxx	By Appreciation in the value of fixed assets	xxxx
To Loss on sale of any non-current asset or fixed asset	xxxx	By Dividends received	xxxx
To Dividends Paid	xxxx	By Interest on Investments	xxxx
To Proposed Dividend and provision for Taxation	xxxx	By Profit on sale of fixed asset or non-current asset	xxxx
To Closing balance of P&L A/c	xxxx		
To Funds Lost in Operations	xxxxx	By Funds from Operations	xxxxx
	xxxxxx		xxxxxx

iii) Proforma of Funds Flow Statement

SOURCES	Amount(Rs.)	APPLICATIONS	Amount(Rs.)
1. Issue of Share Capital and Share Premium received	xxxx	Redemption of Preference Share Capital	xxxx
2. Issue of Debentures	xxxx	Redemption of Debentures	xxxx
3. Raising of Long –term loans	xxxx	Repayment of Long –term loans	xxxx
4. Sale of Fixed Assets	xxxx	Purchase of Fixed Assets	xxxx
5. Sale of Long –term Investments	xxxx	Purchase of Long –term Investments	xxxx
6. Non-trading receipts such as Dividends received and Refund of Tax etc.	xxxx	Non-trading Payments such as Dividend paid and Payment of Tax	xxxx
7. Funds from Operations	xxxx	Funds Lost in Operations	xxxx
8. Net Decrease in Working Capital	xxxx	Net Increase in Working Capital	xxxx
	xxxxxx		xxxxxx

Proforma of Cash Flow Statement

SOURCES	Amount (Rs.)	APPLICATIONS	Amount(Rs.)
1. Opening Balance of Cash and Bank	xxxx	<u>Cash Out Flows:</u> Redemption of Preference Share Capital	xxxx
Add: <u>Cash Inflows:</u> 2. Issue of Share Capital and Share premium received	xxxx	Redemption of Debentures	xxxx
3. Issue of Debentures	xxxx	Repayment of Long –term loans	xxxx
4. Raising of Long –term loans	xxxx	Purchase of Fixed Assets	xxxx
5. Sale of Fixed Assets	xxxx	Purchase of Long –term Investments	xxxx
6. Sale of Long –term Investments	xxxx	Non-trading Payments such as Dividend paid and Payment of Tax	xxxx

SOURCES	Amount (Rs.)	APPLICATIONS	Amount(Rs.)
7. Non-trading receipts such as Dividends received and Refund of Tax etc.	xxxx	Cash Lost in Operations	xxxx
8. Cash from Operations	xxxx	Increase in Current Assets and Decrease in Current Liabilities	xxxx
9. Decrease in Current Assets and Increase Current Liabilities	xxxx	Closing Balance of Cash and Bank	xxxx
	xxxxxxx		xxxxxxx

Meaning of Cash Flow Statement

- Cash Flow Statement is a statement which describes the inflows(sources) and outflows(uses) of cash and cash equivalents in an enterprise during a specified period of time.
- A Cash Flow Statement summarizes the causes of changes in the cash position of a business enterprise between two Balance Sheets.

Advantages of Cash Flow Statement

1. Cash flow statement reveals the causes of changes in cash balances between two dates of balance sheets.
2. This statement helps the management to evaluate its ability to meet its obligations i.e., payments to creditors. The payment of bank loan, payment of interest, taxes, dividend etc.
3. It throws light on causes for poor liquidity in spite of good profits and excessive liquidity in spite of heavy losses.

4. It helps the management in understanding the past behavior of cash cycle and in controlling the use of cash in future.
5. Cash flow statement helps the management in planning repayment of loans, replacement of assets etc.
6. This statement is helpful in short-term financial decisions relating to liquidity.
7. This statement helps the management in preparing cash budgets properly.
8. This statement helps the financial institution who lend advances to business concerns in estimating their repaying capacities.

9. Cash flow statement helps in evaluating financial policies of the management.

10. Cash flow statement discloses the complete story of cash movement. The increase in, or decrease of cash and the reason therefore can be known.
11. Cash flow statement provides information of all activities such as operating, investing and financial activities.
12. Since cash flow statement provides information regarding the sources and utilizations of cash during a particular period. It is easy for the management to plan carefully for the cash requirements in the future, for the pose of redeeming long-term liabilities or /and replacing some fixed assets.

LIMITATIONS OF CASH FLOW STATEMENT

1. A cash flow statement only reveals the inflow and outflow of cash. The cash balance disclosed by the cash flow statement may not represent the real liquid position of the concern.
2. Cash flow statement is not suitable for judging the profitability of a firm as non-cash changes are ignored while calculating cash flows from operating activities.

3. Cash flow statement is not a substitute for income statement or funds flow statement.

- Each of them has separate function to perform.
- Net cash flow disclosed by cash flow statement does not necessarily show net income of the business, because net income is determined by taking into account both cash and non-cash items.

4. Cash flow statement is based on cash accounting. It ignores the basic accounting concept of accrual basis.
5. Cash flow statement reveals the movement of cash only. In preparation it ignores most liquid current assets like Sundry Debtors, Bills Receivables etc.,
6. It is difficult to precisely define the term cash. There are controversies among accountants over a number of near cash items like cheques, stamps, postal orders etc., to be included in cash.
7. Cash flow statement does not give a complete picture of financial position of the concern.

UNIT-V

FINANCIAL STATEMENTS-II

- Alexander Wall is considered to be the pioneer of Ratio Analysis. He presented the detailed system of Ratio Analysis in 1909 and explained its usefulness in financial analysis.
- **Ratio Analysis is most widely used powerful tool of financial analysis. It is an important technique of analysis and interpretation of financial statements.**
- It is also used to analyze various aspects of operational efficiency and degree of profitability.
- **Ratio Analysis is based on different ratios which are calculated from the accounting information contained in the financial statements. Different ratios are used for different purposes.**

Meaning of Ratio

- Ratio is a figure expressed in terms of another.
- It is an expression of relationship between one figure , two figures and the other figures which are mutually inter-dependent.
- In other words a ratio is a mathematical relationship between two items expressed in a quantitative form. When ratio is explained with reference to the items shown in the financial statements.
- It is called as an Accounting Ratio.
- The ratio analysis facilitates easy understanding of financial statements.

Advantages/ importance/significance of Ratio Analysis

- **Ratio Analysis is an important technique of financial analysis.**
- **It is used as a device to analyze and interpret the financial health of enterprises.**
- **Its usefulness is not only confined to business managers but also extends to various interested parties like government, creditors, employees, investors, consumers etc.**

1. Helps in Decision making:

- **Though Financial Statements provide necessary data for decision making.**
- **It is not possible to take appropriate decisions merely on the basis of each data.**
- **Ratio Analysis provides a meaningful analysis and interpretation to the data contained in Financial Statements.**
- **This ratio analysis facilitates the managers to take correct decisions.**

2. Helps in Financial Forecasting and Planning

- Ratios calculated for a number of years reveal the trends in the phenomenon.**
- As such, it is possible to make predictions for a future period.**
- Thus, ratio analysis helps in financial forecasting and planning.**

3. Helps in assessing the operational efficiency:

- Ratio Analysis helps in analyzing the strengths and weaknesses of a concern.**
- It helps in diagnosing the financial health of a concern in terms of liquidity, solvency, profitability etc.**

4. Helps in controlling business:

- With the help of ratio analysis, it is possible to identify the weak spots with regard to the performance of the managers.
- Weakness in financial structure due to incorrect policies in the past and present is revealed by the ratios.
- These weaknesses may be communicated to the people concerned and as such ratio analysis helps in better communication, Coordination and control of unfavorable situations.

5. Helps in comparison of performance:

- Through accounting ratios comparison can be made between one departments of a firm with another of the same firm in order to evaluate the performance of various departments in the firm.
- This is needed for the smooth functioning of the departments.

- 6. Ratio analysis simplifies the complex financial data. It reveals the change in the financial position.**
- 7. Ratio analysis may be used as instruments of management control, particularly in the area of sales and control.**
- 8. Ratios facilitate the function of communication and enhance the value of financial statements.**

9. Ratios are helpful in assessing the financial position and profitability of a concern.

10. Ratio Analysis also helps in effective control of business – measuring performance, control of costs etc., Effective control is a keystone of better management.

11. Ratio analysis helps the investors in making investment decisions to make a profitable investment.

12. It helps to know the relationship between different related items of financial statements.

13. It helps in investigating the factors responsible for financial soundness/deterioration of a particular situation.

14. It helps in analyzing and interpreting the financial data of the enterprise.

15. The ratios are calculated based upon past results. So it help management to frame sound business policies for business in future.

Limitations of Ratio Analysis

1. Limited use of a Single Ratio:

- A single ratio does not convey meaningful message. As such, a number of ratios will have to be calculated for a better understanding of particular situation.
- Thus, a series of ratios computed may create confusion.
- Ratios can be useful only when they are computed in a sufficient large number.
- calculation of more ratios some times confuses the analysts than help him.

2. Lack of Adequate Standards:

- Expecting a few situations, in majority cases, universally accepted standards for ratios are not available.**
- It renders interpretation of ratios difficult.**

3. Lack of comparability:

- **The results of two firms are comparable with the help of accounting ratios only if they follow the same accounting methods.**
- **Comparison becomes difficult if they follow different methods.**
- **Similarly, utilization of facilities , availability of facilities and scale of operation affects the Financial Statements of different firms.**
- **Comparison of such firms would be misleading.**

4. Inherent Limitations of Accounting:

- Accounting records contain historical data. As such, ratios based on data drawn from accounting records also suffer from the inherent weaknesses of accounting records.
- Thus, accounting ratios of the past may not be true indicators of the future.

5. Changes in Accounting Procedures:

- Change in accounting procedure by a firm often makes ratio analysis misleading.
- E.g., a change in the valuation of methods of inventories from FIFO to LIFO Increase the cost of sales and reduces the value of the closing stock which makes inventory turnover ratio to be impressive and an unfavorable gross profit ratio.

6. Window Dressing:

- Financial statements easily be window dressed to present a better picture of its financial and profitability position to outsiders.
- Hence, one has to be very careful in making a decision from ratios calculated from such Financial Statements.
- However, it may be difficult for an outsider to learn about the window dressing made by a firm.

7. Price-Level Changes:

Since ratios are computed for historical data, no consideration is made to the changes in price levels and this makes the interpretation of ratios invalid.

8. Personal Bias:

- Ratios are only means of financial analysis and not an end in itself.
- They have to be interpreted and different people may interpret the same ratio in different ways.

9. Ignoring qualitative factors:

Ratio analysis ignores the qualitative factors which generally influence the conclusions derived.

10. Reliability of data:

- The accuracy and correctness of ratios are totally dependent upon reliability of data contained in financial statements.
- If there are any mistakes or omissions in the financial statements, ratio analysis presents a wrong picture about the concern.

CLASSIFICATION OF RATIOS

- I. **Classification according to the nature of accounting statement from which the ratios are derived into three categories.**

They are

- 1. Balance sheet Ratios**
- 2. Profit and Loss Account Ratios**
- 3. Combined or Composite Ratios**

1. BALANCE SHEET RATIOS

These ratios deal with the relationship between two items appearing in the Balance sheet.

Eg. Current Ratio, Liquid Ratio, Debt to Equity Ratio.

2. PROFIT AND LOSS ACCOUNT RATIOS

This type of ratios show the relationship between two items which are in the profit and loss account itself.

Eg. Gross Profit Ratios, Net Profit Ratios and Operating Ratios.

3. COMBINED OR COMPOSITE RATIOS

These ratios show the relationship between items one of which is taken from profit and loss account and the other from the balance sheet.

Eg. Rate of Return on capital Employed, Debtors Turnover Ratio, creditors turnover ratio, stock/ inventory turnover ratio and capital turnover ratio etc.

II. CLASSIFICATION FROM POINT OF VIEW OF FINANCIAL MANAGEMENT OR OBJECTIVE.

Ratios may be classified into four categories. They are

- 1. Liquidity Ratios**
- 2. capital structure/ gearing Ratios.(Leverage / Solvency Ratios)**
- 3. Turnover Ratios**
- 4. Profitability Ratios**

IMPORTANT FORMULAE IN RATIO ANALYSIS

I. LIQUIDITY RATIOS:

1. **Current Ratio =**

Current Assets / Current Liabilities.

2. **Quick Ratio / Liquid Ratio =**

Liquid Assets / Quick Liabilities

3. **Absolute Quick Ratio =**

Highly liquid Assets / Current Liabilities

II. CAPITAL STRUCTURE/ SOLVENCY **/ LEVERAGE RATIOS:**

1. Debt- Equity Ratio =

**Long-Term Debts/ Shareholders
Funds**

or

**External Equity / Internal
Equity**

2. Proprietary Ratio =

Shareholders Funds / Total Assets

3. Interest Coverage Ratio=
Earning before Interest
and Taxes (EBIT) /
Fixed Interest Charges.

4. Debts to Total Funds
Ratio = Debts / Total
Funds.

III. TURNOVER/ ACTIVITY RATIOS:

1. Inventory /Stock Turnover Ratio=

Cost of Goods Sold / Average inventory at cost.

Or

Sales/ Average Inventory at selling prices

or

Sales / Average Inventory at cost.

2. (i) Debtors Turnover Ratio =

Net Credit Sales / Average Debtors.

(ii) Average Collection Period

(in terms of days) =

(Debtors / Credit Sales) X 365 Days.

3. Creditors Turnover Ratio =

**Net Credit purchases/ Average
Creditors**

4. Working Capital Turnover Ratio =
Cost of Sales / Net Working Capital

5. Fixed Assets Turnover Ratio=
Cost of sales / Fixed Assets at cost
Less Accumulated Depreciation.

6. Capital Turnover Ratio=
Cost of sales / Capital
Employed

IV. PROFITABILITY RATIOS

1. Gross Profit Ratio=

(Gross Profit / Net Sales) x 100

or

(Net Sales- cost of goods sold / net sales)x 100

2. Net Profit Ratio=

(Net Profit / Net Sales) x 100

3. Operating Ratio=

(Cost of goods sold + operating expenses)/ Net Sales.

4. Operating Profit Ratio=

(Operating Net profit / Net Sales) x 100

OR

100% - Operating Ratio

IV. PROFITABILITY RATIOS

5. Expenses Ratios:

For cost of Materials =

(Materials consumed / Net sales) x 100

For Selling Expenses=

(Selling Expenses / Net Sales) x 100

6. Return on Investment Ratio (ROI)=

**(Net profit before interest and Taxes /
Total Capital Employed) x 100**

IV. PROFITABILITY RATIOS

7. Returns on Shareholders Funds=

(Net Profit after Interest and Taxes / Shareholders Funds) x 100

8. Return on Equity Share Capital=

(Net profit after interest, Taxes and Dividend / Equity Shareholders Funds) x 100

IV. PROFITABILITY RATIOS

9. Earning Per Share (EPS)=

(Net Profit after Taxes- Preference Dividend)/ Number of Equity Shares

10. Dividend Payout Ratio=

Dividend per Share / Earning per share.

11. Price Earning Ratio(P/E Ratio)=

Market Price per Equity Share / Earning per share.

- **UNIT-V: FINANCIAL STATEMENT ANALYSIS-II**

- **FINANCIAL STATEMENTS**

- Though financial statements are relevant and useful for the concern, still they do not present a final picture of the concern.
- The utility of these statements is dependent upon a number of factors.
- The analysis and interpretation of these statements should be done very carefully otherwise misleading conclusions may be drawn.

- **IMPORTANCE OF FINANCIAL STATEMENTS**

- The financial statements are mirrors which reflect the financial position and operating strength or weakness of the concern. These statements are useful to management, investors, creditors, Bankers, workers, government and public at large. George O May points out the following major uses of financial statements.

- As a report of stewardship.
- As a basis for fiscal policy.
- To determine the legality of dividends.
- As guide to advise dividend action.
- As a basis for the granting of credit.
- As informative for prospective investors in an enterprise.
- As a guide to the value of investment already made.
- As an aid to the government supervision.
- As a basis for price or rate regulation.
- As a basis for taxation.

The utility of financial statements to different parties is discussed in detail as follows:

1. MANAGEMENT:

The financial statements are useful for assessing the efficiency for different cost centre's. The management is able to exercise cost control through these statements. The efficient and inefficient spots are brought to the notice of the management. The management is able to decide the course of action to be adopted in future.

2. CREDITORS:

The trade creditors are to be paid in a short period. This liability is met out current assets. The creditors will be interested in current solvency of the concern. The calculation of current ratio and liquid ratio will enable the creditors to assess the current financial position of the concern in relation to their debts.

3. BANKERS:

The banker is interested to see that the loan amount is secure and customer is also able to pay the interest regularly. The banker will analyze the balance sheet to determine financial strength of the concern and profit and loss amount will be studied to find out the earning position of the business concern. A banker has a large number of customers and it is not possible to supervise their business activity. It is through the financial statements that a banker can keep a watch on the business plans and performances of its customers. These statements also help the banker to determine the amount of securities it will ask from the customers as a cover of the loans.

- **4. INVESTORS:**

- The investors include both short-term and long-term investors.
- They are interested in the security of the principal amount of loan and regular interest payments by the concern.
- The investors will study the long term solvency of the concern with the help of financial statements.
- The investors will not only analyze the present financial position but will also study future prospects and expansion plans of the concern.
- The possibility of paying back the loan amount in the face of liquidation of the concern is also taken into consideration.

- **5. GOVERNMENT:**

- The financial statements are used to assess tax liability of business enterprise.
- The government studies economic situation of the country from these statements.
- These statements enable the government to find out whether the business is following various rules and regulations or not .
- These statements also become a base for framing and amending various laws for the regulation of the business.

- **6. TRADE ASSOCIATIONS:**

- These associations provide service and protection to the members. They may analyze the financial statements for the purpose of providing facilities to these members. They may develop standard ratios and design uniform system of accounting.

• . 7. STOCK EXCHANGE:

The stock exchange deal in purchase and sale of securities of different companies.

The financial statements enable the stock brokers to judge the financial position of different concerns. The fixation of prices of securities etc., is also based on these statements.

LIMITATIONS OF FINANCIAL STATEMENTS

- 1. Only Interim Reports:** These statements do not give a final picture of the concern. The data given in the statements is only approximate. The actual position can only be determined when the business is sold or liquidated. However, the statements have to be prepared for different accounting periods, generally one year, during the life time of the concern. The costs and incomes be apportioned to different periods with a view to determine profits etc. the allocation of expenses and incomes will depend upon the personal judgment of the account. The existence of contingent assets and liabilities also makes the statements imprecise. So financial statements do not give the final picture and they are at the most interim reports.
- 2. Do not give Exact Position:** The financial statements are expressed in monetary values. So, they appear to give final and accurate position. The value of fixed assets in the balance sheet neither represents the value for which fixed assets can be sold nor the amount which will be required to replace these assets. The balance sheet is prepared on the presumption of a going concern. The concern is expected to continue in the future. So fixed assets are shown at cost less accumulated depreciation. There are certain assets in the balance sheet such as preliminary expenses, goodwill and discount on issue of shares which will realize nothing at the time of liquidation though they are shown in the balance sheet.

3. Historical Costs:

The financial statements are prepared on the basis of historical costs or original costs. The value of assets decreases with the passage of time current price changes are not taken into account. The statements are not prepared keeping in view the present economic conditions. The balance sheet loses the significance of being an index of current economic realities. Similarly, the profitability shown by the income statement may not represent the earning capacity of the concern. The increase in profits may be due to an increase in prices or due to some abnormal causes and not due to increase in efficiency. The conclusion drawn from financial statements may not give a fair picture of the concern.

4. Impact of Non-Monetary Factors Ignored:

There are certain factors which have a bearing on the financial position and operating results of the business but they do not become a part of these statements because they cannot be measured in monetary terms.

Such factors may include the reputation of the management, credit worthiness of the concern, sources and commitments for purchases and sales, co-operation of the employees, etc. The financial statements only show the position of the financial accounting for business and not the financial position.

5. No Precision:

The precision of financial statement data is not possible because the statements deal with matters which cannot be precisely stated.

The data are recorded by conventional procedures followed over the year. Various conventions, postulates, personal judgements etc., are used for developing the data.

FINANCIAL STATEMENT ANALYSIS

Financial statements represent a formal record of financial activities of an entity. These are written reports that qualify the financial strength, performance and liquidity of a company. Financial statements reflect the financial effects of business transactions and events on the entity.

Types of Financial Statements:

The four types of financial statements are

- 1.Statement of Financial Position**
- 2.Income Statement.**
- 3.Cash flow statement.**
- 4.Statement of changes in Equity.**

1.Statement of Financial Position

Statement of Financial Position is also known as the Balance sheet , presents the financial position of an entity at a given date. It is comprised of the following three elements.

Assets: Something a business owns or controls (e.g. cash, inventories, plant and machinery)

Liabilities: something a business owes to someone (e.g. creditors, bank loans etc.)

Equity: what the business owes to its owners. This represents the amount of capital that remains in the business after its assets are used to pay off its outstanding liabilities. Equity therefore represents the difference between the assets and liabilities.

2. Income Statement:

Income statement also known as Profit and Loss statement , reports the company's financial performance in terms of net profit or net loss over a specified period.

Income statement is composed of the following two elements:

i) **Income:** what the business has earned over a period (e.g. sales, revenue, dividend income etc.)

ii) **Expenditure:** the cost of incurred by the business over a period (e.g. salaries, wages, depreciation, rent etc.)

capital and debt together with the payments of interest and dividends.

3. Cash Flow Statement: cash flow statement presents the movement in cash and bank balances over a period of a business. The movement in cash flow is classified into the following segments:

Operating Activities: Represents the cash flow from primary activities of a business.

Investing Activities: Represents cash flow from the purchase and sale of assets other than inventories.(e.g. PURCHASE OF A FACTORY PLANT)

Financing Activities: Represents cash generated or spent on raising and repaying share

4. Statement of Change In Equity: Statement of change in equity also known as the statement of retained earnings, details the movement in owners equity over a period. The movement in owners equity is derived from the following components:

Net profit or net loss during the period as reported in the income statement.

Share capital issued or repaid during the period.

Dividend payments

Gains or losses recognized directly in equity(e.g. revaluation surpluses)

Effects of a change in accounting policy or correction of accounting error.

METHODS OF TECHNIQUES OF FINANCIAL STATEMENT ANALYSIS:

Financial statement analysis can be performed by a number of methods or techniques. The following are the important methods or techniques of financial statement analysis:

Ratio Analysis: ratio analysis is the analysis of the interrelationship between any two financial figures.

Cash Flow Statement Analysis: cash flow analysis is the analysis of the change in the cash position during a period.

Comparative Financial Statements: comparative financial statement is a analysis of financial statements of the company for two years or of the two companies of similar types.

Trend Analysis: Trend analysis is the analysis of the trend of the financial ratios of the company over the years.

The methods to be selected for the analysis depend upon the circumstances and the users need. The user or the analyst should use appropriate methods to derive required information to fulfil their needs.

Horizontal Analysis:

This analysis refers to the study of past consecutive balance sheets, income statements or statements of cash flow at a time.

The analysis can be made between two periods or over a series of periods.

The relevant accounting number of columns each representing a year.

Those figures can also be graphically presented.

The figures of each year are compared with those of base year i.e., the beginning year of the study.

This analysis is also called Dynamic Analysis as it covers several years of the study.

This analysis is very much effective for understanding the direction and trend of the organization particularly when it is undertaken for several years.

Comparative statements and trend analysis are two important tools that can be employed for horizontal analysis.

VERTICAL ANALYSIS:

Vertical Analysis is restricted to the financial statements of one particular period only.

It is known as vertical analysis of financial statements.

In this analysis each item of a particular financial statement is expressed as percentage of a base figure selected from the same statement.

It is also known as Static Analysis as it concentrates solely on one year's financial statement.

Common-size statements and accounting ratios are two important tools used for vertical analysis.

This analysis is very much useful for understanding the structural relationship of various items in a financial statement.

Vertical analysis can also be done for studying the relationship within a set of financial statements at a point of time.

ACCOUNTING STANDARDS

The need for accounting standards arise on account of fast changes in socio economic environment at global level necessitating to have uniform accounting practices so that the final statements give comparable and decision useful information to the users.

The specific reasons for the need of accounting standards include the following:

Varied accounting practices at local, regional levels gave rise to preparation of financial statements not projecting true and fair view of financial position.

After industrial revolution and formation of company form of organizations the size of business transaction has grown enormously.

The financial reports prepared by the corporation undertakings are open to the public apart from owners.

Now almost all countries are shifting from controlled economies to liberalized economies. This has resulted into free flow of goods, services and finance and led to establishment of multinational corporations all over the world.

Economic liberalization brought heavy competition among business organizations. Survival and success of these organizations depend on timely and appropriate decisions and their effective execution. This is possible when accurate, reliable and comparable timely information is provided to the executives. Information prepared on the basis of accepted accounting practices help the executives in this direction.

Features of Accounting Standards:

Accounting standards aims at producing a set of fairly presented financial statements.

A standard is an argued criterion of what is proper practice in a given situation.

A preferred accounting treatment from the available set of methods of treating one or more accounting problems.

Accounting standards are uniform rules for financial reporting applicable to either all or certain class of entity.

Accounting standards are written statements issued from time to time by institutions of accounting profession in the form of policy document.

They are relating to various aspects of measurement, treatment and disclosure of accounting transactions and events.

They are expected to be expressive of the deliberately chosen policies of the highest types of businessmen and the most experienced accountants.

Standards are not designed to conform practice with the rigid limits but rather to serve as guideposts to truth, honesty and fair dealing.

Standards act as basis for comparison and judgement.

They direct a high but attainable level of performance without precluding justifiable departures and variations in the procedures employed.

Standard setting process in India:

The Institute of Chartered Accounts of India constituted Accounting Standards Board (ASB) in India in April 1977, keeping in view the need for harmonizing diverse Accounting practices and developments at international level in the field of accounting.

Indian Accounting Standards:

The Institute of Chartered Accountants of India constituted the Accounting Standard Board on 21st April 1977.

It recognized the need to harmonize the diverse accounting policies and practices at present in use in India and also to fall in line with the developments in the field of accounting at International level.

The main function of Accounting Standard Board of India is to develop accounting standards so that they may be established by the Council of the Institute and to ensure that the established standards are accepted and adopted by the concerned parties in the preparation and presentation of financial statements.

So far the Accounting Standards Board finalized and submitted to the council of Institute of Chartered Accountants of India , 10 Accounting Standards.

AS 1: Disclosure of Accounting Policies.

AS 2: Valuation and Presentation of Inventories.

AS 3: Change in Financial Position.

AS 4: Contingencies and Events occurring after the Balance Sheet.

AS 5: Prior Period and Extra ordinary terms.

AS 6: Depreciation Accounting.

AS 7: Accounting for constitution contracts.

AS 8: Accounting for Research and Development.

AS 9: Revenue Recognition and

AS 10 : Account for Fixed Assets.

INTERNATIONAL FINANCIAL REPORTING:

Are formulated by international accounting standards board. This board comprises of accountants and other interested parties from different countries. U.S . does not follow IFRS but there is pressure on SEC to do so.

US-GAAP STANDARDS:

Generally Accepted Accounting Standards refers to the concepts , conventions or rules practiced in Accounting.

These principles are decided by regulatory agencies or professional associations. In India the accounting standards are set up by the private sector. Which has close ties with the accounting profession?

FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

The FASB is responsible for GAAP in the U.S.

The FASB (Estd in 1973) consists of 7 full time paid members who are mainly investors, managers, accountants and analysts.

It is funded by various professional accounting associations such as the American Institute of Certified Public Accountant (AICPA).

Standards are set up by FASB through a political procedure with participation by financial statement users. Therefore, standards may sometimes compromise solutions.

Securities and Exchange Commission (SEC)

Is an independent quasi judicial agency that administers the securities Act of 1933 and 1934 (disclosures related to public security offering)

FUNCTIONS OF SEC:

To Regulate Information disclosure by companies with publicly traded securities.

Monitor and ensure conformance with accepted practices.

SEC can override, modify or introduce accounting , reporting and disclosure requirements by FASB.

SEC involvement in accounting practice is determined by current public attitude and aggressiveness of its chief accountant.

US-GAAP Objectives:

The main objective of US-GAAP is to prepare, present and report the financial instruments in such a way that it should be useful to the potential investors and creditors in making investments.

The financial information should provide details of economic resources and change in them.

FOUNDAMENTAL QUALITIES OF FINANCIAL STATEMENTS:

The financial information provided must reflect measurable and comparable financial statements between different companies.

The financial information should help creditors to make decision for future.

It should be neutral timely available and more importantly reliable to the potential investors.

ASSUMPTIONS OF US-GAAP:

The business units of partnerships and sole trading proprietorship are separate from legal entities.

It also implies the going concern concept as the business prolongs for a long time.

It also assumes that the business operations can be separated into months Quarter's and years requiring for the comparison between past and present events.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA) RULE 203 of AICPA code of professional ethics states that no departures can be regarded as GAAP unless the member can demonstrate that due to unusual circumstances the financial statements would be misleading.

Such departments are rare and if they do exist, the report must describe the reasons for making it. In 1959 AICAP established Accounting Principles Board (APB) to make overall conceptual framework.

Thank Q