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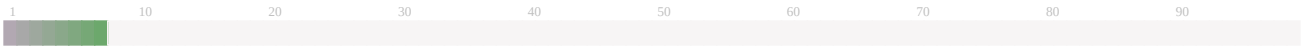

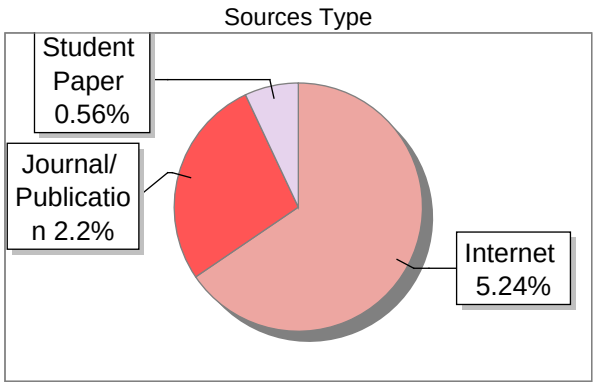

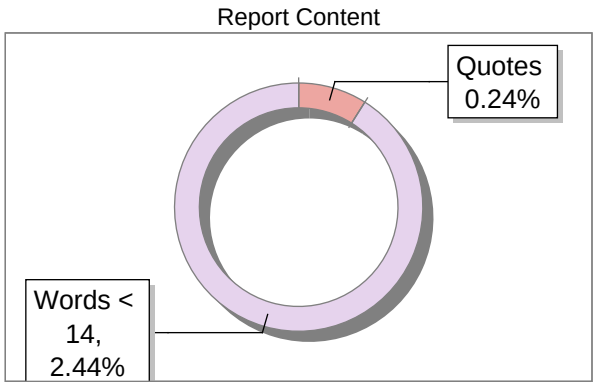

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CONTENT

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BLOCK-I: OVERVIEW OF ACCOUNTING

UNIT-1: ACCOUNTING CONCEPTS, CONVENTIONS AND PRINCIPLES;

STRUTURE

1.0 OBJECTIVES

After studying this unit you should be able to

- explain acknowledges income and costs as they are incurred or earned rather than at the time of money transfer.
- understand that financial statements correctly portray the financial situation, performance, and cash flows of a business is the main goal of accounting concepts, conventions, and principles.
- help consumers in making decisions that impact resource distribution.

1.1 INTRODUCTION

Accounting practices are built upon accounting ideas, norms, and principles. They offer rules and procedures that guarantee accuracy, consistency, and openness in financial reporting.

The foundation of financial reporting is made up of accounting ideas, standards, and principles, which direct the methodical documentation, examination, and dissemination of economic activity inside enterprises. These fundamental components create the structure that guarantees accuracy, consistency, and openness in accounting procedures.

Fundamental ideas like the entity concept—which distinguishes commercial transactions from personal matters—and the going concern concept—which presupposes the entity's ongoing existence—are at the heart of accounting principles. The cost idea requires assets to be originally recognized at historical cost, while the money measurement concept requires only transactions that

can be measured in monetary terms to be documented.

Accounting norms, which are guiding principles that aid in the interpretation and application of accounting rules, complement these ideas. For example, the convention on conservatism advocates for a cautious strategy that prioritizes acknowledging probable losses above speculative profits. In a similar vein, the consistency convention promotes gradual uniformity in accounting practices, which promotes dependability and comparability in financial reporting. To ensure that attention is focused on important information, the materiality convention, in the meanwhile, rules that it is not required to reveal unimportant things in financial statements.

Accounting principles also include rules for revenue recognition, cost-to-income matching, and relevant information disclosure. In line with the matching principle, which matches costs with matching revenues in the same time, the revenue recognition principle states that revenue must be recognized when generated and realized or realizable. In the meanwhile, in order to encourage openness and facilitate well-informed decision-making, the full disclosure principle requires the entire disclosure of all relevant facts.

All of these accounting terms, practices, and guidelines work together to create a strong foundation for financial reporting that makes it easier to produce the precise, timely, and trustworthy data needed for stakeholders' decision-making. By ensuring the comparability and integrity of financial accounts, its application promotes openness and confidence in the corporate sector.

1.2 ACCOUNTING CONCEPTS

Accounting plays a important role in a company by offering a methodical and structured approach to documenting its finances. However, it's crucial to adhere to a few guidelines provided by accounting ideas and conventions in order to implement the accounting operations effectively. Accurate adherence to accounting ideas and principles can support you in making well-informed business decisions that will propel your firm forward.

The idea of accounting refers to a procedure that aids in organizing bookkeeping procedures and preparing and documenting financial transactions inside an organization. Businesses are encouraged to incorporate and analyze financial transactions into significant accounting procedures when accounting ideas are used well.

It is always important for business owners and accountants to have a solid understanding of fundamental accounting concepts. This kind of comprehension aids in incorporating consistency and uniformity into firm accounting procedures.

Implementing accounting ideas and principles throughout the organization is crucial because they facilitate the analysis of various financial theories, regulations, and scenarios and the making of financial decisions in response to them.

1.2.1 Importance of Accounting Concepts

Once you comprehend the following reasons why understanding and using accounting ideas is importance for you, you will be able to comprehend the many parts of accounting concepts with clarity:

1. Reliability and uniformity

Accounting principles give financial reporting consistency and comparability, which makes them crucial. For instance, the idea of a "going concern" holds that a business will always exist. Because of this assumption, long-term perspective may be used to compile financial statements, facilitating meaningful comparisons over many accounting periods.

2. Risk control

Financial reporting should be done with caution, according to the prudence idea. This approach helps businesses manage risk by anticipating potential losses and only recognizing gains when they materialize. A prudent approach to risk management might be demonstrated, for instance, by making reserves for potential bad debts based on historical trends.

3. Assistance with choosing decisions

Accounting principles provide a standardized framework that enables organizations to swiftly and accurately compile financial transaction tracking information. Since revenues and expenses are recognized as they are incurred or generated, the accrual approach offers a more realistic picture of a company's financial status. Effective decision-making is aided by accurate financial reporting, which provides stakeholders with a thorough understanding of a company's profitability and financial health.

4. Authenticity

The use of accounting standards promotes stakeholder trust and increases the credibility of financial reporting. The matching idea ensures that income is in line with the spending necessary to create it, preventing profits from being artificially manipulated. This is achieved by matching revenues with their corresponding

expenditures. Creditors, investors, and other stakeholders that rely on financial statements to assess its viability and health are encouraged to trust it as a result.

1.2.2 Several Types of Accounting Concept

There are several **accounting concepts** that serve as the foundation for preparing and presenting financial statements. These concepts ensure consistency, comparability, and clarity in accounting practices. Below are the **main types of accounting concepts**:

1. The idea of business entity: By treating the business as distinct from its owner(s), the business entity concept ensures that all financial transactions are recorded from the company's perspective. This separation improves clarity, avoids confusion between personal and business finances, and supports accurate financial analysis.

2. The idea of money measurement: By recording only those transactions that can be measured in monetary terms, the money measurement concept ensures uniformity in financial reporting. This idea excludes qualitative factors, which enhances the objectivity and comparability of financial statements.

3. The idea of going concern: By assuming that the business will continue to operate in the foreseeable future, the going concern concept allows assets to be valued based on their ongoing use rather than liquidation value. This approach improves the relevance and continuity of financial information.

4. The idea of historical cost: By valuing assets at their original cost, the historical cost concept provides a strong and impartial basis for financial reporting. By reducing subjective values and

ensuring that asset acquisition expenses are appropriately represented in financial statements, this idea enhances reliability.

5. The idea of accounting period: By dividing the life of a business into specific time periods, the accounting period concept allows businesses to report financial performance regularly. This facilitates periodic assessment, regulatory compliance, and comparison over time.

6. The idea of dual aspect: By recognizing that every transaction affects two accounts, the dual aspect concept ensures that the accounting equation (Assets = Liabilities + Capital) always remains balanced. This concept forms the foundation of the double-entry bookkeeping system and supports accuracy in financial recording.

7. The idea of accrual basis: By recording revenues and expenses when they are earned or incurred, not when cash is exchanged, the accrual concept ensures that financial statements reflect the true financial performance and position of the business during a given period.

8. The idea of matching principle: By matching expenses with the revenues they help to generate within the same accounting period, the matching concept ensures that profit or loss is accurately determined. This alignment enhances the meaningfulness of income statements.

9. The idea of realization: By recognizing revenue when it is earned and realizable, not when payment is received, the realization concept improves the accuracy of income measurement.

It ensures that revenues are reported in the correct accounting period.

10. The idea of full disclosure: By requiring all relevant and material financial information to be disclosed, the full disclosure concept supports transparency and informed decision-making by users of financial statements. It helps in building trust and credibility.

11. The idea of consistency: By applying the same accounting methods and principles over different periods, the consistency concept enables meaningful comparisons of financial data. This stability strengthens the usefulness of financial information over time.

12. The idea of materiality: By focusing on information that is significant enough to influence decisions, the materiality concept allows accountants to ignore trivial details. This practical approach ensures that reports are both efficient and decision-relevant.

1.2.3 Examples of Applied Accounting Concepts

In order to use the previously described accounting ideas, you must have a practical comprehension of them. Each of the accounting concepts you read above has an illustration in the list below.

The notion of going concern

In this instance, a manufacturing company values its machinery and equipment on the balance sheet based on the expectation that it will be in use for an extended amount of time, suggesting that the company will carry on with operations eternally.

Concept of a business entity

A small business owner purchasing a laptop for personal use is protected from being recorded in the company's financial records by the firm entity concept, which maintains a distinct division between personal and business activities.

Accrual idea

A consulting firm that offers services, for instance, in December but gets paid in January, uses the accrual idea. Regardless of the actual amount of money received, the revenue is recognized in December when the service is rendered.

Concept of money measurement

A company guarantees that only transactions with measurable financial value are included in the financial accounts when it registers the purchase of a new piece of machinery.

Concept of accounting period

By releasing its financial performance and position every three months, a firm that generates quarterly financial statements adheres to the accounting period idea and provides stakeholders with timely insights into the company's progress.

Two-dimensional idea

The dual aspect principle ensures that when a business borrows money from a bank, the loan and its corresponding asset, cash, are recorded, maintaining the balance of the fundamental accounting equation.

Concept of revenue realization

Whenever a customer buys a software licence, a software company records revenue, regardless of when the money is received. This

use of the revenue realization idea relates to the process of earning income being finished.

Cost notion from the past

When a company purchases a building, the historical cost concept mandates that the asset be documented at the full cost of acquisition, providing a firm and impartial basis for the financial statement's worth.

1.3 ACCOUNTING CONVENTIONS

Accounting norms, also referred to as doctrine, are recognized as guidelines that serve as limitations for ambiguous or complex organizational transactions. Accounting conventions are generally recognized concepts that assist preserve uniformity in a company's financial statements, even though they are not legally obligatory.

The information is processed by the standard financial reporting system, which also analyzes its applicability, complete disclosure in the financial statements, and comparative analysis of the various elements of the transaction using accounting standards. These conventions are used by the company's accountants to serve as a guidance while creating accounting statements and reports.

1.3.1 The Significance of Accounting Conventions

It is essential that you comprehend the significance of accounting norms in order to grasp what they are. To understand the significance of accounting traditions in a firm, let's look at the following:

1. Ensures Consistency in Financial Reporting

By applying the same principles across periods and entities, accounting conventions such as the consistency convention ensure uniformity in financial reports. This allows users to make meaningful comparisons over time and across organizations.

2. Enhances Comparability

Accounting conventions help standardize how transactions are recorded and reported. For instance, the consistency and disclosure conventions enable stakeholders to compare financial data between different companies or accounting periods effectively.

3. Promotes Objectivity and Reliability

The conservatism convention ensures that financial statements are not overly optimistic, promoting a more cautious and balanced view. This builds trust in financial reports and helps protect users from misleading information.

4. Facilitates Full Disclosure

The full disclosure convention ensures that all relevant and material information is presented in financial statements. This improves transparency and enables investors, creditors, and regulators to make informed decisions.

5. Aids in Decision-Making

With consistent and reliable financial statements, internal and external stakeholders (like managers, investors, and creditors) can assess performance, financial health, and future potential with greater confidence.

6. Simplifies Audit and Regulation

Accounting conventions serve as a practical benchmark for auditors and regulators to evaluate whether financial statements are fair and in compliance with generally accepted practices.

7. Supports Legal and Tax Compliance

By promoting standardization, accounting conventions help businesses stay compliant with statutory requirements and tax regulations, reducing legal risks and penalties.

8. Addresses Practical Realities

Accounting conventions often deal with real-world business complexities that rigid rules might not fully cover. They provide flexibility and guidance in situations involving judgment and estimation.

1.3.2 Different Types of Accounting Convention

Accounting conventions, like accounting principles, come in several forms that facilitate the effective application of the idea in firm financial. The several kinds of accounting conventions are listed below:

1. The Convention on Conservatism

The conservative principle is one of the most significant accounting rules that accountants use in the workplace. According to this concept, the asset or income side of the financial statement should record the lower of two values that are related to a particular transaction. The risk of loss is addressed in this instance.

The goal of this accounting practice is to manage corporate losses by understating assets and earnings. The main benefit of this

technique is that it increases stakeholders' trust in the company's financial reporting.

2. The materiality convention

This accounting practice relates to all pertinent data that is accessible for a particular item or event in the financial operations of a business. In general, anything is deemed substantial if it has the potential to affect an investor's choice. Each organization has a different definition of materiality.

For example, in a small business, some information could be relevant, but in a huge organization, the same information might not be. As a result, the analysis's context determines how the materiality convention should be used.

3. Consistency convention

Consistency convention indicates that, year after year, the business financial statements must be prepared using the same accounting methods. When comparing the prepared financial statements across time, it's critical to get a relevant assessment of the same business from the statements.

Only when the company consistently adheres to the same accounting rules and procedures throughout time would such financial comparisons be possible. The comparison will be unfruitful if there are annual variations in the accounting procedures, and the outcome may also affect financial choices.

4. The Full Disclosure Convention

The full disclosure concept requires financial statements to fully disclose all relevant information. This calls for the full, unbiased,

and abundant disclosure of accounting data.

"Fair" suggests treating consumers equally, "adequate" indicates providing a sufficient quantity of information, and "full" necessitates a thorough and comprehensive presentation. As a result, the convention emphasizes how important it is that financial statements adequately disclose all relevant information.

1.3.3 Examples of Applied Accounting Conventions

After you've grasped the many accounting conventions, it's critical to possess a thorough understanding of them via an example. Let's look at some instances of each accounting convention that was covered in the section above.

Moderate Conservatism

Let's say Raj decides in December 2022 to buy a car from Mohan Motors Inc., and it gets delivered to him in January 2023. It's excellent news from Mohan Motors Inc.'s perspective. However, it is possible that the agreement will be violated in the future as a result of certain unanticipated events.

Therefore, in accordance with conservative precedent, the money received from the sale of the automobile is not recorded in the books until it is actually delivered.

Contentment

Assume for the moment that a major company has lost Rs. 150,000 as a result of a certain client. The company has a net value of about Rs. 300,000,000. Therefore, the firm might consider the loss of 0.05% to be insignificant.

Nonetheless, a loss of Rs. 150,000 will be regarded as a loss of

significant information for a small organization with a net value of Rs. 250,000. Consequently, the use of materiality for both enterprises is defined by the circumstances and environment.

Regularity

For all fiscal years, an organization must calculate depreciation on all of its fixed assets using the same methodology. This contributes to preserving consistency in the depreciation findings over time.

Complete Disclosure

Information on encumbered assets is often disclosed in full by a firm. Notifying the stakeholders of the rationale behind any changes to the application of accounting principles or procedures is another example of a corporation providing full disclosure of information.

1.4 DIFFERENCES BETWEEN ACCOUNTING CONCEPTS AND CONVENTIONS

Here's a clear and structured comparison of the differences between accounting concepts and accounting conventions:

Basis of Difference	Accounting Concepts	Accounting Conventions
Meaning	Fundamental theoretical ideas or assumptions that form the foundation of accounting.	Generally accepted practices developed over time through common usage and tradition.
Nature	Theoretical and mandatory principles.	Practical and flexible guidelines.

Basis of Difference	Accounting Concepts	Accounting Conventions
Objective	To provide a basic framework for recording and reporting financial transactions.	To standardize the application of concepts in a practical, consistent, and comparable way.
Authority	Recognized and enforced by accounting standards and regulatory bodies.	Evolved through general acceptance and practice, not strictly enforced by law.
Examples	Business Entity, Going Concern, Money Measurement, Dual Aspect, Accrual, Matching.	Consistency, Conservatism, Materiality, Full Disclosure.
Application	Must be followed strictly for accurate and fair financial reporting.	Applied when relevant and practical, subject to professional judgment.
Flexibility	Less flexible; concepts must be applied universally.	More flexible; can vary depending on the situation and materiality.
Purpose	To ensure a logical, accurate, and fair system of accounting.	To ensure clarity, comparability, and simplicity in financial reporting.

1.5 ACCOUNTING PRINCIPLES

The general rules and standards pertaining to accounting transactions that are adhered to in order to correctly generate financial statements are known as accounting principles. These guiding concepts serve as the foundation for properly compiling

and documenting financial data for analysis. Generally Accepted Accounting Principles, or GAAP, is another name for these accounting guidelines.

These guidelines guarantee that the quality of a company's financial information is enhanced as effectively as feasible and serve as a guide for accountants doing financial analysis. Additionally, following the guidelines helps accountants create accurate and consistent accounting data. Comparing the financial information of several organizations over time is also beneficial to organizational stakeholders.

Why Accounting Principles Are Used

Accounting standards are primarily designed to ensure that a company's financial records and statements are clear and concise. Understanding accounting principles accurately facilitates investors' ability to obtain and analyze relevant information from financial statements.

Additionally, by preventing fraud from occurring during the accounting process, these regulations contribute to the transparency of firm finances. The identification of any suspicious activity in the company's finances facilitates the comparison of the information over a given time frame.

1.5.1 Accounting Principles' Significance

Accounting principles are deemed significant for a firm for several reasons. The following is a discussion of them:

- To create financial statements that are thorough, dependable, and profitable, adherence to certain criteria is necessary.

- For financial reporting, this idea calculates the costs, income, liabilities, profit, assets, and losses.
- Accounting principles make it simple to compare financial statements and data.
- The financial system remains transparent, and it is feasible to detect financial fraud effectively.
- In order to make financial decisions, investors can analyze and total important information with the help of accounting principles.

1.5.2 Different Types of Accounting Principle

To execute suitable financial procedures and make wise judgments, investors and accountants adhere to a variety of accounting rules. The list appears below.

The Accrual Principle

The accrual concept of accounting records revenue and expenses as they are incurred or spent, regardless of when money is transferred. It ensures that a company's performance and financial status are accurately represented in its financial statements at all times.

Principle of Conservatism

The concept of conservatism instructs accountants to use caution when identifying possible benefits, acknowledging them only upon realization, and to recognize potential losses as soon as they seem likely. This rule encourages caution in financial statements by protecting against overly optimistic reporting.

Principle of Cost

According to the cost principle, assets are first recorded at their historical cost, guaranteeing the accuracy and reliability of

financial reporting. Although future depreciation or impairment adjustments could be necessary, the idea puts the actual transaction values first.

Principle of Revenue Recognition

According to this idea, revenue must be recognized as soon as it is earned and realised. It guarantees that revenue is not prematurely acknowledged and represents the actual value a firm has earned.

Economic Entity Principle

The economic entity principle distinguishes between personal and business money. By treating the company as a distinct accounting entity, it reduces the amount of personal and business assets and liabilities combined and enhances financial transparency.

Principle of Consistency

The notion of consistency promotes consistency in accounting practices throughout time periods. It encourages financial statement comparability throughout time, enabling stakeholders to see patterns and reach well-informed conclusions.

The Objectivity Principle

The objectivity principle states that financial data must be trustworthy and impartial. It highlights the necessity of depending on objective facts rather than subjective assessments to guarantee the reliability of financial data.

Taking Care of Business Principle

Unless there is compelling proof to the contrary, a corporation is presumed to go on operating indefinitely under the continuing concern concept. Realistic financial reporting is encouraged by enabling the appraisal of assets and liabilities as though the

company will always be in operation.

1.5.3 Features of Accounting Principles

Understanding the features of various accounting principles is crucial before incorporating them into your accounting procedures. They are listed below.

- The regulations are designed to promote consistency and facilitate comprehension of various accounting data.
- The fundamentals are dynamic in nature. It may alter over time in response to modifications to corporate procedures, governmental laws, and user requests for accounting.
- Accounting principles are developed based on experiences and motivations. They are not always appropriate and might change depending on the specific company situation.

1.5.4 Characteristics of Accounting Principles

The fundamental components of accounting concepts are three. It is covered in the section below.

1. Utility

If a generally accepted accounting principle (GAAP) does not meet the needs of its users, it will not be relevant or valuable. These guidelines give accountants and other stakeholders the information they need.

2. Reliability

The use of accounting concepts is necessary. If costs are constantly changing, maybe as a result of shifting market pricing, the bookkeeper will find it challenging to reflect such changes in the books. Because of this, accounting regulations are very lenient in

this area.

3. Neutrality

Any rule that is supported by precise data and facts may be rationalized objectively. When it comes to include accounting data in the books, there are no external or personal prejudices at play; if there were, the usefulness of these values would be restricted and would not align with company needs.

1.6 LET US SUM UP

Accounting professionals need to analyze many elements of accounting principles and norms. The use of these two factors influences many financial and commercial decisions. Notwithstanding their differences, both must be used in the creation of financial statements in order to improve the company. As a result, after reading the points, you will have a clear understanding of what they are and how to use them to grow your company.

In general, it's critical to comprehend accounting concepts before putting accounting procedures in place in a company. It will support maintaining transparency of financial occurrences and assist retain a seamless financial track record. To prevent mistakes in financial records and provide correct results, even if you are a newbie accountant, make sure you understand the many kinds and attributes of accounting principles.

1.7 KEY WORDS

Accrual Idea: According to this idea, transactions are recorded as soon as they happen, regardless of when money is received or paid. Put differently, regardless of the timing of cash flows, revenues are reported when generated and costs are recorded when incurred.

Principle of Conservatism: Often referred to as the "prudence principle," it states that the technique of accounting that yields the lowest profits or asset values should be used when there are several suitable options. Avoiding overstating assets or income is the goal of this approach.

Principle of Consistency: According to this concept, an accounting system or principle must be consistently used from one accounting period to the next after it has been approved. Financial information is reliable and comparable when reporting is consistent.

Concept of Going Concern: Unless there is proof to the contrary, this idea presupposes that a firm will continue to run indefinitely. The premise that the business won't go out of business anytime soon serves as the foundation for the creation of financial statements.

Principle of Materiality: The importance of a thing or event to the financial statements is referred to as materiality. According to the materiality principle, information about financial statements should only be revealed if it is significant enough to affect the choices made by those who use them.

Principle of Objectivity: Also referred to as the concept of neutrality, it stipulates that financial statements must be supported by independent, verifiable data. Recordings of events and transactions ought to be made based on factual information rather than subjective judgment or prejudice.

Principle of Revenue Recognition: When revenue is recorded in the accounting records, it must be recorded according to this principle. When money is earned, realized, or realizable—that is, when the products or services are provided or rendered and payment is conceivably guaranteed—it is usually reported as revenue.

Principle of Consolidation: To give a genuine and fair picture of the group's performance and financial condition, the financial results and positions of a parent business and its subsidiaries are merged into a single set of financial statements. This concept is employed in consolidated financial statements.

Principle of Cost: The historical cost principle, which is sometimes referred to as the cost principle, specifies that assets must be documented at the original cost rather than the current market value or another valuation. This idea offers a trustworthy and impartial foundation for asset valuation.

1.8 REVIEW QUESTIONS

Q1. What is the accrual concept in accounting, and how does it differ from the cash basis of accounting?

Q2. Provide an example of how the accrual concept affects the recognition of revenue or expenses in financial statements.

Q3. Explain the conservatism principle in accounting and why it is important.

Q4. How does the conservatism principle influence the treatment of uncertain events or transactions in financial reporting?

Q5. What is the consistency principle, and why is it important for financial reporting?

Q6. Provide an example of how the consistency principle is applied in accounting practices.

Q7. Explain the matching principle and its role in determining the timing of recognizing expenses.

Q8. Discuss the objectivity principle in accounting and why it is essential for financial reporting.

Q9. How can accounting professionals ensure the application of the objectivity principle in practice?

Q10. Explain the revenue recognition principle and its significance in accounting.

Q11. What is the cost principle, and why is it used in accounting?

Q12. Explain how the cost principle differs from the fair value principle in asset?

UNIT 2 ACCOUNTING EQUATION, INTERNATIONAL ACCOUNTING PRINCIPLES AND STANDARDS;

STRUTURE

2.0 OBJECTIVES

After studying this unit you should be able to

- preserving accuracy, uniformity, and openness in financial reporting across nations and organizations.
- standardize the terminology and procedures that accountants must employ in order to analyze financial data.
- preserve equilibrium between a company's assets, liabilities, and owner equity at all times.
- helps in the development of well-informed judgments about investments, resource allocation, and strategy planning

2.2 INTRODUCTION

The foundation of financial accounting is the Accounting Equation, which provides the basic structure for documenting and summarizing a business's financial activities. According to this formula, the assets of a business are equal to the liabilities plus the owner's equity. The resources that the business owns and controls, such as money, stock, and real estate, are represented by its assets. Accounts payable and loans to other parties are examples of the company's liabilities. Owner's equity is the owners' investment in the firm and is the remaining stake in the company's assets after its obligations have been subtracted. Every transaction is guaranteed to have two effects by the Accounting Equation, which keeps the balance in the business's financial records.

International Accounting Principles and Standards are vital in promoting transparent and comparable financial reporting and standardizing accounting procedures among various nations on a worldwide scale. These rules offer instructions for creating financial statements that appropriately depict a company's financial performance and condition. They are principally represented by the International Financial Reporting Standards (IFRS) and the Generally Accepted Accounting Principles (GAAP). More than 140 nations have embraced IFRS, which was created by the International Accounting Standards Board (IASB), encouraging uniformity and openness in financial reporting around the globe. The United States is the primary user of GAAP, which guarantees consistency and dependability in financial reporting inside its borders. When combined, these international accounting standards highlight values like caution, uniformity, and fair presentation, which improve financial information's legitimacy and openness for

regulators, investors, and other stakeholders throughout the world.

2.2 ACCOUNTING EQUATION

The fundamental components of the double-entry accounting system are summed up by the accounting equation. It states that assets always equal the total of liabilities and equity and that debits always equal credits. The link between the business's assets, liabilities, and owner equity is known as the accounting equation.

A basic accounting theory, double-entry bookkeeping is based on the Accounting Equation. It says as follows:

- Liabilities plus Owner's Equity equals Assets
- Liabilities plus Owner's Equity equals Assets

This formula guarantees that the accounting system stays balanced and that each financial transaction impacts two or more accounts. Here's a quick rundown of each element:

Assets are resources that a firm owns or controls that have a monetary worth. Examples of these resources include money, merchandise, real estate, and equipment.

Liabilities: A company's debts, loans, and accounts payable are all examples of its commitments to third parties.

Owner's Equity: The ownership stake in the company is reflected in owner's equity, which is also referred to as net worth or shareholders' equity. Retained earnings, or profits invested back into the company, are added to the original investment made by the

owner or owners.

The foundation for creating financial statements is the Accounting Equation, which offers a moment in time view of a business's financial status.

2.3 RULES FOR ACCOUNTING EQUATIONS

The **accounting equation** is the foundation of the double-entry system of accounting. It represents the relationship between a company's assets, liabilities, and owner's equity:

Accounting Equation:

\text{Assets} = \text{Liabilities} + \text{Owner's Equity}

To maintain this equation, certain **rules** must be followed whenever transactions occur. These rules ensure that the equation remains balanced after every financial transaction.

Basic Rules for Accounting Equations:

1. Every transaction affects at least two accounts

- For the equation to stay balanced, each transaction must be recorded in such a way that at least two components (Assets, Liabilities, or Equity) are affected.

2. Increase in assets must be matched by:

- An equal increase in liabilities, or
- An equal increase in owner's equity, or
- A decrease in another asset.

3. Decrease in assets must be matched by:

- A decrease in liabilities, or
- A decrease in owner's equity, or
- An increase in another asset.

4. Increase in liabilities must be matched by:

- An increase in assets, or
- A decrease in owner's equity (in rare cases like losses).

5. Decrease in liabilities must be matched by:

- A decrease in assets, or
- An increase in owner's equity (if liabilities are paid off by profits).

6. Increase in owner's equity results from:

- Profits earned, or
- Capital introduced by the owner(s).

7. Decrease in owner's equity results from:

- Losses incurred, or
- Drawings (withdrawals by the owner), or
- Expense recognition.

Examples of Transactions and Their Effect on the Equation:

Transaction	Effect	New Equation
Owner invests ₹10,000 in business	+₹10,000 Assets (Cash), +₹10,000 Owner's Equity (Capital)	Assets ↑, Equity ↑
Purchase goods for cash ₹4,000	+₹4,000 Inventory, -₹4,000 Cash	Asset ↑, Asset ↓ (no net change)
Take loan from bank ₹5,000	+₹5,000 Cash, +₹5,000 Liability (Loan)	Assets ↑, Liabilities ↑
Pay ₹1,000 rent	-₹1,000 Cash, -₹1,000 Owner's Equity (as expense)	Assets ↓, Equity ↓
Sell goods for ₹6,000 (cost ₹4,000)	+₹6,000 Cash, -₹4,000 Inventory, +₹2,000 Profit (Equity ↑)	Assets ↑, Equity ↑

2.4 FUNDAMENTALS OF ACCOUNTING EQUATIONS

The equation for the balance sheet is always: asset = liability + owner equity.

It is important to remember that the "Balance Sheet Equation" is also known as the basic accounting equation. The following equation explains why the balance sheet always balances:

Liabilities plus Owner Equity equals assets: The three main components of the balance sheet are the elements of this equation: assets, liabilities, and owner's equity. The bookkeepers and accountants use the equation above to make sure that the "balance"—that is, that both sides of the equation—always holds.

Total debits and total credits are always equal. Total debits minus total credits : When a corporation uses a double-entry bookkeeping system, the accounting equation is an expansion of the "Basic Equation" to incorporate an additional basic rule that pertains to every accounting transaction.

Credits minus Debits

The following is summarized by this accounting equation:

- Any occurrence that affects an account should result in an equal amount of debit and credit.
- The balance is the same for each pair of "entries" that follows a transaction because the total of all debit entries must equal the total of all credit entries throughout any given time period.

- When accountants prepare financial statements, this equation acts as a crucial kind of integrated error checking system.

2.5 TYPES OF ACCOUNTING FORMULAE AND CORRELATION FORMULAE

The accounting equation, sometimes referred to as the "Balance Sheet Equation," is the foundation of all financial accounting. The many forms of fundamental accounting equations are as follows:

- **Capital + Liability Equals Asset**
- **Capital - Assets = Liabilities**
- **Capital (owners' equity) = Assets - Liabilities**

Liabilities plus Owner's Equity equals Assets

According to this equation for the balance sheet, every asset that the firm has is either financed by the owners' equity or by the amount that the business should owe suppliers or loans.

Owner's equity plus assets equals liabilities.

The liabilities you owe other people in the form of payables to banks, suppliers, and other parties make up the difference between your assets and the owner's investment in the firm.

Equity held by Owners = Assets - Liabilities

The value of assets held only by owner equity is shown by this equation.

We may see that when attempting to establish this link, profits or revenues will raise owner equity and costs, while losses will lower them.

2.6 ACCOUNTING EQUATION EXAMPLES

Here are some **clear and simple examples** of the **accounting equation** in action:

1. Accounting Equation Formula:

Assets=Liabilities+Owner’s Equity\text{Assets} = \text{Liabilities} + \text{Owner's Equity}Assets=Liabilities+Owner’s Equity

Example 1: Capital Invested

Transaction: Owner invests ₹50,000 cash into the business.

- **Effect:**
  - Cash (Asset) increases by ₹50,000
  - Owner's Equity increases by ₹50,000

2. Accounting Equation:

Assets (Cash ₹50,000)=Liabilities (₹0)+Owner’s Equity (₹50,000)\text{Assets (Cash ₹50,000)} = \text{Liabilities (₹0)} + \text{Owner's Equity (₹50,000)}Assets (Cash ₹50,000)=Liabilities (₹0)+Owner’s Equity (₹50,000)

Example 2: Purchase of Equipment with Cash

Transaction: Business purchases equipment worth ₹20,000 in cash.

- **Effect:**
  - Equipment (Asset) increases by ₹20,000
  - Cash (Asset) decreases by ₹20,000

3. Accounting Equation:

Assets (Cash ₹30,000 + Equipment ₹20,000)=Liabilities (₹0)+Owner's Equity (₹50,000)\text{Assets (Cash ₹30,000 + Equipment ₹20,000)} = \text{Liabilities (₹0)} + \text{Owner's Equity (₹50,000)}Assets (Cash ₹30,000 + Equipment ₹20,000)=Liabilities (₹0)+Owner's Equity (₹50,000)

Example 3: Loan Taken from Bank

Transaction: Business takes a loan of ₹25,000 from a bank.

- **Effect:**
  - Cash (Asset) increases by ₹25,000
  - Liabilities increase by ₹25,000

4. Accounting Equation:

Assets (₹75,000)=Liabilities (₹25,000)+Owner's Equity (₹50,000)\text{Assets (₹75,000)} = \text{Liabilities (₹25,000)} + \text{Owner's Equity (₹50,000)}Assets (₹75,000)=Liabilities (₹25,000)+Owner's Equity (₹50,000)

Example 4: Purchase of Inventory on Credit

Transaction: Purchased goods worth ₹10,000 on credit.

- **Effect:**
  - Inventory (Asset) increases by ₹10,000
  - Liabilities (Creditors) increase by ₹10,000

5. Accounting Equation:

Assets (₹85,000)=Liabilities (₹35,000)+Owner's Equity (₹50,000)\text{Assets (₹85,000)} = \text{Liabilities (₹35,000)} + \text{Owner's Equity (₹50,000)}Assets (₹85,000)=Liabilities (₹35,000)+Owner's Equity (₹50,000)

Example 5: Sale of Goods (Cost ₹6,000, Sold for ₹10,000)

Transaction: Goods sold for ₹10,000 (cost ₹6,000). Cash received.

- **Effect:**
  - Cash (Asset) increases by ₹10,000
  - Inventory (Asset) decreases by ₹6,000
  - Profit (₹4,000) increases Owner's Equity

6. Accounting Equation:

Assets (₹89,000)=Liabilities (₹35,000)+Owner’s Equity (₹54,000)\text{Assets (₹89,000)} = \text{Liabilities (₹35,000)} + \text{Owner's Equity (₹54,000)}Assets (₹89,000)=Liabilities (₹35,000)+Owner’s Equity (₹54,000)

Example 6: Payment of Expenses ₹3,000

Transaction: Paid office rent ₹3,000.

- **Effect:**
  - Cash (Asset) decreases by ₹3,000
  - Owner's Equity decreases by ₹3,000 (as expense reduces profit)

Accounting Equation:

Assets (₹86,000)=Liabilities (₹35,000)+Owner’s Equity (₹51,000)\text{Assets (₹86,000)} = \text{Liabilities (₹35,000)} + \text{Owner's Equity (₹51,000)}Assets (₹86,000)=Liabilities (₹35,000)+Owner’s Equity (₹51,000)

These examples show how each transaction affects the accounting equation while **keeping it always balanced**.

2.7 INTERNATIONAL ACCOUNTING PRINCIPLES AND STANDARDS;

Guidelines and regulations known as International Accounting Principles and Standards were developed in order to harmonize accounting procedures among various nations and legal systems. These guidelines are meant to guarantee financial reporting's dependability, comparability, and openness. Important elements consist of:

International Accounting rules Board (IASB) developed the International Financial Reporting Standards (IFRS), an internationally recognized set of accounting rules that are utilized by businesses across more than 140 nations. It addresses a number of financial reporting topics, such as financial information disclosure, measurement, presentation, and recognition.

GAAP stands for "Generally Accepted Accounting Principles," which are the rules and regulations governing accounting in the US. Despite not being seen as worldwide, GAAP has a significant impact on the world economy because of the size and importance of the US economy. The Financial Accounting Standards Board (FASB) is in charge of GAAP, which attempts to offer a foundation for transparent and uniform financial reporting.

The aforementioned principles and standards are designed to guarantee that financial statements precisely depict a firm's financial performance and status. They place particular emphasis on ideas like materiality, fair presentation, consistency, and reasonableness. Investors, creditors, regulators, and other stakeholders gain when these standards are followed because they

improve financial reporting's credibility, comparability, and openness.

2.8 LET US SUM UP

The essential foundation for documenting financial transactions and guaranteeing that a company's resources are appropriately accounted for is provided by the accounting equation, Assets = Liabilities + Equity. It draws attention to the connection between an organization's equity and liabilities, which stand for what the firm owes its shareholders, and its assets, which reflect what the company owns.

International Financial Reporting rules (IFRS) are one set of rules and principles for international accounting that offer guidelines for financial reporting that support uniformity, transparency, and cross-border comparability. These guidelines place a strong emphasis on materiality, comparability, accrual basis accounting, going concern assumption, fair presentation, and content over form. Following these guidelines guarantees that a company's cash flows, performance, and financial status are appropriately reflected in financial statements, allowing creditors, investors, regulators, and other stakeholders to make well-informed decisions. Multinational corporations that want to function effectively in international marketplaces and win over investors from all over the world must adhere to international norms.

2.9 KEY WORDS

Assets: Assets are resources that a firm owns or controls; they usually have monetary worth and the potential to provide gains in the future.

Liabilities: Debts or obligations due by a company to outside parties that call for the forfeiture of future profits.

Equity: Equity is the owners' remaining stake in an entity's assets following the deduction of its obligations. It is the asset-based claim of the owners.

Transparency: The idea that financial data should be presented in an easily comprehensible, transparent, and accessible way to help readers of financial statements make well-informed decisions.

Consistency: The idea that, in order to allow for meaningful comparisons over time, financial statements should be prepared using consistent accounting principles and procedures from one period to the next.

Comparability: The capacity to evaluate financial data from several companies or time periods in order to make sure that the information in financial statements is pertinent and helpful to users.

Fair Presentation: The need to provide financial statements in a way that gives an accurate and impartial picture of the status, performance, and cash flows of the business.

Going Concern: The financial statements are prepared based on the premise that a business will continue to function indefinitely, unless there is evidence to the contrary.

Compliance: Making sure that financial statements are prepared and presented in accordance with all applicable laws, rules, and accounting standards.

Global markets: The worldwide network of linked financial markets where multinational corporations raise capital, exchange securities, and carry out commercial activities.

Stakeholders: People or organizations that have an interest in the operations, performance, or activities of a business, such as suppliers, customers, workers, shareholders, and the general public.

Regulations: Guidelines and standards set out by governmental agencies or regulatory groups to control corporate behavior and operations, including obligations for financial reporting.

2.10 REVIEW QUESTIONS

Q1. Describe the accounting equation's importance in relation to financial reporting.

Q2. What impact does a transaction have on the accounting formula? Give instances.

Q3. What are the parts of the accounting equation and what connections exist between them?

Q4. How can the accounting equation aid in the comprehension of a business's performance and financial health by stakeholders?

Q5. Talk about the value of financial reporting transparency and how it relates to international accounting standards.

Q6. What are the advantages of adhering to international accounting standards for multinational companies that have operations across borders?

Q7. Describe how international accounting rules' financial reporting takes the going concern assumption into consideration.

UNIT 3 MATCHING OF INDIAN ACCOUNTING STANDARDS WITH INTERNATIONAL ACCOUNTING STANDARDS.

STRUTURE

3.0 OBJECTIVES

After studying this unit you should be able to

- improve financial reporting's reliability, comparability, and openness on a national and worldwide level.
- synchronize Indian accounting procedures with global industry standards.
- draw insightful comparisons between foreign and Indian businesses to aid in decision-making.
- more accurate and trustworthy financial statements through enhanced financial reporting, which includes better

measurement, identification, and disclosure of financial information.

3.1 INTRODUCTION

An important step in India's path toward global financial integration and harmonization of accounting procedures is the process of aligning Indian Accounting Standards (Ind AS) with International Accounting Standards (IAS). This project is a reflection of the country's dedication to implementing globally accepted accounting standards and promoting financial reporting that is transparent, comparable, and credible.

The initiative's beginnings can be linked to the expanding globalization of company operations and the globalization of financial markets. In order to enable cross-border transactions and boost investor trust, Indian firms had to align with globally accepted accounting standards as they grew internationally and sought foreign investment.

The widely used Indian Generally Accepted Accounting Principles (GAAP) have been replaced by Ind AS, which is mostly based on International Financial Reporting Standards (IFRS). This change is a result of the realization that following international standards can have a number of advantages, such as greater comparability of financial data, more financial transparency, and easier access to foreign capital markets.

The full study and adjustment of current accounting standards to maintain compatibility with worldwide norms while taking into consideration the particular regulatory, economic, and cultural

settings of India is required in the process of aligning Ind AS with IAS. To address particular issues and complexity, this approach frequently involves lengthy consultations with a variety of stakeholders, including regulators, standard-setting agencies, industry experts, and the accounting profession.

Furthermore, the need to harmonize India's accounting methods with international best practices and standards makes the adoption of Ind AS a strategic necessity rather than just a technical one. It is a major move in the direction of principles-based accounting, prioritizing content over form and raising the standard and applicability of financial reporting.

The process of aligning Indian Accounting Standards with International Accounting Standards is a continuous one, characterized by constant improvement and adjustment to changing regulatory needs and international accounting standards. Even though there have been great advancements in this area, there are still obstacles to overcome, such as the requirement for capacity building, continuous training, and stakeholder awareness raising to guarantee compliance and successful implementation.

3.2 ACCOUNTING STANDARDS IN INDIA

The ICAI acknowledges that in contemporary global times, a worldwide standard is necessary. As a result, the Indian government and ICAI chose not to embrace IFRS in its current form. Rather, it presented the Indian AS, or Ind AS as it is commonly called. Let's examine Indian AS in detail, going over its background and some of its key ideas.

3.2.1 AS in India

The organization responsible for establishing India's accounting standards is the Institute of the Chartered Accountants of India (ICAI). The International Financial Reporting Standards (IFRS) transition was started in 2006 by ICAI. The IFRS are published by the International Accounting Standards Board (IASB). The Indian corporates' financial statements will be more widely accepted and transparent on the international stage as a result of the ICAI's move to IFRS.

The first step was a detailed analysis of the IFRS regulations by the government and ICAI. They then made the decision to merge it. The Indian AS was developed by the Accounting Standards Board (ASB). It has made every effort to maintain them consistent with IFRS. Only utterly necessary adjustments were done.

After consulting with the National Advisory Committee on Accounting Standards (NACAS), the Central Government of India released Indian Accounting Standards. It carried out this action under the direction and oversight of the ICAI Accounting Standards Board (ASB).

Indian Accounting Standards (Ind AS) are important because they make it easier for money to move across borders and for financial statements to be listed and compared globally. This in turn makes international investment easier and benefits all parties involved in the capital market. It improves the investor's capacity to conduct a worldwide comparison of the investments. Thus, there is a lower chance of making poor decisions. Additionally, it does away with the expensive requirements for financial statement reinstatement.

3.2.2 Indian Accounting Standards' applicability

The Ministry of Corporate Affairs delayed the implementation of

Indian AS from its original 2011 deadline owing to a number of problems. The Finance Minister declared in July 2014 that Ind AS will be applied immediately. The Companies (Indian Accounting Standards) Rules were released in February 2015 by the Ministry of Corporate Affairs. As a result, it updated the firms' implementation plan for Ind AS and removed the sections pertaining to banking, insurance, and non-bank financial institutions.

According to the announcement, Ind AS will be optional starting on April 1, 2015, and required starting on April 1, 2016. Afterwards, it released the implementation roadmap for NBFCs, banks, and insurance providers.

3.3 INDIAN ACCOUNTING STANDARDS ADOPTION PHASES

The phased implementation of Ind AS has been notified by the Ministry of Corporate Affairs. This notice is aided by certain kinds of corporations according to their listing status and net worth.

1. First Phase

Indian AS became mandatory for all firms as of April 1, 2016, given that:

Is the firm listed or unlisted?

Its net worth is less than or equal to ₹ 500 crores. To determine net worth, use data from the last three fiscal years (ending on March 31, 2014, March 31, 2015, and March 31, 2016).

2. Second Phase

Indian AS is mandatory for all firms as of April 1, 2017, given

that:

Either it has been listed or it is in the process.
Its net value, on any of the aforementioned dates, is between >= and ₹ 500 crores.
Utilizing data from the preceding four fiscal years (31.03.2014, 31.03.2015, 31.03.2016, and 31.03.2017), determine net worth.

3. Third Phase

With effect from April 1, 2018, all banks, NBFCs, and insurance businesses were required to comply with Phase III Indian AS, provided:

As of April 1, 2018, net worth is greater than ₹ 500 crores.
With effect from April 1, 2018, IRDA has announced a distinct set of Ind AS for Banking and Insurance Companies. NBFCS includes venture capitalists, stockbrokers, core investment businesses, and so on.

Utilizing data from the preceding three fiscal years (31.03.2016, 31.03.2017, and 31.03.2018), determine net worth.

4. Four Phase

Indian AS will be required to be applied to all NBFCs as of April 1, 2019, given that:

Net value is between ₹ 250 and ₹ 500 crores.
Businesses may choose to freely or involuntarily adhere to Ind AS. However, once a business adopts Ind AS, it cannot go back to using its previous accounting procedure.

When Ind AS is adopted by a business, it will instantly be applied

to:

all of its subsidiaries, holding companies, affiliated firms, and joint ventures, regardless of each company's unique qualification.

Net worth is calculated as follows: total paid-up share capital plus all reserves made from earnings and securities premium; net worth minus cumulative losses; delayed expenses; and other expenses not written off.

Only capital reserves derived from government grants and promoter contributions should be included. It shouldn't include depreciation write-backs in capital reserves or reserves resulting from asset revaluations.

3.4 IFRS AND AS CONVERGENCE

Every nation has its own set of accounting rules and policies. However, the state of the world economy has drastically changed in the last several decades. Transnational corporations now function in several different countries. Thus, the need for a worldwide standard has emerged. Here's where IFRS become relevant. Let's investigate it further and the necessity of bringing it into line with Indian Accounting Standards.

IFRS stands for International Financial Reporting Standards.

International Accounting Standards group (IASB), a group located in London, released International Financial Reporting Standards (IFRS) in an effort to provide a single, consistent accounting standard. The general guidelines and norms for financial reporting are outlined in these standards, which are founded on principles.

Our world economy is very linked right now. Businesses raise money from all across the world. Additionally, they advertise and sell their goods abroad. As such, they also have tax obligations in a number of other nations. As a result, there is now a need for an international accounting standard.

The ultimate objective of the IFRS is to use standardized accounting to create a single global language for international commerce. Therefore, if a business deals with many nations, it only releases a single set of financial statements that satisfy the legal requirements of each nation in which it conducts business. Additionally, readers of these financial statements will find it much simpler to compare them if there is a worldwide standard.

In general, the IFRS include the following:

- 13 International Accounting Standards (IFRS) 28 (published prior to IFRS)
- 15 Ways to Interpret the IFRIC
- Nine Standard Interpretation Committee (SIC) interpretations

The IASB is updating these international standards throughout time to reflect contemporary practices. Global convergence is the ultimate aim, but they have begun by concentrating on Europe. The International Financial Reporting rules (IFRS) are now the accounting rules in around 120 nations. Ninety of these nations have fully integrated, or adhered to IFRS. These 120 nations include the UK, Australia, Canada, Japan, and so on.

3.5 THE CONVERGENCE OF INDIAN AS AND IFRS

The Ministry of Corporate Affairs notifies the Accounting Standard Board (ASB) of the ICAI, which develops Indian Accounting Standards. The economic climate and customs of India have been taken into consideration when crafting these standards. They are designed to meet the needs of Indian corporations and the government's transparency regulations.

In contrast, the global norms and environment are taken into consideration while creating the IFRS. Bridging the gap between the two, the India AS and the IFRS, would be the definition of convergence. Achieving convergence will need the two sets of standards to align. Adopting the IFRS policies fully or at least substantially achieves the compromise.

These are a few advantages of convergence.

1] Positive Impact on the Economy

Convergence of accounting standards will boost foreign trade and the amount of capital coming into the nation. This will support the expansion of India's economy. More cash will be available for domestic enterprises as a result of international investment.

2] Advantageous for Investors

Investors looking to put money into other markets or economies benefit greatly from convergence. It greatly facilitates their ability to examine and contrast the financial accounts of international businesses. Investors will also find it easier to comprehend and evaluate the financial statements because they are prepared

according to the same set of guidelines.

3] Advantageous for the Sector

The sector may advance further with internationally recognized standards. Thus, convergence is crucial for the sector as a whole. The sector will be able to reduce the cost of foreign funding thanks to it. Businesses will have an easier time entering the market if they do not get burnt by adopting two separate sets of standards.

4] Greater Openness

The consumers of the financial statements will gain from convergence as well. Their comprehension of the financial statements will be facilitated. Additionally, this will improve transparency and boost investors' trust in making financial investments.

5] Saving Money

First of all, it will spare businesses from keeping distinct accounting records in accordance with distinct standards. The finance department will save a ton of money and labor hours as a result. Additionally, organizing and carrying out audits will get simpler.

It will be especially beneficial for businesses that have subsidiaries across many nations. Additionally, as capital will be easier to obtain, the cost of capital will go down as well.

3.6 LET US SUM UP

To sum up, the alignment of Indian Accounting Standards with International Accounting Standards is a critical step in improving

India's global competitiveness, building investor trust, and advancing sustainable economic progress. It emphasizes India's dedication to adopting worldwide financial reporting best practices and establishing itself as an accountable and open player in the world economy.

India's strategic alignment with international financial reporting standards is demonstrated by the alignment of Indian Accounting Standards (Ind AS) with International Accounting Standards (IAS). By facilitating global integration, enhancing investor confidence, enabling cross-border comparisons, improving the quality of financial reporting, increasing access to international capital markets, expediting regulatory compliance, and encouraging professional development within the accounting profession, this convergence aims to improve transparency, comparability, and credibility in financial reporting. All things considered, it's a big step in the right direction toward establishing India as an open and trustworthy player in the international economy.

3.7 KEY WORDS

Transparency: The idea of giving stakeholders access to extensive, accurate, and understandable financial data so they may decide on an entity's performance and financial status.

Comparability: Made possible by the adoption of uniform accounting standards and procedures, the capacity to meaningfully compare financial statements from various businesses or across various time periods.

Credibility: Credibility is the quality of financial information that

comes from following globally accepted accounting rules and principles.

Cross-border transactions: Cross-border transactions are business dealings that include partners from several nations and necessitate the use of standardized accounting standards to guarantee consistency and openness in financial reporting throughout legal systems.

Access to cash Markets: The capacity of businesses to raise cash from both local and foreign capital markets, made possible by adherence to internationally recognized accounting standards, which boosts investor trust and lowers investment barriers.

Professional development: Professional development is the ongoing process of advancing the abilities, know-how, and proficiencies of accounting professionals in order to enable them to successfully apply and adhere to changing accounting standards and practices.

3.8 REVIEW QUESTIONS

Q1. What is the significance of aligning Indian Accounting Standards (Ind AS) with International Accounting Standards (IAS)?

Q2. How does the convergence of Ind AS with IAS contribute to the globalization of Indian businesses?

Q3. What are the key objectives behind the matching of Indian Accounting Standards with International Accounting Standards?

Q4. What challenges might arise during the process of matching Indian Accounting Standards with International Accounting Standards, and how can they be addressed?

Q5. In what ways does convergence with international accounting standards benefit investors and other stakeholders?

Q6. What are the main differences between Indian Accounting Standards and International Accounting Standards, and how are they being reconciled?

Q7. What role do regulatory bodies and standard-setting organizations play in the convergence of Indian Accounting Standards with International Accounting Standards?

Q8. How does the convergence of accounting standards impact the professional development of accountants and financial professionals in India?

BLOCK-II: MECHANICS OF ACCOUNTING

UNIT-4: DOUBLE ENTRY SYSTEM OF ACCOUNTING, JOURNALIZING OF TRANSACTIONS;

STRUTURE

4.0 OBJECTIVES

After studying this unit you should be able to

- ensuring proper recording of each and every financial transaction.
- making certain that every transaction is entered into the books.
- ensuring that transaction records are consistent and uniform.
- supplying trustworthy data for external reporting and decision-making.

4.1 INTRODUCTION

Accounting is the language of business, and, much like any language, it is governed by frameworks and conventions that allow for the efficient exchange of financial data. The double-entry method is a fundamental accounting technique that serves as the foundation for precise financial reporting and record keeping.

Every transaction has an impact on at least two accounts, according to the double-entry system's guiding principle: one account is credited and another is debited. After every transaction, this system makes sure that the accounting equation, which reads Assets = Liabilities + Equity, stays balanced. Essentially, there needs to be a credit to match every debit, and vice versa.

The foundation of financial record-keeping is the double-entry accounting system, which offers an organized way to precisely record the intricacies of corporate transactions. Fundamentally, this system works on the tenet that each financial transaction affects a minimum of two accounts, guaranteeing that assets equal liabilities + equity in a balanced manner. Every transaction is meticulously recorded in chronological order through careful journalizing, providing an understandable and thorough record of the organization's financial activity. Identification, analysis, and proper debiting and crediting of accounts according to their impact and type are all part of this process. Following this procedure to the letter allows organizations to retain accuracy in their financial reporting while also gaining important insights for regulatory compliance and well-informed decision-making. As a result, the double-entry method acts as a foundation that promotes the honesty, dependability, and openness of accounting procedures—

all of which are necessary for the long-term development and prosperity of businesses.

4.2 MEANING OF DOUBLE ENTRY

One of the most crucial accounting fundamentals is double entry, a bookkeeping procedure that is rather easy to comprehend. Double-entry accounting basically requires that there be an equal and opposite entry made into a separate account for each entry made into one account. One or more accounts will see a debit entry as a consequence, and one or more accounts will see a matching credit entry.

- One of the most crucial accounting fundamentals is the notion of double entry in bookkeeping.
- Double-entry accounting makes sure that there must be an equal and opposite entry made into a separate account for each entry made into an account. One or more accounts will see a debit entry as a consequence, and one or more accounts will see a matching credit entry.
- A double-entry bookkeeping system's primary goal is to guarantee that an organization's accounts are kept in balance and are suitable for providing a true picture of the organization's present financial situation.

4.2.1 An Overview of Double-Entry Bookkeeping's History

There have been double-entry books for hundreds, if not thousands of years. Because it is essential to record parties' transactions, accounting has been a crucial aspect of business and society for millennia.

The history of accounting dates back to Mesopotamian ancient civilizations, and it is intimately linked to the evolution of writing, counting, and money. Simplified variants of the double-entry accounting approach may be found in the writings of the Romans and early Medieval Middle Eastern cultures.

Italian merchants introduced the double-entry accounting method to the world in the 13th and 14th centuries, which is when it first became popular. Because of the book he released that year that explained the principles of the double-entry accounting technique, Luca Pacioli—who is regarded as the "Father of Accounting"—wrote the first documented account of the double-entry system in 1494.

4.2.2 Process of Double-Entry Bookkeeping

A double-entry bookkeeping system's primary goal is to maintain account balance so that management and external stakeholders—such as present and potential investors, shareholders, suppliers, or the government—can accurately see the company's current financial situation. Because of this, the fundamental accounting formula, **Assets = Liabilities + Shareholders' Equity,** is crucial to double-entry bookkeeping.

Accountants utilize the notion of debits and credits to record transactions for each account on the company's balance sheet in order to attain the previously indicated balance. A debit entry in one account must match a credit entry in another in double-entry bookkeeping in order to maintain equation balance.

Generally speaking, a ledger's left side represents debits while its right side represents credits. T-accounts are frequently used to explain this, particularly when introducing the idea in

foundational-level accounting schools. However, because T-accounts provide a visual representation of the flow of figures from one account to another, they are also utilized by more seasoned experts.

4.2.3 Example of a double-entry accounting system

To help us grasp the principles of double-entry bookkeeping, let's go over a basic example. Let's say Alpha Company pays cash for $5,000 worth of office furnishings right now. In this scenario, Alpha would need to deduct $5,000 from Cash and add $5,000 from one of its asset accounts, most likely Furniture or Equipment.

In this case, the cash account would be credited and the asset account—furniture or equipment—would be debited. It is significant to observe that following the transaction, the $5,000 credit amount and the $5,000 debit amount are exactly identical.

It's crucial to keep in mind that a debit does not imply a rise or decline, respectively. To raise an asset account, a debit entry is needed, whereas a credit entry is needed to grow a liability account. This is a straightforward technique to employ.

Here is an example of what debit and credit entries look like as a journal entry:

Ref	Date	Account Titles and Explanation	Debit	Credit
100	Date of the transaction	Debit Account Name	$XX	
		Credit Account Name		$XX

And here's a cheat sheet for debit and credit rules, so you can easily remember them:

Types of accounts	Debit	Credit
Assets are the resources a business owns, such as cash, accounts receivable, inventory, prepaid expenses, land, equipment, etc.	Increase	Decrease
Expenses are the cost of using assets, such as the cost of goods sold, operating expenses, etc.	Increase	Decrease
The owner's equity is the owner's investment in their business.	Decrease	Increase
Liabilities are claims against assets and include accounts payable, accrued expenses, bonds, etc.	Decrease	Increase
Revenue is the income generated from business operations such as sales, dividends, services, etc.	Decrease	Increase

DEAD Regulation

The DEAD rule is a shorthand that makes it easy to recall that expenses, assets, and dividend accounts should always be debited, in that order. In these kinds of situations, the typical balance would be a debit; debits increase the accounts, while credits lower them. It is simple to comprehend that any other accounts would be handled in the exact opposite way from the accounts covered by the DEAD rule if one is familiar with it.

4.3 VARIOUS TYPES OF ACCOUNT

In accounting, a variety of account types are often utilized. The most popular ones are the asset, liability, capital, expense, and income accounts.

- Asset accounting deal with the products, machinery, or money that a company possesses.
- What a firm owes to other suppliers or companies, such as credit card amounts that need to be paid later, building mortgages, or equipment or supplies purchased on credit, are referred to as liability accounts.

- Accounts pertaining to shareholders' equity, such as preferred stock, ordinary stock, and retained earnings, are included in capital accounts.
- Expense accounts provide specific amounts for things like rent, advertising, payroll, and administrative charges.
- The diverse kinds of money that come in from different sources, such interest, investment income, or money from the sale of products or services, are represented by income accounts.

4.4 KEEPING DOUBLE-ENTRY BOOKS TO PREVENT ERRORS

As a firm grows and its transactions get more sophisticated, there is a greater chance of administrative mistakes. Due to the need that debits and credits balance, double-entry accounting is useful in minimizing mistakes on balance sheets and other financial statements, even if it does not completely eradicate them.

Naturally, it follows the equation Assets = Liabilities + Shareholders' Equity. The balance criterion makes sure that any faults are quickly detected and that the wrong input can be tracked down before it causes more complicated issues later on.

4.5 JOURNALIZING TRANSACTIONS

Your financial data is recorded and analyzed through a multi-step process called the company accounting cycle. Transaction journalizing initiates this cycle.

The first recording of every financial transaction made by a firm is

referred to as the journalizing process. Listing journal entries in the diary is how this recording is accomplished.

The double-entry bookkeeping approach is all you need to know about journal entries. Every recorded transaction in double-entry results in a change to at least two accounts, one of which is credited and the other debited.

After completed, journal entries are entered into the journal, the day-by-day, chronological accounting record that provides a summary of company dealings.

Visit our detailed guide on the accounting cycle to learn more about the process financial transactions go through once they are recorded in the journal.

4.6 THE STEP-BY-STEP GUIDE TO JOURNALIZING TRANSACTIONS

In order to properly record your transactions in your diary, you need to do three easy steps.

1. Determine Which Accounts Are Affected

When journalizing, the first step is to analyze the transaction to determine which accounts are changed and by how much.

As an illustration, suppose that on January 29th, a business gets $500 in service revenue for its repair services. Since cash is entering the firm, both revenue and cash grow by $500.

See our tutorial on the chart of accounts for additional information on the many kinds of company accounts and how to identify them.

2. Convert the Modifications into Credits and Debits

The most challenging aspect of journalizing transactions is this.

In the first example, we said that there is a rise in the cash account and service income.

Since cash is an asset that the company owns, it qualifies as an asset account. On the other hand, service revenue is unmistakably a revenue category that shows earnings from repair services.

The debit and credit cheat sheet shows us that credits increase income and debits increase assets. For this reason:

$500 will be deducted from the cash account, and $500 will be added to the service revenue account.

This is how the journal entry would now appear:

Account Titles and Explanation	Debit	Credit
Cash	$500	
Service Revenue		$500

3. Record the Description, Reference Number, and Date.

Once the debits and credits have been completed, provide the transaction date, reference number, and a brief explanation.

As previously stated, the transaction date in our case is January 29.

Any number may be used as the reference number; it is issued by the firm and must be different for each entry.

The description should be succinct and direct, such as "Received cash for repair services."

Our example's completed journalized transaction would appear in the journal as follows:

Ref	Date	Account Titles and Explanation	Debit	Credit
100	January 29th	Cash	$500	
		Service Revenue		$500
		Received cash for repair services		

4.7 LET US SUM UP

A fundamental concept of accounting that guarantees precise and methodical documentation of financial transactions is the double-entry system. Every transaction impacts a minimum of two accounts, one of which is credited and the other is debited. This is how it works. Accuracy, completeness, consistency, and dependability of financial records are only a few advantages of this system, which strives to maintain the equilibrium of the accounting equation (Assets = Liabilities + Equity).

The practice of documenting financial occurrences in the journal, or original entry book, is known as journalizing transactions. It entails recognizing transactions, assessing how they affect accounts, figuring out debits and credits using the double-entry method, creating journal entries with pertinent information, and uploading them to the ledger. This methodical approach guarantees accurate documentation of all financial transactions, offering a transparent and well-structured record for regulatory compliance, financial analysis, and decision-making.

4.8 KEY WORDS

Double-Entry System: A way of keeping track of financial transactions in which each one impacts a minimum of two accounts, and debits and credits balance each other out to maintain the accounting equation's equilibrium.

Debit: A debit is an item that appears on the left side of an account and denotes a drop in equity or obligations or a gain in assets.

Credit: A figure that appears on the right side of an account and denotes a rise in equity or liabilities or a drop in assets.

Journal: The original entry book in which transactions are first noted in a chronological manner, with the date, the debited and credited accounts, a description, and the sums.

Journalizing: Journalizing is the process of detecting, evaluating, and documenting every financial transaction that is entered into a journal.

Ledger: A group of accounts to which journal notes are written, offering a thorough history of transactions for each account.

Posting: Ensuring that every ledger account accurately represents the impact of transactions by moving journal entries to the appropriate accounts.

Accuracy: The accuracy and dependability of financial records attained by journalizing and the double-entry method, which offers reliable data for reporting and decision-making.

4.9 REVIEW QUESTIONS

Q1. What is the double-entry system of accounting, and why is it considered fundamental in financial record-keeping?

Q2. Explain the concept of debits and credits in the context of the double-entry system.

Q3. How does the double-entry system ensure the accuracy and integrity of financial records?

Q4. What are the objectives of journalizing transactions in the accounting process?

Q5. Describe the process of journalizing a transaction, including the necessary steps and components of a journal entry.

Q6. Why is it important to maintain chronological order when recording transactions in the journal?

Q7. What is the purpose of posting journal entries to ledger accounts?

Q8. Can you provide an example of a journal entry for a typical business transaction, explaining the debits and credits involved?

UNIT-5: PREPARATION OF FINAL ACCOUNTS, PROFIT & LOSS ACCOUNT, PROFIT & LOSS APPROPRIATION ACCOUNT AND BALANCE SHEET,

STRUTURE

5.0 OBJECTIVES

After studying this unit you should be able to

- gives stakeholders a comprehensive understanding of the company's profitability by summarizing the income, costs, and net profit or loss.
- recognize how a company's profit and loss statement is prepared and structured.
- recognize how a company's balance sheet is presented and disclosed.
- comprehend the format and process of creating a cash flow statement.

5.1 INTRODUCTION

A key component of firm financial accounting is the creation of final accounts, which include the balance sheet, profit and loss account, and profit and loss appropriation account. A thorough summary of a company's financial performance, status, and profit distribution is given by these financial statements.

The income statement, sometimes referred to as the profit and loss account, is a financial statement that shows the total amount of money received and spent during a given time period, usually a fiscal year. It determines the profitability of the company by calculating the net profit or loss produced by its activities.

The distribution of the net profit or loss to different stakeholders, including shareholders, through dividends, retained profits, reserves, or other methods, is specified in the Profit & Loss Appropriation Account. This account guarantees equity and openness in the allocation of profits.

The balance sheet, which lists the company's assets, liabilities, and equity, provides a moment in time view of its financial situation. It gives information on the company's liquidity, solvency, and general financial health by reflecting its assets, liabilities, and owner equity.

Collectively, these financial statements fulfill a number of functions, such as meeting legal obligations, assessing financial performance and position, aiding in decision-making, comparing and analyzing data, allocating profits, and communicating with interested parties. In order to evaluate a company's financial health

and advise stakeholders on its current situation and future prospects, final accounts must be prepared.

5.2 PREPARATION OF FINAL ACCOUNTS

The **preparation of final accounts** is the process of summarizing and reporting a business's financial performance and position at the end of an accounting period. These statements help determine the **profit or loss** and the **financial position** of the business.

Components of Final Accounts

Final accounts typically include the following three main parts:

1. Trading Account

Purpose: To calculate **Gross Profit or Gross Loss**

Format:

Trading Account for the year ended...
Dr.	**Cr.**
Opening Stock	Sales
Purchases	Less: Sales Returns
Less: Purchase Returns	Closing Stock
Direct Expenses (wages, freight, etc.)	
Gross Profit (c/d)	

Gross Profit=Sales−(Opening Stock+Purchases+Direct Expenses−Closing Stock)\text{Gross Profit} = \text{Sales} - (\text{Opening Stock} + \text{Purchases} + \text{Direct Expenses} - \text{Closing Stock})Gross Profit=Sales−(Opening Stock+Purchases+Direct Expenses−Closing Stock)

2. Profit and Loss Account

Purpose: To calculate **Net Profit or Net Loss**

Format:

Profit and Loss Account for the year ended...
Dr.	**Cr.**
Indirect Expenses (rent, salaries, depreciation)	Gross Profit (b/d)
Bad Debts, Interest Paid	Discount Received
Loss on Sale of Assets	Commission Received
Net Profit (c/d)	

Net Profit=Gross Profit+Other Income−Operating and Indirect Expenses\text{Net Profit} = \text{Gross Profit} + \text{Other Income} - \text{Operating and Indirect Expenses}Net Profit=Gross Profit+Other Income−Operating and Indirect Expenses

3. Balance Sheet

Purpose: To show the **financial position** of the business on a specific date.

Format:

Balance Sheet as on...
Assets	**Liabilities and Capital**
Fixed Assets (Machinery, Building)	Capital
Current Assets (Cash, Debtors, Stock)	Add: Net Profit
Prepaid Expenses	Less: Drawings
	Long-term Liabilities (Loan)
	Current Liabilities (Creditors, Outstanding Expenses)

Assets=Capital + Liabilities\text{Assets} = \text{Capital + Liabilities}Assets=Capital + Liabilities

Steps in Preparing Final Accounts:

1. **Trial Balance** – Start with the balances of all ledger accounts.
2. **Adjustments** – Account for items like closing stock, outstanding expenses, prepaid expenses, depreciation, etc.
3. **Prepare Trading Account** – Calculate Gross Profit or Loss.
4. **Prepare Profit & Loss Account** – Calculate Net Profit or Loss.
5. **Prepare Balance Sheet** – Present the financial position using the adjusted figures.

Purpose of Final Accounts

- To determine **profitability**
- To evaluate **financial position**
- To provide information to **stakeholders** (owners, creditors, investors, etc.)
- To comply with **legal and tax regulations**

5.2.1 The Companies Act of 2013's Schedule III

The corporations Act of 2013's Schedule III requires the corporations to compile and submit their final accounts. The Schedule was developed in order to stay up with the evolving economic ideologies that give rise to globalization, privatization, and the ensuing changes in company financial reporting standards. The following are some of Schedule III's many new features:

- The Balance Sheet elements are presented in a vertical manner with their division into current and non-current headings.
- A profit and loss statement in a vertical style that classifies costs according to their kind.

- Removing the idea of "Schedules" and providing this information instead in "Notes to accounts"
- It lacks a precise disclosure for items listed under the heading "Miscellaneous Expenditure" in Schedule VI.
- The profit and loss statement's debit balance will be shown under the "Reserves and Surplus" heading as a negative amount.
- Cash flow statement prepared in accordance with AS-3.
- In the event of a dispute between AS and the Schedule, AS is given priority by the Schedule.

5.2.2 General Guidelines for Financial Statement Preparation

1. Consistency Principle

Financial statements must be prepared using **consistent accounting policies** and procedures from one period to another. This enhances **comparability** of financial results over time.

2. Going Concern Assumption

Statements should be prepared on the assumption that the business will **continue to operate** in the foreseeable future, not liquidate or significantly reduce its operations.

3. Accrual Basis of Accounting

Revenues and expenses should be recorded in the period in which they are **earned or incurred**, not when cash is received or paid.

4. Compliance with Accounting Standards

Follow relevant **accounting standards (like IFRS, GAAP, or IND-AS)** to ensure that the financial statements are prepared in line with accepted norms and legal requirements.

5. True and Fair View

Statements must present a **true and fair** representation of the financial performance and position of the business without intentional misstatement or omission.

6. Materiality

Only **material information**—that which can influence decisions of users—should be disclosed. Trivial details can be omitted.

7. Full Disclosure

All relevant and significant information must be disclosed in the financial statements or in the accompanying **notes to accounts** to avoid misleading the users.

8. Objectivity and Verifiability

Figures should be based on **verifiable evidence** like invoices, receipts, contracts, etc., not personal judgment alone.

9. Timeliness

Statements should be prepared and published **promptly** at the end of each accounting period to be useful for decision-making.

10. Matching Principle

Expenses should be matched with the **revenues** they helped to generate during the accounting period to accurately calculate **net profit or loss**.

11. Prudence (Conservatism)

Do not overstate assets or income, or understate liabilities and expenses. Always **anticipate losses** but not gains.

12. Classification and Aggregation

Similar items must be **grouped together** and presented under appropriate heads and subheads for clarity and understanding.

13. Comparative Figures

Present **figures of previous years** alongside the current year to allow users to evaluate performance trends.

Conclusion: Following these guidelines ensures that financial statements are **accurate, comparable, reliable, and useful** to stakeholders like investors, management, regulators, and creditors.

5.3 PROFIT & LOSS STATEMENT – PART II OF SCHEDULE-III

Particulars		Note No.	Figures for the current reporting period		Figures for the previous reporting period	
I.	Revenue from operations			xxx		xxx
II	Other income			xxx		xxx
III	Total Revenue(I+II)			xxx		xxx
IV	Expenses:			xxx		xxx
	Cost of materials consumed			xxx		xxx
	Purchases of Stock-in-Trade			xxx		xxx
	Changes in inventories of Finished goods, Work-in-Progress and Stock-in-Trade			xxx		xxx
	Employee benefits expense			xxx		xxx
	Finance costs			xxx		xxx
	Depreciation and Amortisation expense			xxx		xxx
	Other expenses			xxx		xxx

Total expenses				xxx		xxx
V.	Profit before exceptional and extraordinary items and tax(III-IV)			xxx		xxx
VI	Exceptional items			xxx		xxx
VII	Profit before extraordinary items and tax (V-VI)			xxx		xxx
VIII	Extraordinary Items			xxx		xxx
IX.	Profit before tax (VII-VIII)			xxx		xxx
X	Tax expense:					
(1) Current tax			xxx	xxx	xxx	xxx
(2) Deferred tax			xxx	xxx	xxx	xxx
XI.	Profit(Loss) for the period from continuing operations (VII-VIII)			xxx		xxx
XII	Profit/(Loss) from discontinuing operations			xxx		xxx
XIII	**Tax expense of discontinuing operations**			xxx		xxx

5.4 SCHEDULE III: PART I OF THE BALANCE SHEET

- Assets are the resources that the business has as a result of previous events and from which it anticipates receiving future financial rewards enterprise.
- Liabilities are the commitments made by an organization as a result of a previous incident, the settlement of which results in the withdrawal of resources that represent financial gains.
- Equity refers to the remaining stake in a business after all obligations have been subtracted.

Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous period
1	2	3	4
I. EQUITY AND LIABILITIES			
(1) **Shareholder's funds**			
(a) Share capital			
(b) Reserves and surplus			
(c) Money received against share warrants			
(2) **Share application money pending allotment**			
(3) **Non-current liabilities**			
(a) Long-term borrowings			
(b) Deferred tax liabilities (net)			
(c) Other Long-term liabilities			
(d) Long-term provisions			
(4) **Current liabilities**			
(a) Short-term borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short-term provisions			
TOTAL			
II. ASSETS			
(1) Non-current assets			
(a) Fixed Assets			
(i) Tangible assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under development			
(b) Non-current investments			
(c) Deferred tax assets (net)			
(d) Long-term loans and advances			
(e) Other non-current assets			
(2) Current assets			
(a) Current investments			
(b) Inventories			
(c) Trade receivables			
(d) Cash and cash equivalents			
(e) Short-term loans and advances			
(f) Other current assets			

5.5 LET US SUM UP

The creation of final accounts, which include the Balance Sheet, Profit & Loss Appropriation Account, and Profit & Loss Account, is essential to corporate financial reporting. In order to calculate the net profit or loss for a given period, the revenues and costs incurred are compiled in the Profit & Loss Account. In addition, transparency and fair distribution are guaranteed by the Profit & Loss Appropriation Account, which describes how the net profit is distributed among stakeholders. In the meanwhile, the balance sheet, which lists the company's assets, liabilities, and equity, offers a quick glance at its current financial situation. Together, these financial statements serve essential tasks such meeting legal obligations, assessing financial performance and position, assisting in decision-making, comparing and analyzing data, allocating profits, and interacting with stakeholders. They provide a thorough grasp of a business's financial health through this process, assisting in well-informed decision-making and building stakeholder confidence.

5.6 KEY WORDS

Preparation of Final Accounts: The process of assembling financial statements to provide a summary of a business's financial performance and condition. These statements include the Balance Sheet, Profit & Loss Account, and Profit & Loss Appropriation Account.

Profit & Loss Account (Income Statement): A financial statement used to calculate net profit or loss by summarizing a

business's costs and revenues for a given time period, usually a fiscal year.

Profit and Loss Appropriation Account: A statement that shows how net profit is distributed to different parties, including shareholders, through reserves, dividends, and retained profits, among other methods.

Balance sheet: A balance sheet is a type of financial statement that shows the assets, liabilities, and equity of a business at a certain point in time. It provides information on the company's liquidity, solvency, and general financial health by reflecting its assets, liabilities, and owner equity.

5.7 REVIEW QUESTIONS

Q1. What is the purpose of preparing final accounts for a business?
Q2. Explain the difference between a Profit & Loss Account and a Profit & Loss Appropriation Account.
Q3. What are the main components of a Balance Sheet? Describe each component briefly.
Q4. How does the Profit & Loss Account contribute to assessing a company's profitability?
Q5. Describe the significance of the Balance Sheet in evaluating a company's financial health.
Q6. How are assets and liabilities classified in a Balance Sheet?
Q7. What are some key financial ratios that can be calculated using information from the Profit & Loss Account and Balance Sheet?

UNIT-6: POLICIES RELATED WITH DEPRECIATION, INVENTORY AND INTANGIBLE ASSETS LIKE COPYRIGHT, TRADEMARK, PATENTS AND GOODWILL.

STRUTURE

6.0 OBJECTIVES

After studying this unit you should be able to

- get a good idea of how much something is worth, spread out its costs over the time it will be useful.
- help spread the cost of goods out over the time they are useful, which smooths out changes in income.
- intangible goods are meant to keep them safe from being stolen, misused, or diminished.

- correlate with the organization's strategic goals, making it easier to manage and use these assets in a way that improves the company's competitiveness and market place.

6.1 INTRODUCTION

Policies about inventory, devaluation, and intangible assets like copyright, trademarks, patents, and goodwill are very important to organizations because they help people make decisions and make sure that valuable resources are managed well. Depreciation policies set rules for evenly spreading the prices of physical assets over the time they can be used. This allows for accurate valuation, helps level out income, and makes it easier to plan for taxes and strategic asset replacement. Inventory policies spell out how to keep the right amount of goods on hand while also controlling costs, improving output, and managing risks. This keeps inefficiencies and losses related to inventory in check. Intangible asset policies protect and increase the value of intellectual property such as copyrights, trademarks, patents, and goodwill by following the law, managing assets strategically, and giving accurate financial information. This gives the organization a competitive edge and keeps its intangible assets from being stolen or losing value. All of these policies work together to help businesses in a wide range of fields stay financially stable, run efficiently, and be able to adapt to changing circumstances.

Any business needs to have rules about inventory, depreciation, and intangible assets in order to properly handle and report its finances. These policies give the structure and rules needed to manage and keep track of different kinds of assets that are important to the organization's operations and progress.

Depreciation rules set up a way to evenly spread the cost of physical assets over the time they can be used. These policies make sure that accurate financial reports and following accounting standards happen by outlining the ways and rates for depreciating assets. In the end, they help the organization make smart decisions and keep its finances stable by figuring out how to recognize income, value assets, and plan for taxes.

Inventory policies spell out how to keep track of, value, and handle inventory levels. These rules say how to figure out how much an item is worth, how often it should be counted, and how to best set the amount of an item's stock to balance costs and meet demand. These rules help keep operations running smoothly and making money by handling inventory management risks like items going out of date and running out of stock.

The main goal of intangible asset policies is to find, value, and safeguard assets like copyrights, trademarks, patents, and reputation. They set standards for identifying intangible assets, decide how to value them, and make sure that the laws that protect intellectual property are followed. These rules are very important for making sure that the organization's intellectual property rights are protected, its financial records accurately show the value of its intangible assets, and it stays competitive in the market.

6.2 DEPRECIATION POLICIES

Depreciation policies are important rules that tell businesses how to handle the loss of value or decline of their physical assets over time. These rules are very important for managing money because they do several important things:

Choice of Method: Depreciation rules say which method or methods should be used to figure out depreciation costs. Some common ways are units of output depreciation, declining balance depreciation, and straight-line depreciation. The way you choose affects when and how much depreciation is shown on your financial statements.

Useful Life Determination: They also give advice on how to figure out how long things will be useful. This estimate is very important for spreading the cost of an asset over the time it is supposed to last. When figuring out useful life, depreciation policies usually look at things like new technologies, normal wear and tear, and industry norms.

Valuing Assets: Depreciation rules make sure that the balance sheet correctly shows the value of assets. By spreading the cost of an object over the time it can be used, these rules help show how its value drops over time. This evaluation is very important for giving everyone involved a correct and honest picture of the company's financial state.

Follow the rules: Depreciation policies make sure that financial rules and standards are followed, like Generally Accepted financial Principles (GAAP) or International Financial Reporting Standards (IFRS). To make sure that financial data is consistent and easy to compare, these standards spell out specific rules for how to record and measure depreciation costs.

Tax Planning: The rules for depreciation are also important for tax planning. The choice of depreciation methods can change the amount of depreciation cost that is taxed, which can change

taxable income and tax liabilities. Companies can choose which depreciation methods to use in order to get the best tax breaks while still following the rules.

In general, depreciation plans give you a structured way to handle and record the gradual loss of value of physical assets. These policies make sure that financial reporting is clear, accurate, and consistent by setting clear rules for choosing methods, figuring out useful lives, valuing assets, following the rules, and planning taxes. This helps people make better decisions and builds trust among stakeholders.

6.3 INVENTORY POLICIES

To manage time, demand, and uncertainty in a supply chain, inventory policies are crucial. Businesses may increase their flexibility, productivity, and profitability with well-adjusted policies.

Since it's difficult to foresee every tiny thing that may go wrong during the process, these guidelines provided by an inventory policy will, at the very least, assist in resolving such issues. Ideally, it will lessen such errors in addition to doing that.

Three primary tiers of inventory choices need to be handled by those policies. They have to deal mostly with supply chain strategy choices, such as:

- What other options are there to inventory?
- How is the product made?

For example, it would be prudent for a business to invest in quicker shipping and have less inventory. In other situations, having a larger stock may be the best course of action when dealing with items that require longer transit times.

You need to know how the product is made in order to decide what strategy, supply chain, and inventory path to take. Shipping and keeping are two important parts. There are also deployment questions, which are more tactical in nature, along with the strategic choices that need to be made at the supply chain level. They have to deal with important things like

- What things should you keep as inventory?
- What should be done to keep them up?
- How much should you hold?
- Where should they be held?

You should try to guess where the market for the product will come from, which is why this happens. When that kind of planning is done ahead of time, the process runs more smoothly and things get to customers faster.

6.3.1 Different kinds of inventory policies

There are two types of stocking policies based on when you need to place your order. With this strategy, you can place an order at any time. A periodic review strategy, on the other hand, says that orders can only be placed at certain times.

Policy for continuous review

During the continuous review, the policy says that the company must buy a set number of units from the supplier as soon as the net

inventory hits a certain level.

But when we talk about stock, we need to think about units that are at different points in the supply chain. As an example:

- On-hand inventory is the number of units that are ready for customers to buy. These are the goods that are already in the building.
- Back-orders are used when you don't have enough stock on hand but still want to keep the sale.
- Net inventory includes both items that are in stock and items that are being shipped. This includes both units that are in the building and units that are being shipped.
- In-transit items are units that are on their way to the warehouse or goods that have been bought from a supplier but are not yet available to customers.

With these concepts, we have a better idea of how to think about units in an inventory.
But if there is a strategy of continuous review, the time between two orders will be different. It will depend on many things, such as how long it took for the warehouse to empty.

But even if the amount of time has changed, the amount will always be the same. If you think you can place an order whenever you want, this choice is safe.

This is a good rule to follow when you need to keep a close eye on expensive things. On the other hand, this model won't let you order multiple things from the same supplier at the same time.

Policies for Periodic review

The policy for periodic review says that goods must be ordered on a set schedule, and the stock must always be brought back to its full potential. In other words, it works in an up-to-level way.

The quarterly review always starts with an order that brings enough goods to the net inventory. But each turn, a different amount will be needed because it depends on how much stock the company has at the time.

However, there is a set time every day when you should place your order. In other words, the amount of time that has passed between two orders will always be the same.

The best thing about this plan is that it lets businesses bulk-order from all of their suppliers. It's probably the most usual way to handle inventory because of that.

The problem is that this policy is usually risky because it covers up the fact that orders can't be placed between cycles, even though it does allow orders to be grouped.

6.4 INTANGIBLE ASSETS POLICIES

Intangible assets are defined as identifiable non-monetary assets that cannot be seen, touched, or physically measured. Intangible assets are created through time and effort and are identifiable as a separate asset.

Intangible assets are valuable despite having no physical attributes

because of the benefits or unique rights and privileges they offer a company. The two main sources of intangible assets are:

(1) exclusive rights bestowed by a governing body or through a legal agreement, such as patents, copyrights, franchises, trademarks and trade names, and leases; and

(2) exceptional managerial ability or customer loyalty, also known as goodwill.

Not all nonphysical assets are intangibles, but all intangible assets are nonphysical. For instance, even though they are not physical, accounts receivable and prepayment expenditures are categorized as current assets as opposed to intangible assets. Typically nonphysical and non-current, intangible assets are listed in the "Intangible assets" long-term portion of the balance sheet.

Like most other assets, intangibles are first recorded by businesses at cost. Nevertheless, there are differences in determining the purchase cost of a plant asset and an intangible asset. The cost of internal development or self-creation of the asset is not included in the acquisition cost of an intangible asset; only the outright purchase prices may be included by businesses. All costs associated with a domestically developed intangible asset are not capitalized. As a result, some businesses might not even have assets that are that valued listed in their asset accounting.

Organizations use policies pertaining to intangible assets as crucial frameworks for managing, appraising, and safeguarding their intellectual property and other intangible assets. These regulations cover a range of topics related to the management of intangible assets:

Identification and Recognition: The organization's balance sheet's intangible asset rules specify the standards for locating and acknowledging intangible assets. Assets including copyrights, trade secrets, patents, trademarks, goodwill, and software licenses are included in this. Uniformity in the identification and recording of intangible assets obtained from internal or external sources is ensured by clear criteria.

Methods of Valuation: Policies lay forth standards for valuing intangible assets, which might involve estimating future cash flows, fair market value, or acquisition cost. Valuation techniques take into account several aspects, including industry norms, regulatory limits, and market circumstances, to guarantee that intangible assets are appropriately recorded on the balance sheet at their proper value.

Legal Protection and Compliance: Policies pertaining to intangible assets cover legal aspects of trademarks, patents, copyrights, and intellectual property rights. These policies guarantee adherence to relevant laws and rules controlling intangible assets, including those pertaining to intellectual property, contracts, and licensing. For businesses to keep their competitive edge and market position, they must safeguard their intangible assets from theft, unlawful use, and infringement.

Asset Management Strategies: Policies provide guidelines for the efficient lifecycle management of intangible assets. This covers methods for optimizing the worth of intangible assets, such technological commercialization endeavors, brand development programs, and licensing agreements. The techniques for preserving, modernizing, and replenishing intangible assets are likewise covered by asset management policies, guaranteeing their

ongoing significance and worth to the company.

Financial Reporting and Disclosure: Requirements for the presentation and disclosure of intangible assets in financial statements are laid forth in intangible asset policies. Companies are required to provide accurate disclosures on the type, value, useful life, and any impairment losses of their intangible assets. Investors, creditors, and other stakeholders may make more informed decisions when there is transparency in financial reporting, which boosts stakeholder confidence.

Risk management: Policies pertaining to intangible assets include steps to reduce risks related to them, such the possibility of obsolescence, losing a competitive edge, or getting into legal trouble. Implementing security measures to prevent unauthorized use or disclosure, keeping an eye on market trends, and doing periodic assessments of the value of intangible assets are some examples of risk management techniques.

In general, intangible resource policies are crucial for safeguarding, controlling, and optimizing the value of other intangible resources, such as intellectual property. These policies help businesses effectively leverage their intangible assets to meet their strategic goals and keep a competitive edge in the market by laying out clear guidelines for asset management, identification, valuation, legal protection, financial reporting, and risk management.

6.5 GOODWILL

A money ledger with a compass on top of it.Goodwill, as used in accounting, is an intangible asset that a business has that stems mostly from its customer-friendly reputation and managerial expertise. A company's worth might exceed the sum of its identifiable intangible and physical assets' fair market values. Due to its higher worth, the firm makes more money than the average for every dollar invested in it. Therefore, a company's capacity to produce above-average profits or income is evidence of its goodness.

Only in cases when goodwill has been bought can an accounting record include a goodwill account. Goodwill is an ancillary intangible asset that may only be acquired by a firm via the purchase of a whole or partial enterprise. A company's goodwill may be attributed to several factors such as its excellent reputation, devoted client base, superb product design, unrecorded intangible assets (due to internal development), and exceptional people resources. Together, these positive attributes represent goodwill since they cannot be measured separately. Goodwill is an intangible asset that is not amortized. Periodically, goodwill must be examined for impairment. Any goodwill impairment loss must be shown as a distinct line item in the income statement, preceding the subtotal income from continuing activities (or caption of a like kind). The same amount would be deducted from the goodwill account.

6.6 PATENTS

One example of an intangible asset is a patent. This is so because a patent offers its owner long-term value and has no physical substance. As a result, a patent is valued in the same way as any other type of intangible fixed asset, which is:

Note the original asset cost as the amount spent on obtaining or creating the patent.

- The registration, documentation, and other legal fees related to a patent application are included in the asset's cost if a company files for one; however,
- The capitalized cost of a patent does not include the costs of research and development (R&D) needed to develop the patented idea. Instead, these R&D expenses are charged to expenditure as spent; this approach is justified by the notion that R&D should not be treated as an asset because it is inherently hazardous and does not guarantee future rewards.
- The costs of getting a patent should be included as an expense if they are so little that they neither meet nor exceed the capitalization limit of the business.
  "Lowe's patent" on a street drain.

Spread out the patent's expense over the course of its useful life.
An amortization period for a patent asset should not exceed the duration of the patent's protection. Use the useful life for amortization if the patent's anticipated useful life is significantly shorter. Therefore, the amortization time should be based on whichever is shorter—the useful life or the legal life of a patent.
In the event that a patent's value has significantly decreased,

acknowledge an impairment and lower the asset's carrying value. The asset can be written off by crediting the amount in the patent asset account and debiting the balance in the cumulative amortization account if the business is no longer using the patented concept.

6.7 COPYRIGHTS

A copyright is a federally given exclusive right that prevents others from illegally reproducing an author's written works, artwork, or literary projects. A copyright's limited useful life is equal to the creator's lifetime plus fifty years. The majority of publications have a limited (finite) lifespan; an author may choose to amortize the copyright costs on a straight-line basis or according to the pattern in which the financial gains are depleted.

Copyright policies are fundamental frameworks that control how businesses handle, safeguard, and utilize their copyrighted content. Copyrights grant the owner of the copyright the exclusive right to reproduce, distribute, perform, and exhibit their original works of authorship, including literary, artistic, musical, and dramatic compositions. Key elements of copyright regulations are as follows:

Identification and Registration: In order to prove ownership and provide legal protection, copyright regulations set up processes for locating and registering works that are protected by a copyright. To claim their rights and prevent infringement, organizations must keep accurate records of the copyrighted items they use and register them with the appropriate copyright authorities.

Ownership and Rights Management: Policies specify who owns what with relation to copyrighted works produced by workers, subcontractors, or outside parties. To guarantee clarity and transparency in ownership and usage rights, they set down agreements, contracts, and licensing arrangements. Organizations are free to set up protocols for securing releases, licenses, or permissions before exploiting another person's copyrighted works.

Use and Distribution Guidelines: Within the company and to other parties, copyright rules offer guidelines for the proper use, distribution, and dissemination of items protected by copyright. They set up procedures for securing licenses, attributions, and consents for distributing, duplicating, or altering works protected by copyright. Policies may include cover copyright exceptions and fair use when used for transformative, educational, or research purposes.

Enforcement and Compliance: Copyright policies guarantee adherence to the laws and rules pertaining to the usage and safeguarding of works protected by copyright. They set up protocols for tracking and enforcing infringement, piracy, and illegal use, as well as for identifying and resolving such incidents. Policies may also include fines or other legal repercussions for copyright infractions.

Digital Rights Management (DRM): In the era of digitalization, copyright laws may incorporate tactics for handling digital rights, such putting DRM systems in place to restrict who may access, share, and use digital information. DRM regulations are designed to facilitate allowed access and usage while preventing unlawful duplication, distribution, or alteration of digital items protected by copyright.

Education and Training: To increase understanding and encourage adherence to copyright rules and best practices among workers, contractors, and stakeholders, copyright policies may include educational programs and training efforts. Digital rights management, fair use, licensing, and copyright fundamentals are a few of the subjects that training programs may touch on.

6.8 TRADEMARKS

A symbol, design, or emblem that is associated with a certain firm or product is called a trademark. A trade name is a brand name that a firm uses for commercial purposes or to sell products. Trademarks and trade names are frequently quite valuable to a business, but if they were created internally, there is no asset cost reported for them. On the other hand, when a company buys these things from outside sources, it records the cost of the products and spreads it out over the objects' limited useful life.

Trademarks are legally protected words, symbols, or logos that set one company's products or services apart from another. These might be any combination of words, names, symbols, logos, and slogans. In addition to being used to identify the source of a good or service, trademarks can be registered with government agencies to provide its owner exclusive rights within a particular area.

Here are some essential trademark-related points:

Distinctiveness: In order to qualify for protection, trademarks must be unique. They shouldn't only be descriptive or general about the good or service.

Registration: The legal assumption of ownership and the exclusive right to use the mark in connection with the products or services covered by the registration are two benefits of registration, while it is not necessarily necessary for protection.

Scope: Only the particular products or services for which the mark is registered are covered by trademark protection. A trademark that is registered for use with apparel, for instance, would not stop another business from using the same mark for software or other unrelated products.

Duration: If the mark is consistently used in commerce and the registration is correctly maintained by submitting the necessary renewal applications, trademark protection may remain unrestricted indefinitely.

Enforcement: Owners of trademarks are entitled to take legal action, such as infringement litigation, to prevent unlawful use of their marks by other parties.

International Protection: Generally speaking, trademark rights are territorial, meaning they are only recognized in the country in which they are registered. Nonetheless, international agreements like the Madrid Protocol offer ways to apply for trademark protection in several nations with a single application.

Symbols: To denote trademark rights, the symbols ® and ™ are frequently employed. While the ® sign is only used for registered trademarks, the ™ symbol can be used to assert ownership with unregistered marks.

6.9 LET US SUM UP

To sum up, depreciation, inventory, and intangible asset policies are important for organizations to have in order to handle their money well, report it, and follow the rules. These policies help people make smart decisions, lower risks, and support the organization's long-term success by setting clear rules and standards.

Depreciation, inventory, and intangible asset policies, including those pertaining to copyrights, trademarks, patents, and goodwill, are essential elements of firm financial management. In order to ensure correct asset assessment and represent the progressive consumption of tangible assets, depreciation policies define standards for methodically distributing the cost of those assets over the course of their useful life. Inventory rules control the measurement and value of products kept for sale or raw materials used in production, which has an effect on profitability and financial statements. In the meanwhile, regulations pertaining to intangible assets determine how assets like as patents, trademarks, and copyrights are recognized, valued, and amortized, guaranteeing that they receive the correct accounting treatment. In order to prevent overvaluation and account for variations in asset value over time, goodwill policies handle the valuation and impairment testing of intangible assets resulting from acquisitions. When taken as a whole, these regulations support clear financial reporting, adherence to accounting rules, and knowledgeable decision-making by stakeholders.

6.10 KEY WORDS

Depreciation: Tax laws, accounting rules, allocation, tangible assets, and useful life.

Inventory: Value, measurement, weighted average, FIFO, LIFO, lower of cost or market, turnover, and obsolescence are characteristics of inventory.

Intangible assets: Recognition, measurement, amortization, copyrights, trademarks, patents, goodwill, and impairment testing are examples of intangible assets.

Goodwill: Acquisition, Impairment, Valuation, and Intangible Assets comprise Goodwill.

6.11 REVIEW QUESTIONS

Q1. Which depreciation techniques does the business apply to its material assets, and why?

Q2. How does the business calculate the assets' useful lives?

Q3. Which form of inventory value does the organization use, and why?

Q4. How does the business handle the problem of outdated inventory?

Q5. Could you explain the relevance of the company's inventory turnover ratio?

Q6. How does the business value its intangible assets—like trademarks and copyrights—and identify them?

Q7. What is the policy of the organization about the intangible asset amortization?

Q8. How does the business evaluate goodwill impairment, and how frequently does it do so?

BLOCK-III: ANALYSIS OF FINANCIAL STATEMENT

UNIT-7: RATIO ANALYSIS- SOLVENCY RATIOS, PROFITABILITY RATIOS, ACTIVITY RATIOS, LIQUIDITY RATIOS, MARKET CAPITALIZATION RATIOS

STRUTURE

7.0 OBJECTIVES

After studying this unit you should be able to

- assess the company's ability to pay back its loans and its long-term financial health.
- evaluate the company's overall profitability and operational effectiveness.

- ascertain whether the business has enough liquid assets to pay for its liquid debt.
- evaluate how the market views the company's performance and prospects for expansion.

7.1 INTRODUCTION

With the use of strong financial tools like ratio analysis, stakeholders may evaluate a company's performance and overall health by examining a variety of financial ratios. These ratios fall into a number of important categories, each of which fulfills a particular purpose. Solvency ratios give information about a company's long-term stability by concentrating on its capacity to fulfill long-term financial obligations. Profitability ratios measure a company's capacity to create profits in relation to its revenue, assets, or equity, which helps determine how efficient its operations are. Activity ratios, sometimes referred to as asset management ratios, assess how well assets are used to produce revenue and sales. Liquidity ratios evaluate the overall liquidity condition and short-term financial capacity of an organization. Market capitalization ratios, which show the equity worth of the firm in relation to financial measures, provide insight into how the market evaluates the performance and growth potential of the company. Ratio analysis in these areas may help stakeholders make well-informed judgments about financing, investments, and strategic planning, which will improve financial management and decision-making in the long run.

7.2 RATIO ANALYSIS

Ratio analysis is a mathematical technique that examines financial accounts like the income statement and balance sheet to provide insight into a company's liquidity, operational effectiveness, and profitability. A key component of basic equity analysis is ratio analysis.

By analyzing different correlations between financial variables, ratio analysis is a key approach used to assess a company's financial health and performance. This analytical technique compares several ratios that are obtained from the balance sheet, income statement, and cash flow statement of the business.

- Ratio analysis examines line-item data from the financial accounts of an organization to provide information on solvency, profitability, liquidity, and operational effectiveness.
- Ratio analysis is a useful tool for comparing one firm to another within the same industry or sector and gauging its performance over time.
- External parties that set standards frequently associated with risk may also demand ratio analysis.
- Ratios may provide valuable insights into a business, but in order to get a more complete view of a company's financial health, they should be combined with other indicators.
- The current ratio, gross profit margin ratio, and inventory turnover ratio are a few instances of ratio analysis.

7.3 RATIO ANALYSIS REVEALS

Ratio analysis is a tool used by analysts and investors to assess a company's financial health by carefully examining its recent and historical financial statements. Comparative data may be used to predict expected future performance as well as show how a firm is doing over time. This information may also be used to assess how a firm compares financially to industry averages and to other businesses in the same industry.

The financial statements of a corporation provide all the figures required to compute the ratios, making ratio analysis simple for investors to apply.

Ratios serve as benchmarks for businesses. They assess equities within a sector. In a similar vein, they assess a business now based on its past performance. Most of the time, it's also critical to comprehend the factors that influence ratios because management may occasionally change course to improve the attractiveness of the company's stock and ratios. Ratios are usually employed in conjunction with other ratios rather than alone. Gaining a thorough understanding of the ratios in each of the four previously stated areas will enable you to observe the business from various perspectives and identify any potential red flags.

The relationship between two quantities that indicates how often one value includes or is contained inside the other is called a ratio.

7.4 TYPES OF RATIO ANALYSIS

Based on the data sets they offer, the many types of financial ratios that are accessible may be generally categorized into the following six silos:

1. Ratios of Liquidity

Liquidity ratios assess a company's capacity to use its fast or current assets to settle its short-term debts when they fall due. The working capital ratio, quick ratio, and current ratio are examples of liquidity ratios.

2. Ratios of Solvency

Solvency ratios, also known as financial leverage ratios, assess a company's chances of surviving over the long run by paying down its long-term debt as well as the interest on its debt by comparing its debt levels with its assets, equity, and profits. Debt-to-equity, debt-to-assets, and interest coverage ratios are a few examples of solvency ratios.

3. Ratios of Profitability

These ratios show how successfully an organization may turn a profit from its activities. Examples of profitability ratios are profit margin, return on equity, return on assets, return on capital utilized, and gross margin ratios.

4. Ratios of Efficiency

Efficiency ratios, often known as activity ratios, assess how well a business uses its assets and liabilities to create sales and optimize profits. The turnover ratio, inventory turnover, and days' sales in inventory are important efficiency ratios.

5. Ratios of Coverage

The capacity of a business to pay off its loans' interest and other associated responsibilities is gauged by coverage ratios. The debt-service coverage ratio and the times interest earned ratio are two examples.

6. Ratios of Market Prospects

In basic analysis, these are the ratios that are most frequently utilized. These comprise the earnings per share (EPS), dividend payout ratio, P/E ratio, and dividend yield. These measures are used by investors to forecast future performance and profitability.

A stock with a P/E ratio of seven would be deemed inexpensive, for instance, if the average P/E ratio of all businesses in the S&P 500 index is twenty and the majority of companies had P/Es between fifteen and twenty-five. On the other hand, one with a 50 P/E ratio would be deemed overpriced. In the future, the former could trend upward and the latter might trend downward until each reaches its inherent worth.

The majority of ratio analyses are limited to internal decision-making. Despite the fact that some standards are established externally (covered below), ratio analysis is frequently not a necessary component of planning or budgeting.

7.5 UTILIZING RATIO ANALYSIS

Comparing several statistics and arriving at a computed value forms the essential premise of ratio analysis. That value might be worthless on its own. Rather, in order to ascertain if a company's

financial health is robust, poor, improving, or declining, ratio analysis must frequently be performed on a similar.

Ratio Analysis Using Time

Ratio analysis is a useful tool that a business may use to better understand its own trajectory over time. The firm is more concerned in how it has fared over time, what improvements have worked, and what dangers remain as it looks to the future than it is in where it is at now moment. Making long-term judgments and strategic planning requires doing ratio analysis.

In order to do ratio analysis over time, a business first chooses one financial ratio and computes it on a regular basis (for example, by calculating its quick ratio each month). Consider seasonality and the brief variations in account balances that might affect the computation of month-over-month ratios. Subsequently, an organization evaluates the evolution of the ratio throughout time, including its improvement, the pace of change, and the company's intention for the ratio to change.

Ratio Analysis Between Businesses

Consider a business that has a gross profit margin of 10%. This financial ratio may excite a business, but only until it finds out that all of its rivals are attaining a 25% gross profit margin. A firm can better understand how its performance compares to that of similar companies by using ratio analysis.

Think about focusing your ratio research on comparable businesses in the same industry if you want to compare various firms in an accurate manner. Additionally, keep in mind how a firm's capacity for efficiency may be impacted by varying financial structures and company sizes. Furthermore, take into account how businesses

with diverse product lines—for example, technology firms that provide both products and services, or two distinct product lines with differing effects on ratio analysis—manage their operations.

It's only that various sectors have varied expectations for ratios. For a technological business that depends more on finance from private investors, a debt-to-equity ratio that could be considered average for a utility company that can secure low-cost loans may be considered unsustainable high.

Comparing Ratio Analysis to Benchmarks

Businesses might establish internal goals for their financial ratios. These estimations could aim for operational expansion or maintain present levels. For instance, if a company's current ratio is 1.1, it can establish an internal goal to reach 1.2 by the end of the fiscal year in order to increase its liquidity.

Furthermore, third parties like lenders regularly use benchmarks. Covenants in loan papers are frequently used by lending institutions to impose restrictions on financial health. The terms and conditions of the loan include covenants, which require businesses to meet specified benchmarks or risk having the loan recalled.

Should these standards not be reached, a corporation could have to pay a higher interest rate in order to compensate for the risk, or the entire loan could become callable. A common example of a benchmark established by a lender is the debt service coverage ratio, which compares the cash flow of an organization to the total amount of debt it has.

Ratio analysis examples that are in use

For better or worse, ratio analysis can forecast a company's success in the future. Profitable businesses often have strong ratios across the board, and any unexpected indication of weakness in one area might cause a large stock sell-off. Let us examine a few basic instances.

Investors use net profit margin, often known as the bottom line or just profit margin, as a ratio to assess how profitable different businesses are in the same industry. It is computed by dividing net income by revenues for a business. An investor might utilize this ratio in place of analyzing financial documents to evaluate the profitability of different organizations. Let's take an example where two companies in the same sector, ABC and DEF, with profit margins of 50% and 10%, respectively. Investors may readily compare the two businesses and determine that, although DEF only turned 10% of its revenues into profits, ABC turned 50% of its revenues into earnings.

Assume, using the businesses from the previous example, that ABC and DEF have respective P/E ratios of 100 and 10. The average investor comes to the conclusion that, for every $1 in revenues generated by ABC, investors are ready to pay $100, but only $10 for every $1 generated by DEF.

7.6 ACTIVITY RATIO

Activity ratios are sometimes called asset utilization or operating efficiency. They assess a company's asset management efficiency. Income statement and balance sheet data are usually used in these ratios.

Below are the most typical activity ratios:

Calculating Inventory Turnover: cost of goods sold/average inventory. Inventory management effectiveness can be measured by the ratio. Higher inventory turnover ratios indicate shorter inventory holding times.

To calculate DOH, divide the number of days in a period by the inventory turnover.

The ratio can help assess inventory management effectiveness. Lower DOH means shorter inventory holding time.

Receivables To calculate turnover, divide revenue by average receivables.

Interpretation: this measures credit and collection efficiency in an organization. A corporation with a high receivables turnover ratio may have efficient credit and collections. It could also mean a corporation has excessively strict credit or collection policies.

To calculate Days of Sales Outstanding (DSO), consider the number of days in the period and received revenue turnover.

This quantifies the duration between a sale and cash collection. It shows how quickly a corporation obtains credit-exposed clients' cash. A company with a low DSO has effective credit and collection operations.

Payables To calculate turnover, divide purchases by average trade payables.

Interpretation: this is the number of times a corporation theoretically pays out its creditors per year.

Payable Days
Calculation: period days/payables turnover

This shows the average time a company takes to pay its suppliers.

To calculate working capital turnover, divide revenue by average working capital.

Interpretation: this shows how well a corporation uses working capital to generate income. Efficiency increases with a high working capital turnover ratio.

To calculate Fixed Asset Turnover, divide revenue by average net fixed assets.

This assesses how well a corporation makes money from its fixed assets. More effective income generation from fixed assets is indicated by a greater turnover ratio.

To calculate total asset turnover, divide revenue by average total assets.

Interpretation: this analyzes a company's revenue generation potential using its assets. Company inefficiency or capital intensity may be indicated by a low asset turnover ratio.

7.7 LIQUIDITY RATIOS

Companies' short-term liquidity ratios evaluate their capacity to meet obligations. Company position is shown by these ratios. Instead of averages, they use ending balance sheet data. The most frequent liquidity ratios are listed below.

To calculate the current ratio, divide current assets by current liabilities.

High current ratios imply liquidity or ability to meet short-term obligations.

Calculate Quick Ratio: (cash + short-term investments + receivables)/current liabilities.

Higher fast ratios imply liquidity or ability to meet short-term obligations. This is a better measure of liquidity than the current ratio for illiquid inventory.

Calculation of Cash Ratio: (cash + short-term investments)/current liabilities.

Interpretation: the ratio accurately measures crisis liquidity.

Calculate Defensive Interval Ratio: (cash + short-term marketable investments + receivables)/daily cash expenditures.

Interpretation: this evaluates how long a corporation can pay its daily expenses with only its liquid assets and no cash inflow.

Other ratios

The cash conversion cycle is another liquidity measure besides the above ratios. Calculated as DOH + DSO – Number of days of payables, it indicates the time it takes a corporation to go from cash paid (spent in operations) to cash received.

7.8 SOLVENCY RATIO

Solvency ratios evaluate a business's capacity to meet its long-term commitments. They offer details about the proportion of debt in the capital structure of a business. Additionally, they show if a company's cash flow and earnings are sufficient to pay interest and other fixed costs as they become due.

Solvency ratios exist in two flavors:
(i) debt ratios, which gauge a company's debt-to-equity capital ratio by looking at the balance sheet; and
(ii) coverage ratios, which gauge a company's debt-to-income ratio by looking at the income statement. When determining a company's solvency and the caliber of its bonds and other financial commitments, both sets of statistics are helpful.

The list of the most often used solvency ratios is as follows:

Calculation of the Debt-to-Assets Ratio: total debt / total assets

Interpretation: this indicates the proportion of debt-financed assets that make up a corporation. Higher ratios are indicative of lower solvency and more financial risk.

The debt-to-capital ratio is calculated as follows: total debt divided

by total shareholders' equity.

Interpretation: this indicates the proportion of debt that makes up a company's capital (debt plus equity). Higher ratios are indicative of lower solvency and more financial risk.

Calculation of the Debt-to-Equity Ratio: total debt divided by total shareholders' equity

Interpretation: This shows how much debt capital there is in comparison to equity capital. Higher ratios are indicative of lower solvency and more financial risk.

Calculation of the Financial Leverage Ratio: average total assets / average total equity

Interpretation: This counts the total number of assets backed by each $1 unit of equity. The greater the ratio, the more indebted the business is when financing assets with debt and other obligations.

Interest Coverage Ratio: Interest payments / EBIT computation

Interpretation: this counts the amount of times an organization's EBIT may pay interest. Stronger solvency is indicated by a greater ratio.

The formula for calculating the fixed-charge coverage ratio is (EBIT + lease payments)/(interest payments + lease payments).

Meaning: this calculates how many times a company's earnings (before taxes, interest, and lease payments) are sufficient to pay for

interest and lease payments. Stronger solvency is indicated by a greater ratio.

7.9 PROFITABILITY RATIOS

The capacity of a business to turn a profit from its resources (assets) is gauged by profitability ratios. Return-on-sales profitability ratios, which express different sub-totals on the income statement as a percentage of revenue, and return-on-investment profitability ratios, which gauge income in relation to a company's assets, equity, or total capital employed, are the two types of profitability ratios.

The most often used solvency ratios are shown below:

Calculation of Gross Profit Margin: gross profit / revenue

Interpretation: this shows the portion of income that may be used to pay for overhead, other costs, and operational costs in addition to making a profit. bigger product price and lower product expenses are combined to provide a bigger gross profit margin.

Operating Profit Margin Calculation: sales / operating income

Interpretation: If the operational profit margin rises more quickly than the gross profit margin, operating costs, including administrative overheads, may be more under control.

EBT (profits before tax but after interest) / revenue is how pretax margin is calculated.

Interpretation: this shows how leverage and other non-operating revenue and costs affect profitability.

Calculating Net Profit Margin: net income / revenue

Interpretation: This shows the percentage of profit that is generated from every dollar received in revenue.

Operating Income/Average Total Assets is how operating ROA is calculated.

Interpretation: this calculates the return on an organization's assets (before interest on loan capital is subtracted).

Calculation of Return on Assets (ROA): net income divided by average total assets

Interpretation: this calculates the return on an organization's assets.

Computation of Return on Total Capital: EBIT/Long- and short-term debt and equity

Interpretation: this calculates a company's earnings on all of the capital it uses.

Calculation of Return on Equity (ROE): net income divided by average total equity

Interpretation: This gauges a business's return on equity capital, which includes common, preferred, and minority stock.

Average common equity divided by net income (preferential dividends) is the return on common equity.

Interpretation: this calculates a company's return only on its common equity.

7.10 LET US SUM UP

An essential technique used by lenders, investors, and managers to assess a company's financial health is ratio analysis. Debt-to-equity, interest coverage, and debt service coverage ratios are examples of solvency ratios that offer information on a company's capacity to pay its long-term debts and maintain stability over time. A company's capacity to generate profits in relation to revenue, assets, and equity is measured by profitability ratios such as gross profit margin, net profit margin, and return on assets. These ratios provide insight into the operational performance of the business. Activity ratios, such turnover in inventory and accounts receivable, evaluate how well a business uses its resources to produce income and show how efficient its operations are. The current ratio and quick ratio are two examples of liquidity ratios that assess a company's capacity to swiftly turn assets into cash in order to pay short-term financial obligations and maintain financial flexibility. Investment decisions are guided by market capitalization ratios, such as price-to-book, price-to-earnings, and earnings per share, which reveal how the market values a company's stock in relation to its earnings and book value. Ratio analysis provides useful insights into a company's financial performance and health, providing a thorough framework for stakeholders to make decisions regarding loans, investments, and strategic planning.

7.11 KEY WORDS

Turnover Ratios: Measures of operational efficiency that show how profitable a business may be in relation to its revenue, assets, or equity. Return on equity (ROE), net profit margin, return on assets (ROA), and gross profit margin are a few examples.

Activity ratios: Activity ratios are financial measures of a company's operational effectiveness that show how well it uses its assets to create revenue. The turnover ratios for inventories, accounts receivable, and assets are a few examples.

Availability of liquid assets Ratios: Metrics that assess a business's capacity to swiftly turn assets into cash in order to pay short-term financial obligations while maintaining financial flexibility. The fast ratio (acid-test ratio) and the current ratio are two examples.

7.12 REVIEW QUESTIONS

Q1. What does the debt-to-equity ratio measure, and why is it important for assessing a company's financial health?

Q2. How would an increase in the interest coverage ratio affect investors' perception of a company's risk?

Q3. How does the gross profit margin differ from the net profit margin, and what insights do these ratios provide about a company's profitability?

Q4. Describe the relationship between a company's profitability ratios and its competitive position in the market.

Q5. What does a high inventory turnover ratio indicate about a company's operations, and how might this affect its profitability?

Q6. How does the accounts receivable turnover ratio help assess a company's credit and collection policies?

Q7. Explain the difference between the current ratio and the quick ratio, and when might each be more appropriate for assessing liquidity?

Q8. How does a low liquidity ratio affect a company's ability to handle unexpected financial challenges?

Q9. Discuss the importance of liquidity ratios for creditors and investors when evaluating a company's financial health.

UNIT-8: COMMON SIZE STATEMENT

STRUTURE

8.0 OBJECTIVES

After studying this unit you should be able to

- help in recognizing alterations in the financial statements' composition over time.
- assistance in assessing several facets of a business's financial performance, including solvency, profitability, liquidity, and efficiency.
- aids in determining the financial structure of a company's strong and weak points.
- give information on the past trends of several financial variables, which helps with financial forecasting.

8.1 INTRODUCTION

By presenting each line item as a percentage of a base item—typically total assets for the balance sheet and total revenue for the income statement—a common size statement is a financial reporting technique used to assess and comprehend the structure of financial statements. This standardization makes it possible to make insightful comparisons between businesses of various sizes as well as between the same business across time. Common size statements make trend analysis, financial ratio identification, and an assessment of the strengths and weaknesses in a company's financial structure easier by providing financial data in relative terms. They provide as the basis for financial analysis, helping to predict future performance and offering information on the dynamics and makeup of financial statements. All things considered, common size statements are priceless resources for analysts, investors, and other stakeholders trying to properly comprehend and analyze financial data.

8.2 COMMON SIZE STATEMENT

Items are shown as a percentage of a common base amount, such as total sales revenue, in a financial statement of common size. This kind of financial statement makes it simple to compare one firm to another or to compare one period to the next. Nevertheless, any comparison could not be true if the businesses employ different accounting techniques.

- Instead of showing items as absolute numerical values, a common size financial statement presents them as a percentage of a common base number.
- Common size statements enable analysts to make apples-to-apples comparisons across businesses of various sizes, across industries, or over time.
- The income statement, balance sheet, and cash flow statement are examples of common size financial statements.

Even though the majority of businesses do not submit their financial statements in a standard format, analysts should consider doing so when comparing two or more businesses of varying sizes or various economic sectors. This method of formatting financial statements minimizes potential bias and enables examination of a corporation across time. For example, this research shows how the cost of products sold has evolved over time and what proportion of sales it represents. The income statement, balance sheet, and cash flow statement are examples of common size financial statements.

All numbers in common size financial statements are condensed into a single, comparable number, such a percentage of assets or sales. To standardize figures, each financial statement adheres to a somewhat different norm.

Comparing a company's financial statements to those of comparable firms and figuring out what drives a company's profitability are made easier with common size financial statements.

One method of analyzing and interpreting the financial statement is the common size statement. Another name for it is vertical analysis. Using each line item as a percentage of the base amount

for that specific accounting period, this approach analyzes financial accounts.

Common size statements are a very simple way to describe financial statements, which facilitates their analysis. However, they are not the same as financial ratios of any type.

Common size remarks are usually stated as percentages. Since each individual item is treated as a percentage of 100, these statements are also known as component percentage statements or 100 percent statements.

8.3 TYPES OF COMMON SIZE STATEMENT

Common size assertions come in two varieties:

- Average income statement size
- Standard size balance sheet

8.3.1 Income Statement in Common Size

This is one kind of typical size statement where all calculations are based on sales. As a result, each line item's computation will use sales as a foundation, and each item's expression will be in terms of a percentage of sales.

Utilizing a Common Size Income Statement

It aids the company owner in comprehending the next elements.

- if the earnings are rising or falling in comparison to the sales made.
- percentage of the cost of the items sold during the accounting period that changed.
  variation in costs that may have happened.
- whether the rise in retained earnings is commensurate with the company's growth in profit.
- makes it easier to compare income statements from many periods.
- identifies changes occurring in the organization's financial accounts, which will assist investors in choosing whether to participate in the company.

Standard Income Statement Size

The profit and loss (P&L) statement, often known as the income statement, gives a summary of the sales, expense, and net income flows for the reporting period. Sales less costs and adjustments equals net income in the income statement calculation. For this reason, every item is expressed as a percentage of sales in the typical size income statement. Although the balance sheet and the cash flow statement can also be stated as common size statements, the phrase "common size" is most frequently used when discussing components of the income statement.

8.3.2 Balance Sheet of Common Size

A statement where the balance sheet items are determined as the ratio of each asset to the total assets is known as a common size balance sheet. Each liability is determined as a percentage of the total liabilities for the liabilities.

Comparing firms with different sizes may be done using common size balance sheets. Since a variety of factors appear to impact the overall data, comparing such figures for different times is not proven to be all that informative.

This approach cannot develop standard values for different assets since it is unable to study the patterns in the numbers and may produce inaccurate conclusions.

8.4 COMMON SIZE INCOME STATEMENT FORMAT

The common size income statement format is as follows:

Common Size Income Statement
for the years ended ...

Particulars	Absolute Amounts		Percentage of Revenue from Operation (Net Sales)	
	Previous Year (₹)	Current Year (₹)	Previous Year (%)	Current Year (%)
(1)	(2)	(3)	(4)	(5)
I. **Revenue from Operations** (Net sales)	...	...	...	...
II. **Other Income**	...	...	...	...
III. **Total Revenue** (I + II)	...	...	...	...
IV. **Expenses**				
(a) Cost of Materials Consumed	...	...	...	...
(b) Purchases of Stock-in-trade	...	...	...	...
(c) Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade	...	...	...	...
(d) Employee Benefit Expenses	...	...	...	...
(e) Finance Cost	...	...	...	...
(f) Depreciation and Amortisation	...	...	...	...
(g) Other Expenses	...	...	...	...
Total Expenses	...	...	...	...
V. **Profit before Tax** (III – IV)	...	...	...	...
VI. (–) Income Tax	...	...	...	...
VII. **Profit after Tax**	...	...	...	...

8.5 PREPARING COMMON SIZE BALANCE SHEET

A quick summary of the company's assets, liabilities, and shareholders' equity for the reporting period is given by the balance sheet. The common size income statement and balance sheet are organized using the same principles. Liabilities + shareholders' equity equals assets in the balance sheet calculation.

As a result, the balance sheet shows an asset proportion. An alternative representation of the common size balance sheet displays the percentages of the asset line items relative to the total assets, the liabilities relative to the total liabilities, and the stockholders' equity relative to the total stockholders' equity.

(1) Assume that there are 100 assets and/or liabilities.

(2) Different liabilities are likewise computed according to total liabilities, and each individual asset is expressed as a proportion of the total assets, or 100. Let's take an example where the inventory value is Rs. 1 lakh and the total assets are around Rs. 4 lakhs. If so, it will be considered a quarter of the total assets.

8.6 LIMITATIONS OF COMMON SIZE STATEMENT

The restrictions that were considered are listed below.

- Due to the lack of an authorized benchmark, it is useless in the decision-making process.
- It might be deceptive for a company that has seasonal swings.

8.7 CASH FLOW STATEMENT OF COMMON SIZE

An overview of the sources and uses of cash for the company is given by the cash flow statement. Cash flows from financing, cash flows from investment, and cash flows from operations make up the cash flow statement. Further details about the sources and uses of money in each company activity are provided in each area.

Every line item is expressed as a percentage of total cash flow in one variation of the typical size cash flow statement. For items in cash flows from operations, total investment cash flows, total financing cash flows, and total investing cash flows, respectively, are the phrases used to represent cash flow in the more widely used form.

8.8 LET US SUM UP

A common size statement is a financial analysis technique that allows for standardised comparisons between businesses and time periods by expressing each line item as a percentage of a base item. It makes trend analysis, ratio computation, and the identification of financial structure strengths and weaknesses easier, which helps with forecasting and gives analysts and investors insightful information.

Common Size of financial statements is a method used to determine a company's resource allocation and distribution among balance sheet and income statement accounts, determining the relative weight of each account and its share in asset resources or revenue generation. Common Size of financial statements analyzes

a company's resource allocation and distribution among balance sheet and income statement accounts, determining their relative weight and share in asset resources or revenue generation.

8.9 KEY WORDS

Standardized: Standardized financial data is expressed consistently, usually as percentages of a base item, to facilitate comparisons.

Base item: The starting point for percentage calculations; typically, this is total revenue for income statements and total assets for balance sheets.

Comparisons: Finding patterns and trends in financial data by analyzing and assessing information from several businesses or historical periods.

Analysis: The process of looking over and interpreting financial data to learn about the performance, advantages, and disadvantages of a business.

Trend: Visible through common size statements, the direction and pattern of changes in financial data over time.

Ratio: A mathematical relationship based on information from common size statements between two financial variables that sheds light on several elements of a business' performance.

Insights: important knowledge and information gleaned by analyzing typical size statements that supports forecasting and decision-making.

Financial Structure: As shown by typical size statements, the makeup and organization of a company's financial assets, liabilities, and equity.

8.10 REVIEW QUESTIONS

Q1. What is the purpose of creating a common size statement?

Q2. How are common size statements different from traditional financial statements?

Q3. What base item is typically used for expressing line items in a common size statement?

Q4. How do common size statements facilitate financial analysis?

Q5. What types of comparisons can be made using common size statements?

Q6. Can you explain how common size statements are useful in trend analysis?

Q7. What are some key financial ratios that can be calculated using common size statements?

Q8. How do common size statements help in identifying strengths and weaknesses in a company's financial structure?

Q9. How are common size statements utilized in financial forecasting?

Q10. Can you provide an example of how common size statements are applied in real-world financial analysis?

UNIT-9: COMPARATIVE BALANCE SHEET AND TREND ANALYSIS OF MANUFACTURING, SERVICE & BANKING ORGANIZATIONS.

STRUTURE

9.0 OBJECTIVES

After studying this unit you should be able to

- analyze changes in their equity, liabilities, and assets to see how well their financial management plans, investments, and operations are working.
- trends in asset composition analysis might provide light on how well a manufacturing business manages its resources.
- assist financial firms in tracking their liquidity over time.

9.1 INTRODUCTION

Performance and strategic direction of businesses in a range of industries, such as banking, manufacturing, and services. These evaluations examine how asset usage, cost structures, and operational efficiency vary over time in manufacturing companies, supporting resource allocation and strategic decision-making. Comparative balance sheet and trend analysis are used to guide marketing strategies and service offers for service-oriented firms. These analyses center on revenue growth trends, operational efficiency improvements, and customer satisfaction measures. Analyses of this kind are similarly crucial to financial organizations for assessing profitability trends, risk exposure, and liquidity management. They also help guide lending practices, efforts to comply with regulations, and investment choices. Organizations may obtain important insights into their financial performance, pinpoint opportunities for development, and modify their plans to prosper in changing market conditions by closely examining the elements and patterns of their balance sheets. Therefore, trend analysis and comparative balance sheets are essential tools for evaluating and improving the financial competitiveness and resilience of industrial, service, and banking firms.

9.2 COMPARATIVE BALANCE SHEET

In order to facilitate easy understanding and analysis, a comparative balance sheet presents financial data on assets, liabilities, and equity for "two or more periods of the same company,""two or more subsidiaries of the same company," or "two or more companies of the same industry" in the same format.

Every balance sheet item in the comparative balance sheet includes two amount columns. The financial status for the current year is displayed in one column, while the financial situation for the prior year is displayed in the other. This makes it simple for stakeholders and investors to comprehend and compare the company's financial performance to previous year.

Comparative balance sheet analysis compares the balance sheets of several periods in a manufacturing company to evaluate changes in equity, liabilities, and assets. For instance, a rise in fixed assets might be a sign of investments in brand-new machinery or buildings, whilst a fall in inventories would point to better inventory control. Through an examination of these modifications, the company may assess how well its capital structure and asset usage are working.

9.3 IMPORTANT LESSONS FOR COMPARATIVE BALANCE SHEET

- Comparative balance sheets, as the name implies, are financial statements that aggregate and display a company's market position over time for two distinct time periods, two subsidiaries, or two businesses in the same sector.
- A rapid ratio analysis utilizing the company's data from reliable online sources is a useful tool for comparing the financial positions of different companies. In order to identify a link between the numbers, the ratio analysis procedure looks at the data in the financial statements, such as total costs or net profit.
- Comparing balance sheets has several benefits, including making it simpler for investors to predict the future,

identifying industry trends, and evaluating the long-term success of various businesses.

- A few disadvantages of comparative analysis include that genuine information is missing, the inflationary impact surrounding the market is ignored, and it may occasionally be deceptive.

9.4 EXAMPLE FORMAT OF COMPARATIVE BALANCE SHEET

Below is the format of a comparative balance sheet of XYZ Inc. for 2018 and 2017. In this balance sheet, the financial position of the year ended 2018 and 2017 are mentioned in columns 2018 and 2017, respectively. There are two columns – the first column shows the change in absolute terms, and the second column leads the change in % terms.

Current Ratio Analysis	2018	2017
Current Assets	**85000**	**74000**
Current Liabilities	**55000**	**49000**
Current Ratio	**1.5**	**1.5**

In the books of XYZ Inc.				
Comparative Balance Sheet For the Year ended 31st Dec'2018 and 2017				
Particulars	2018 Amount ($)	2017 Amount ($)	Change in Absolute Value	Change in Percentages
Equity and Liabilities				
Shareholder's Fund				
a. Share Capital	100000	100000	-	0%
b. Reserve & Surplus	25000	20000	5000	25%
Non - Current Liabilities				
a. Long term Borrowings	30000	35000	-5000	-14%
Current Liabilities				
a. Trade Payables	45000	40000	5000	13%
b. Short Term Borrowings	10000	9000	1000	11%
Total	**210000**	**204000**	**6000**	
Assets				
Non Current Assets				
a. Fixed Assets	70000	80000	-10000	-13%
b. Investment	55000	50000	5000	10%
Current Assets				
a. Trade Receivables	35000	25000	10000	40%
b. Inventory	30000	39000	-9000	-23%
c. Cash & Bank	20000	10000	10000	100%
Total	**210000**	**204000**	**6000**	-

Following an analysis of the balance sheet above, the following findings are noted:

- The share capital of the corporation remains unchanged in both years. It suggests that no shares have been issued by the corporation for the current year.
- The reserve and surplus of the corporation went up by $5,000, or 25%. It demonstrates that the business has made money, added reserves, and excess.
- $5,000, or 14%, less in long-term borrowing shows that the business has paid off a $5,000 debt.
- Depreciation caused a $10,000 decrease in fixed assets.
- Trade receivables climbed by $10,000 and inventory decreased by $9,000, indicating that the firm has sold its product to consumers but has not yet received the money.

- Upon examining the current ratio, we saw that it has grown by $0.04 from the previous year, suggesting that the business has done well this year compared to last.

9.5 BENEFITS OF COMPARATIVE ANALYSIS OF BALANCE SHEETS

Since the numbers from both years are provided in one location, comparing the numbers from the current year with those from the past is simple. Additionally, it helps with the analysis of data from two or more businesses or a single company's subsidiaries.

Trend Indicator: This tool displays the financial trends of a firm over a period of several years, including changes in profit, current assets, current liabilities, loans, reserves, surplus, and any other information that might be useful to investors in making decisions.

Ratio Analysis: The items on the balance sheet are the source of financial ratios. To assess the financial health of the firm, the financial ratio of the two-year comparative balance sheets of the two companies may be calculated. For instance, current assets and current liabilities are used to calculate the current ratio. If the current year's current ratio is higher than the previous one, it indicates that the company's liabilities have decreased relative to its assets.

Compare Performance with Industry Performance: This tool facilitates the comparison of a company's performance with that of its peers or with the average performance of the industry.

Assists in Forecasting: The historical trends of the firm are provided, allowing management to project the company's financial status. This aids with forecasting as well.

9.6 LIMITATIONS OF COMPARATIVE ANALYSIS OF BALANCE SHEETS

Uniformity in Policy and Principles: If two firms implement different policies and accounting principles throughout the preparation of the balance sheet, or if the same company adopts different accounting procedures in two more years, then comparative balance sheets will not provide an accurate comparison.

Inflationary Effect is Not Taken into Account: The inflation effect is not taken into account while generating the comparative balance sheet. As such, comparing the balance sheet to another balance sheet alone will not provide an accurate view of the company's trajectory.

Political climate, the state of the market, and any other element influencing the company's operations are not taken into account while creating the comparative balance sheet. As a result, it occasionally fails to provide the accurate image. Let's say, for instance, that the current year's general economy is contracting or that the political landscape is more precarious than it was a year ago. In that instance, demand would decline and overall firm sales

will decelerate due to outside forces rather than internal performance.

False Information: Occasionally, it provides false information, which causes the reader of the comparative balance sheet to be misled. For instance, a product that was not available for the prior year but is now accessible for the current year will be displayed as having changed 100% from the year before. It suggests that reading the entire financial statement—rather than simply the comparative balance sheet—is necessary.

9.7 TREND ANALYSIS

In industrial companies, trend analysis looks for trends and shifts in important financial measures across time. This covers patterns in operational costs, cost of goods sold, and revenue growth. A decreasing trend in the cost of goods sold as a percentage of revenue, for example, may be a sign of increased manufacturing efficiency or cost-cutting measures. Analyzing operational expense patterns also aids in pinpointing areas that might benefit from cost cuts to increase profitability.

Examining the financial statements over a period of time, say five years, and seeing the pattern during that time is another crucial method of financial statement analysis. This is especially essential for items of the income statement such sales, earnings, or balance sheet items such as debt and net wealth.

In banking institutions, trend analysis primarily monitors shifts in important financial parameters such capital adequacy, net interest margin, and loan-to-deposit ratio. For example, examining patterns in the loan-to-deposit ratio aids in evaluating the lending capability

and liquidity situation of the company. In a similar vein, patterns in net interest margin reveal information about the profitability and interest rate risk management of the company.

9.8 LET US SUM UP

In conclusion, industrial, service, and banking companies need to use trend analysis and comparative balance sheets to assess their financial performance, pinpoint opportunities for development, and formulate well-informed strategic choices. These companies can reduce risks, adjust to changing market conditions, and succeed over the long run by monitoring changes over time.

In order to evaluate the financial performance and overall health of industrial, service, and banking firms, comparative balance sheet and trend analysis are essential. These assessments concentrate on cost structures and asset utilization in manufacturing, whereas they place more emphasis on revenue development and operational efficiency in service firms. Financial institutions evaluate profitability, risk exposure, and liquidity. Organizations may attain long-term success by identifying areas for development, adapting to market dynamics, and making well-informed strategic decisions by comparing balance sheets and monitoring trends over time.

9.9 KEY WORDS

Trend analysis: Trend analysis is the study of patterns and variations over time in important financial measures, such profitability, costs, and sales. It helps determine areas for development and helps comprehend performance trends.

Manufacturing Organization: A business that uses a variety of processes to produce physical things; this type of business requires asset analysis in relation to inventories, equipment, and production facilities.

Service Organization: A company that provides clients with intangible goods or services; as such, it must analyze revenue sources, operational costs, and KPIs pertaining to customers.

Asset Utilization: A ratio like asset turnover or inventory turnover is frequently used to assess how well a business uses its assets to produce income.

Revenue Growth: The pace at which a business's sales or revenue rises over time, a measure of the effectiveness of its marketing initiatives and business plans.

Cost control: Cost control refers to management initiatives to control and lower costs in order to guarantee effective resource allocation and preserve profitability.

Risk assessment: Risk assessment is the evaluation of possible risks and uncertainties, such as credit risk, market risk, and operational risk, that might have an influence on the stability or performance of an organization's finances.

Solvency: An organization's capacity to pay its long-term debts; this may be determined by looking at its debt-to-equity and interest coverage ratios.

9.10 REVIEW QUESTIONS

Q1. How does comparative balance sheet analysis differ between manufacturing, service, and banking organizations?

Q2. What are the key metrics used in trend analysis for manufacturing organizations?

Q3. How do service organizations use trend analysis to improve customer satisfaction?

Q4. What specific financial ratios are commonly analyzed in comparative balance sheet analysis for banking organizations?

Q5. How do manufacturing organizations utilize trend analysis to improve operational efficiency?

Q6. What are the main challenges faced by service organizations in conducting trend analysis?

Q7. How does liquidity management differ between service and banking organizations?

Q8. How do comparative balance sheet and trend analysis contribute to strategic decision-making in manufacturing, service, and banking organizations?

BLOCK-IV: FUNDS FLOW STATEMENT & CASH FLOW STATEMENT

UNIT-10: MEANING, CONCEPT OF GROSS AND NET WORKING CAPITAL, PREPARATION OF SCHEDULE OF CHANGES IN WORKING CAPITAL,

STRUTURE

10.0 OBJECTIVES

After studying this unit you should be able to

- Comprehending gross working capital facilitates the evaluation of a company's capacity to fulfill its immediate financial commitments and finance its daily activities.
- indicates the liquidity position of a company after considering its short-term liabilities.
- recognize patterns in the way that existing assets and liabilities are managed.
- support decision-making in the areas of investing, financing, and liquidity management.

10.1 INTRODUCTION

With gross and net working capital acting as important indications of a company's liquidity and operational health, an understanding of working capital's nuances is essential to financial management. All of a company's current assets are included in its gross working capital, which gives an indication of how well-equipped it is to pay short-term debt and continue running its business. This include liquid assets like cash and accounts receivable as well as inventories. However, by accounting for short-term commitments, net working capital—which is obtained by deducting current liabilities from current assets—provides a more complex picture. A company's capacity to pay its short-term creditors is indicated by a positive net working capital, whereas a negative number might indicate possible liquidity issues. In financial analysis, creating a timetable that shows changes in working capital over a given time period is quite helpful. This schedule makes it possible to carefully analyze changes in existing assets and liabilities, which helps with forecasting, trend detection, and decision-making. Businesses may enhance operational effectiveness, develop liquidity management techniques, and make well-informed financial decisions that are

essential for long-term growth and stability by understanding these changes.

10.2 WORKING CAPITAL

The quantity of money required to meet an enterprise's running costs is known as working capital. Working capital refers to the money (capital) that is accessible and utilized for an organization's daily activities. In general, it refers to the part of a company's assets that are utilized or connected to its ongoing commercial activities. It describes money that is utilized throughout an accounting period to produce current income that is in line with the main reason for a company's existence.

Estimates of working capital are based on the variety of assets and liabilities seen on a company balance sheet. A corporation can get a better idea of its liquidity in the near future by focusing primarily on its current obligations and balancing them with its most liquid assets.

Another indicator of a business's operational effectiveness and short-term financial stability is working capital. A business may be able to invest in growth and develop if it has a significant positive net worth. A corporation may struggle to expand or make payments to creditors if its current assets are not greater than its current obligations. It may even declare bankruptcy.

"Short term capital" is another name for working capital. "Circulating or revolving capital,""liquid capital,"

10.2.1 Formula for Working Capital

Subtract a company's current liabilities from its current assets to

get working capital. For public corporations, both data are available in the publicly reported financial accounts; however, private companies might not have easy access to this information.

The following is the working capital formula:

Working Capital = Current Assets - Current Liabilities.

It is common to see working capital expressed in dollars. Let's take an example where a corporation has current obligations of $30,000 and current assets of $100,000. That means the operating capital of the firm is supposedly $70,000. This indicates that if the business has to raise money for a certain purpose, it will have $70,000 available to it in the near future.

10.2.2 Nature of Working Capital

The following is a discussion of working capital's nature:

- It is used to pay for bills, labor, and the acquisition of raw supplies.
- Its shape is continually shifting in order to maintain corporate operations.
- Working capital improves an organization's creditworthiness, liquidity, solvency, and reputation.
- It produces the cost components, which include labor, materials, and costs.
- It permits the business to take advantage of the cash discount programs provided by its suppliers.
- Business leaders' morale is raised, and their productivity reaches a peak thanks to it.
- It supports the company's expansion plans and aids in keeping fixed assets operating efficiently.

10.3 TYPES OF WORKING CAPITAL

Working capital essentially comes in four varieties:

- Gross working capital concept
- Net working capital concept
- Fixed or permanent working capital
- Temporary or variable working capital

On the basis of Concept

- Gross working capital concept
- Net working capital concept

Concept of Gross Working Capital

The total amount invested in current assets is referred to as gross working capital. The current assets used by the company provide insight into how working capital is used and how the business is doing financially. In the world of finance, gross working capital is a widely accepted notion.

Total current assets = gross working capital.

Concept of Net Working Capital

Current assets less current liabilities is known as net working capital. Net working capital is the amount that remains after deducting current obligations from current assets. A firm can pay its current liabilities if its net working capital is positive. The idea of net working capital offers a means of measuring a company's creditworthiness.

Current Assets - Current Liabilities equals net working capital.

On the basis of Time

- Fixed or permanent working capital
- Temporary or variable working capital

Permanent Working Capital

Fixed Working Capital is the term for this kind of working capital. The portion of working capital that is permanently locked up in the present assets to maintain the smooth operation of the firm is referred to as permanent working capital. Permanent working capital is the minimal amount of current assets needed to run a firm profitably throughout the year.

Investments needed, for instance, to keep the cash balance or the minimum raw material stock. The size and expansion of the business determine how much permanent working capital is needed. Two other categories can be used to further separate fixed working capital:

Temporary Working Capital

The phrase "variable working capital" describes a transient and varying level of working capital. Variable working capital can fluctuate depending on the type of asset and how much business is being done.

10.4 GROSS WORKING CAPITAL

The total of a company's current assets, or assets that may be converted into cash in less than a year, is its gross working capital. Net working capital, or simply "working capital," is the result of subtracting current liabilities from gross working capital. This makes it a more usable metric for balance sheet research.

The amount of working capital that may be turned into cash within a given accounting period is referred to as the gross working capital concept. Businesses may get a sense of their cash flow by calculating the entire value of this capital. They can determine how many assets are easily convertible into cash at any one time by computing this number.

The total value of a company's current assets is its gross working capital. Nevertheless, the net working capital value—which is even more helpful or a more realistic statistic to evaluate a company's cash flow availability—is produced when the current liabilities are deducted from these current assets.

- The overall worth of a business's current assets is known as its gross working capital.
- Marketable securities, inventories, and accounts receivable are all included in gross working capital.
- Gross working capital is useless by itself since it only provides a partial view of a company's liquidity.
- Working capital, which is a genuine representation of a company's liquidity and capacity to satisfy its short-term commitments, is calculated by adding current liabilities to the equation.
- Similar to other financial metrics, gross working capital gains significance when a business monitors its fluctuations over time or evaluates its numbers in relation to its rivals.

Determining the company's liquidity condition using gross working capital is challenging. It solely takes into account the short-term capital invested in the company, which may be converted into cash in less than a year.

The short-term financial liabilities, such as those owed to the supplier of raw materials, unpaid labor compensation, and other outstanding payments to the firm, are not taken into consideration. Therefore, we must take the net-working capital into account when evaluating the company's liquidity.

In summary, while gross working capital might be a useful indicator of a company's immediate financial health, it is not a reliable indicator of the company's precise financial status. In reality, even if a business appears to have a healthy gross working capital in its records, it may be deeply in trouble. Therefore, what should be taken into account instead is total current assets adjusted to current liabilities.

10.4.1 Components of Working Capital

There are several components that make up gross working capital, some of which are as follows:

Cash and cash equivalents: Cash and cash equivalents refer to the total amount that the company has invested, including short-term securities, petty cash, and cash in bank accounts.

Recipients in accounts: It is the amount that the business is expected to get from its client, as the name suggests. This category includes any sum owed to third parties.

Inventory: Total goods and stuff that need to be sold are included in inventory. All items needed for manufacturing, be they raw materials, objects needed for processing, or the completed goods themselves, fall under the inventory category.

Marketable securities: Marketable securitiesare financial assets that are easily convertible into cash at any time by being bought and sold on the open market. These securities include mutual funds, stocks, and bonds.

10.4.2 Mathematical formula

The following is the mathematical formula that is used to determine gross working capital:

Gross Working Capital Formula = Total Value of Current Assets

Gross Working Capital Formula = Receivables + Inventory + Cash and Marketable Securities + Short Term Investments + Any other Current Asset

To comprehend gross working capital and learn how to calculate it, let's look at the following example:

The following are quotes from Apple Inc.'s annual 10k filing that was submitted to the US Securities and Exchange Commission:

Example of Gross Working Capital -

CONSOLIDATED BALANCE SHEETS - USD ($) $ in Millions	Sep. 28, 2019	Sep. 29, 2018
Current assets:		
Cash and cash equivalents	$ 48,844	$ 25,913
Marketable securities	51,713	40,388
Accounts receivable, net	22,926	23,186
Inventories	4,106	3,956
Vendor non-trade receivables	22,878	25,809
Other current assets	12,352	12,087
Total current assets	162,819	131,339
Non-current assets:		
Marketable securities	105,341	170,799
Property, plant and equipment, net	37,378	41,304
Other non-current assets	32,978	22,283
Total non-current assets	175,697	234,386
Total assets	338,516	365,725
Current liabilities:		
Accounts payable	46,236	55,888
Other current liabilities	37,720	33,327
Deferred revenue	5,522	5,966
Commercial paper	5,980	11,964
Term debt	10,260	8,784
Total current liabilities	105,718	115,929
Non-current liabilities:		
Term debt	91,807	93,735
Other non-current liabilities	50,503	48,914
Total non-current liabilities	142,310	142,649
Total liabilities	248,028	258,578
Commitments and contingencies		
Shareholders' equity:		
Common stock and additional paid-in capital, $0.00001 par value: 12,600,000 shares authorized; 4,443,236 and 4,754,986 shares issued and outstanding, respectively	45,174	40,201
Retained earnings	45,898	70,400
Accumulated other comprehensive income/(loss)	(584)	(3,454)
Total shareholders' equity	90,488	107,147
Total liabilities and shareholders' equity	$ 338,516	$ 365,725

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By summing up all of the company's current assets, we can determine Apple Inc.'s gross working capital based on the provided figures.

As a result, the company's current assets as of September 2019 are valued at US$162,819 million.

Additionally, the business has short-term debt of US$105,718

million.

Therefore, the company's net-working capital (current assets less current liabilities) is US$57,101 million. Given that the company has 1.5 times the value of its total assets as its financial obligations, it appears to be in a strong liquidity situation.

10.5 NET WORKING CAPITAL

The difference between a company's current assets and current liabilities on its balance sheet is known as net working capital, or NWC. It is a gauge of a company's liquidity and capacity to pay for both ongoing business operations and short-term commitments. Having a positive net working capital balance, or having more current assets than current liabilities, is the ideal situation.

The most popular method for calculating NWC is to solely include the present fraction of debt and cash.

10.5.1 Important Points

- The idea of net working capital is crucial for both corporate analysis and the way it affects cash flow projections.
- Non-cash current assets less non-debt current liabilities is the formula that is most frequently used.
- Determining whether the business is utilizing or producing cash from its working capital requires an understanding of the net working capital calculation.

10.5.2 Formula for Net Working Capital

Various techniques exist for determining net working capital, contingent upon the elements an analyst want to incorporate or omit from the computation.

Method:

Net Working Capital = Current Assets – Current Liabilities

or

Net Working Capital = Current Assets (less cash) – Current Liabilities (less debt)

or

NWC = Accounts Receivable + Inventory – Accounts Payable

The formula above that includes all accounts is the broadest; the formula that includes only three accounts is the narrowest; and the formula that includes all accounts is the most narrow. The Financial Analyst Training Program at CFI has further information.

10.5.3 Creating a Schedule for Net Working Capital

The actions an analyst would take to forecast NWC using an Excel schedule are listed below.

First Step

Refer to the income statement's sales and cost of goods sold for each of the pertinent periods at the very top of the working capital schedule. These are going to be utilized in a later step to anticipate the working capital accounts by computing drivers.

Step Two

The necessary balance sheet accounts should be shown under sales and cost of goods sold. Divide the current liabilities and assets into two divisions. Don't forget to subdivide cash from current assets and any current debt into current liabilities. Organize the accounts according to their appearance on the balance sheet for consistency and clarity.

Step Three

For both total non-debt current obligations and total non-cash current assets, create subtotals. To get the final amount for net working capital, subtract the latter from the former. If the information below is useful, add another line to the calculation to see if net working capital increased or decreased from the prior period to the present one.

Step Four

Add historical data to the schedule by hardcoding data into the net working capital schedule or by referring to the appropriate data in the balance sheet. Use the balance sheet as a reference to add forecast data to the schedule if one has previously been generated with future predicted periods available.

Step Number Five

Provide a section outlining the drivers and underlying assumptions for the primary assets if future periods for the current accounts are not available. Calculate drivers and assumptions for future periods using the previous data. For a list of typical drivers used to calculate particular line items, see the information below. Lastly, compute the line items' future values using the drivers that have been created and your assumptions.

10.6 COMPARING NET AND GROSS WORKING CAPITAL

The ideas of gross and net working capital are important in figuring out how much cash the firms have on hand right now. They do, however, vary from one another in a number of ways. The distinction between gross and net working capital will be

examined in the sections that follow:

The whole of the company's current assets that are tradable within a year is known as gross working capital. Conversely, net working capital is the amount that separates the company's current liabilities from its current assets.

Businesses can evaluate the anticipated cash flow associated with working capital in a given accounting period by looking at the gross value of that capital. In summary, it shows the entire amount of money that is now accessible to finance assets as needed. Conversely, net working capital provides a more realistic picture of the company's ability to pay its current liabilities, or short-term financial commitments. A positive net working capital is shown when the company's current assets exceed its current liabilities. Having more assets than liabilities indicates that the firm is in a favorable situation with regard to liquidity. On the other hand, the negative networking shows that there are not enough current assets for the company to meet its short-term financial obligations.

While net working capital is obvious when it comes to accounting systems, gross working capital is important in financial management.

10.7 PREPARATION OF SCHEDULE OF CHANGES IN WORKING CAPITAL

The process of creating a schedule of changes in working capital is methodically examining variations in the current assets and liabilities of a business over a given time frame, usually quarter or year. This schedule is an essential tool for financial analysis since

it offers information on the company's overall financial health, operational effectiveness, and liquidity management. Here's how to create one, step-by-step instructions included:

Compile Financial Information: Gather the balance sheets and other required financial statements for the periods being examined. Make sure the information is current and correct.

Determine Working Capital Components: List the current assets and current liabilities that make up working capital, such as cash, accounts receivable, inventory, and accounts payable and short-term debt.

Determine Changes in Current Assets: Determine the change in each current asset component from the start of the period to its conclusion. This entails deducting the starting and ending balances of the current asset balances from each other.

Compute Changes in Current Liabilities: Compute the changes in each of the current liabilities' components throughout the same time period. Take the beginning and ending balances of the current liabilities and subtract them from each other.

Get the schedule ready: To show the changes in working capital for each component, make a table or spreadsheet. Add columns for the balances at the start and end of the period, any adjustments made during that time, and any pertinent remarks or justifications.

Examine the Changes: Examine how working capital has changed overall and for each component separately. Examine the company's financial management for any trends, patterns, or anomalies that could point to areas of strength or weakness.

Analyze the Results: Evaluate the timetable in light of the overall financial performance and strategic goals of the organization. Think about the potential effects of working capital adjustments on profitability, liquidity, and potential future growth.

Make Recommendations: In light of the study, suggest ways to enhance overall financial performance, maximize liquidity, and manage working capital better. These suggestions might entail modifying the amount of goods on hand, enhancing the procedures for collecting payments, or renegotiating terms of payment with suppliers.

Monitor and Review: To evaluate the success of management goals and plans, periodically review the schedule and keep a close eye on changes in working capital over time. Changes in market dynamics and company situations may call for adjustments.

By using these simple steps, companies may efficiently create a working capital calendar and use it as an important tool for performance management, financial analysis, and decision-making.

10.8 LET US SUM UP

In financial management, the idea of working capital—which includes both gross and net working capital—is essential. A company's capacity to satisfy short-term obligations and continue with daily operations is reflected in its gross working capital, which is the entirety of its current assets. By taking into account short-term commitments, net working capital—which is computed by subtracting current liabilities from current assets—offers a more detailed picture. The process of creating a working capital schedule

is methodically examining variations in current assets and liabilities over a certain time frame. This schedule is an essential tool for financial analysis since it offers information on managing liquidity, optimizing operations, and assessing overall financial health. Businesses may improve liquidity, sustain growth and stability, and optimize their financial plans by appropriately measuring changes in working capital.

10.9 KEY WORDS

Gross working capital: Gross working capital is the entire amount of current assets utilized by a business to support its daily operations, such as cash, accounts receivable, inventories, and other liquid assets.

Net Working Capital: After short-term commitments are taken into account, a company's net working capital, or liquidity position, is determined by subtracting its current liabilities from its current assets.

Preparation: The act of organizing or preparing something for a certain task or activity is called preparation.

Schedule: A schedule is a plan or timetable that shows the order of occurrences and their corresponding times.

Changes: The alterations or adjustments that take place in a certain circumstance or state over a predetermined length of time.

Analysis: Analysisis the methodical process of looking over and

assessing facts or information in order to find trends, make inferences, or obtain new insights.

Liquidity management: The strategic management of an organization's assets and liabilities to guarantee that it has enough cash and liquid resources to cover its immediate financial commitments is known as liquidity management.

Operational efficiency: Operational efficiency is the skill with which a business uses its resources to manufacture products or provide services with the least amount of waste and expense.

Optimization: Optimization is the act of maximizing desirable results and decreasing unwanted ones in order to make anything as effective, useful, or efficient as feasible.

10.10 REVIEW QUESTIONS

Q1. What is the meaning of working capital, and why is it important for businesses?

Q2. Can you explain the concept of gross working capital and provide examples of its components?

Q3. How does net working capital differ from gross working capital, and what does it indicate about a company's financial health?

Q4. Why is the preparation of a schedule of changes in working capital crucial for financial analysis?

Q5. What are the key steps involved in preparing a schedule of changes in working capital?

Q6. How does analyzing changes in working capital help businesses make informed financial decisions?

Q7. What factors might cause fluctuations in working capital, and how can businesses mitigate risks associated with these changes?

Q8. How often should a company review and update its schedule of changes in working capital, and why?

UNIT-11: PREPARATION OF FUNDS FLOW STATEMENT AND ITS ANALYSIS;

STRUTURE

11.0 OBJECTIVES

After studying this unit you should be able to

- recognize how a company's financial situation has changed over a certain time frame. It aids in determining the funding's origins and purposes, or where the money came from and was spent.
- contributes to efficient financial management by offering information on capital structure, liquidity, and solvency.
- helps in analyzing working capital fluctuations, which is important for determining a company's short-term liquidity and operational effectiveness.
- aids in evaluating the viability of different funding options and investment initiatives.

11.1 INTRODUCTION

A company's financial health and operational efficiency may be better understood by companies, investors, and financial analysts with the help of the production and analysis of a funds flow statement. Fundamentally, a Funds Flow Statement is a detailed financial record that follows the flow of money inside a firm for a given time frame, usually a quarter or a fiscal year.

First and foremost, creating a money Flow Statement entails a methodical analysis of the sources and uses of money, providing insight into the origins of capital and its distribution within the organization. Changes in the financial situation are reflected in this statement, which also clarifies important factors including liquidity, solvency, and total capital structure.

Furthermore, examining a funds flow statement provides important information about a company's cash flow trends. The Funds Flow Statement reveals trends in cash inflows and outflows and focuses exclusively on cash movements, in contrast to standard financial statements such as the Income Statement, which highlight profitability. Businesses may strengthen their forecasting skills and improve their cash management methods by examining these tendencies.

Moreover, the Funds Flow Statement makes it easier to do a thorough evaluation of working capital. This assessment is essential for determining operational effectiveness and short-term liquidity, allowing businesses to fine-tune their working capital management strategies for best results.

The Funds Flow Statement also acts as a benchmark for assessing finance and investment choices. Businesses can examine how these choices will affect their cash flow and assess the merits of different financing options and investment initiatives.

Furthermore, this financial record is essential for encouraging open dialogue with stakeholders. The Funds Flow Statement is used by creditors, shareholders, and other interested parties to assess a company's financial strength, capacity to raise capital, and skill in effectively managing it.

Finally, firms may use Funds Flow Statements from various periods to compare and contrast them in order to spot patterns, strengths, and weaknesses. Decision-makers are equipped with vital insights for strategic planning and well-informed decision-making thanks to this comparative method.

A thorough knowledge of cash flow dynamics, working capital management, and overall financial performance may be gained by preparing and analyzing a funds flow statement, which serves as a guide for navigating the financial world. Equipped with these discernments, enterprises may steer clear of obstacles and achieve long-term prosperity.

11.2 FUNDS FLOW STATEMENT

As everyone knows, the goal of creating financial statements using the income statement, profit and loss account, and balance sheet is to provide as much financial information as possible to the people who will be using the financial statements. Without a doubt, the Income Statement and the Balance Sheet perform admirably in

serving such fundamental goals.

Through the assets (which demonstrate the development of resources in various types of properties) and liabilities (which show how these resources were used), the balance sheet presents the financial situation at the conclusion of the period.

In contrast, the Income Statement evaluates the operation's outcomes at the conclusion of the period, namely the shift in owner's equity as a consequence of the period's productive and commercial activities.

Therefore, even if there are additional important relationships between the two Balance Sheets (the opening and closing accounting periods) that the customary above two statements are unable to provide any more light on, the aforementioned two statements are still highly helpful.

To this end, it becomes imperative to ascertain the available money for the duration and use of the same, in addition to the profit derived from the business operations. Therefore, it is required to compile a statement known as a Funds Flow Statement, which will present such financial information to the readers of financial statements, in order to know such changes in the financial situation.

11.3 THE FUNDS FLOW STATEMENT CONCEPT:

The definition of "fund" is necessary in order to comprehend the Funds Flow Statement, despite the fact that the term has several

meanings and interpretations. The name has been used in a variety of ways by different writers and accountants, such as Cash Fund, Capital Fund, Working Capital Fund, etc.

To put it another way, they have been interpreted in a number of ways, including:

(A) Fund for Cash:

Since "the amount of Cash" is synonymous with "Cash," some people interpret it in a cautious or limited meaning (i.e., un-deposited cash + demand deposits at bank). A fund statement is a statement that serves as a "Cash Flow Statement," evaluating different kinds of cash transactions. Some others believe that cash should be added together with marketable securities.

(b) Fund for Net Monetary Assets:

Other accountants hold different opinions on the quantity of cash. Along with such a cash fund, short-term receivables, marketable and bank securities, and secondary cash reserves should be included.

(c) Capital Investment Fund:

Some use the term "fund" more broadly to refer to all of the resources used by the company. It is seen as purchasing power, spending power, or all financial resources that come from the firm's external rather than internal activities, as several authors have noted. To put it succinctly, this fund comprises the monetary assets that impact areas other than working capital.

(d) Fund for Working Capital:

Others believe that, especially when creating a Funds Flow Statement, the amount of Net Working Capital—that is, the excess

of current assets over current liabilities—should be regarded as "Fund." The main argument against this viewpoint is that cash is seen to be similar to stock, debt, and short-term investments.

For this reason, rather than include the changes of each individual item, the aggregated changes of the several components that make up the fund are taken into account when creating the Funds Flow Statement. The transactions that are restricted to working capital alone have no bearing on this statement.

11.4 PREPARE A FUND FLOW STATEMENT

A balance sheet and a profit and loss statement are already included in a company's financial statements. What is the purpose of a money flow statement, then?

- A company's financial condition will be displayed on a profit and loss and balance sheet, but these documents do not provide an explanation for any variances or volatility in the company's cash or financial situation.
- A balance sheet and profit and loss statement will provide two sets of numbers from the prior and current year, but they won't explain why there has been change in the numbers.

Example

XYZ Company

Funds Flow Statement

For the Year Ended [Date]

Sources of Funds	Amount ($)	Uses of Funds	Amount ($)
Cash from Operating Activities	XXXX	Investments in Fixed Assets	XXXX
Proceeds from Sale of Assets	XXXX	Repayment of Long-term Debt	XXXX
Issue of New Shares	XXXX	Payment of Dividends	XXXX
Borrowings	XXXX	Working Capital Investments	XXXX
Other Sources	XXXX	Other Uses	XXXX
Total Sources	XXXX	Total Uses	XXXX
Net Change in Funds	XXXX		

In this example:

Sources of Funds: This section lists all the inflows of funds into the company. These could include cash generated from operating activities, proceeds from the sale of assets, new share issuances, borrowings, and any other sources of cash.

Uses of Funds: This section details all the outflows of funds from the company. These could include investments in fixed assets, repayment of long-term debt, dividend payments to shareholders, investments in working capital, and any other uses of cash.

Total Sources and Total Uses: These lines represent the sum total of all sources and uses of funds, respectively.

Net Change in Funds: This line calculates the net change in funds by subtracting the total uses of funds from the total sources of funds. It represents the overall increase or decrease in the company's funds during the specified period.

Please note that in a real-world scenario, the Funds Flow Statement would likely include more detailed information and additional categories based on the specific financial activities of the company. Additionally, it's important to ensure accuracy and consistency with accounting principles and standards while preparing financial statements.

11.5 ANALYZING A FUNDS FLOW STATEMENT

Analyzing a Funds Flow Statement involves interpreting the movement of funds within a company to gain insights into its financial health, operational efficiency, and strategic decisions. Here's how you can analyze a Funds Flow Statement:

Assess Sources and Uses of Funds: Start by examining the sources and uses of funds listed in the statement. Identify the primary sources from which funds were generated, such as operating activities, asset sales, new share issuances, and borrowings. Similarly, identify the key uses of funds, including investments in fixed assets, debt repayments, dividend payments, and working capital investments.

Evaluate Changes in Working Capital: Analyze changes in working capital by comparing current assets (e.g., cash, accounts receivable, inventory) and current liabilities (e.g., accounts

payable, short-term debt) over time. Positive changes in working capital indicate an increase in liquidity, while negative changes may suggest liquidity challenges.

Assess Cash Flow Patterns: Examine the patterns of cash inflows and outflows to understand the company's cash flow dynamics. Determine whether cash generated from operating activities is sufficient to fund investments and debt obligations. Analyze the proportion of cash flow allocated to different activities to assess the company's priorities and financial management strategies.

Evaluate Financing and Investment Decisions: Assess the impact of financing and investment decisions on the company's financial position. Evaluate the effectiveness of capital-raising activities, such as share issuances and borrowings, in meeting funding requirements. Analyze the allocation of funds to investments in fixed assets and working capital to determine their contribution to business growth and profitability.

Monitor Debt Levels and Repayment Capacity: Evaluate the company's debt levels and its capacity to repay debt obligations. Compare the amount of funds raised through borrowings with the repayment of long-term debt to assess the company's leverage and debt management practices. Monitor changes in debt-to-equity ratios and interest coverage ratios to gauge the company's financial stability and risk exposure.

Assess Dividend Policy: Analyze dividend payments relative to cash flow generated from operations to assess the company's dividend policy and its impact on shareholder returns. Evaluate the sustainability of dividend payments based on the company's cash flow generation and capital expenditure requirements.

Compare with Previous Periods and Industry Benchmarks: Compare the current Funds Flow Statement with previous periods to identify trends and changes in financial performance. Benchmark the company's financial metrics against industry peers to assess its relative performance and identify areas for improvement.

Consider Non-Financial Factors: In addition to financial metrics, consider non-financial factors such as market conditions, industry trends, and strategic initiatives when interpreting the Funds Flow Statement. These factors can provide context and insights into the company's financial performance and future prospects.

By conducting a thorough analysis of the Funds Flow Statement, stakeholders can gain valuable insights into the company's financial performance, capital allocation decisions, and overall financial health, enabling informed decision-making and strategic planning.

11.6 LET US SUM UP

An essential part of a business's financial management process is creating and analyzing a funds flow statement. This document carefully outlines the sources and uses of funding for a given organization during a given time frame. When it comes to preparation, a thorough analysis of cash inflows—such as operational operations, asset sales, and financing sources including borrowings and stock issuances—as well as outflows—such as investments, debt repayments, and dividend distributions—are conducted. After everything is said and done, the study of the

Funds Flow Statement provides priceless information about the state of the company's finances, liquidity, and strategic choices. It makes it easier to assess the dynamics of working capital, cash flow trends, and the success of financing and investment plans. Furthermore, trend identification and development opportunities are facilitated by comparing analysis against industry standards or historical eras. In addition, evaluating non-financial aspects in addition to financial indicators deepens the analysis and empowers stakeholders to devise well-informed choices and strategic plans for long-term prosperity and expansion.

11.7 KEY WORDS

Sources of Funds: The origins of capital inflows into a company, including operating activities, asset sales, borrowings, and equity issuances.

Uses of Funds: The destinations or purposes of capital outflows from a company, encompassing investments, debt repayments, dividend payments, and working capital expenditures.

Cash Flow Dynamics: The patterns and movements of cash inflows and outflows within a company, indicating its ability to generate and manage cash effectively.

Financing Decisions: Choices made by a company regarding how to raise capital, such as through debt financing (borrowings) or equity financing (issuing shares).

Investment Decisions: Choices made by a company regarding where to allocate capital, typically towards investments in fixed assets (property, plant, equipment) or working capital.

Debt Repayment Capacity: The ability of a company to meet its debt obligations, assessed by comparing the amount of funds raised through borrowings with the repayment of long-term debt.

Comparative Analysis: The process of comparing financial data over different periods or against industry benchmarks to identify trends, patterns, and areas for improvement.

Non-Financial Factors: Additional considerations beyond financial metrics, such as market conditions, industry trends, and strategic initiatives, that can impact a company's financial performance and decision-making.

11.8 REVIEW QUESTIONS

Q1. What are the primary sources of funds that can be included in a Funds Flow Statement?

Q2. Describe the process of preparing a Funds Flow Statement. What are the key steps involved?

Q3. What are the typical uses of funds that can be identified in a Funds Flow Statement?

Q4. Explain the significance of working capital in the context of a Funds Flow Statement analysis.

Q5. Describe the impact of investment decisions on a company's Funds Flow Statement.

Q6. Why is it important to compare a company's Funds Flow Statement with industry benchmarks or previous periods? What insights can be gained from such comparisons?

Q7. How can the analysis of a Funds Flow Statement contribute to strategic planning and decision-making within a company?

Q8. What are some potential limitations or challenges associated with preparing and analyzing a Funds Flow Statement?

Q9. How can stakeholders, such as investors and creditors, use the information provided in a Funds Flow Statement to assess a company's financial performance and prospects?

UNIT-12: VARIOUS CASH AND NON-CASH TRANSACTIONS, FLOW OF CASH, PREPARATION OF CASH FLOW STATEMENT AND ITS ANALYSIS.

STRUTURE

12.0 OBJECTIVES

After studying this unit you should be able to

- Pay for products or services delivered right away. Since cash is transferred immediately, the transaction is completed quickly.
- give parties involved privacy and anonymity to both the payment and the payee because they don't leave an electronic trace.
- assist parties in avoiding the transaction costs connected to using electronic payment systems.
- Electronic records of transactions are automatically created, making record-keeping simple for all parties involved. This helps with financial management, accounting, and budgeting.
- demonstrating how well the company uses its cash resources, it offers insights into its financial health.
- evaluates how well a business turns sales into cash by comparing its operational cash flow to net sales.

12.1 INTRODUCTION

Modern economies rely heavily on cash and non-cash transactions to facilitate the exchange of financial assets, products, and services. Cash transactions are straightforward exchanges of actual money that offer both parties ease of use and quick payment. They are especially helpful in emergency situations or when electronic payment alternatives are not accessible. They also provide secrecy and simplicity. However, non-cash transactions cover a broad spectrum of digital or electronic payment options, including mobile wallets, electronic financial transfers, and credit/debit card payments. These transactions are crucial for distant transactions and the integration of the digital economy because they provide simplicity, security, and ease of record-keeping. In addition, non-cash transactions are important for establishing credit, advancing

loyalty plans, and improving financial management with features like real-time tracking and automated bill payment. In today's connected world, cash and non-monetary transactions serve different functions and satisfy the varied demands and preferences of people and enterprises.

A company's ability to satisfy its financial obligations, invest in expansion prospects, and weather economic uncertainty is largely dependent on its cash flow. A vital component of financial reporting is the creation of a cash flow statement, which provides a detailed picture of the company's cash inflows and outflows over a certain time period. Cash flows from financing, investing, and operating operations are usually included in this statement. Critical information about the company's liquidity, financial stability, and operational effectiveness may be obtained by analyzing the cash flow statement. A company's capacity to generate cash, pay its debts, and provide value for investors may be evaluated by stakeholders by looking at indicators including operating cash flow ratios, free cash flow, and cash flow adequacy. In addition, evaluating a company's strengths, shortcomings, and opportunities for progress through comparison with industry standards and historical patterns aids in strategic decision-making and guarantees the company's long-term viability.

12.2 TYPES OF TRANSACTION

Transactions fall into two categories:

1 Cash Transaction and

2 Non-cash Transaction

12.3 CASH TRANSACTION

Any exchange of money between parties is referred to as a "cash transaction". Cash transactions often occur in retail establishments when customers make in-store cash payments. Coins or paper money are two examples of cash.

When an asset is purchased, cash must be paid for it right away. This is known as a cash transaction. It is not the same as other kinds of transactions including forward contracts, futures contracts, credit transactions, and margin transactions that entail delayed delivery of the purchased goods or delayed payment for the item.

- The instantaneous payment of cash for the acquisition of an asset is known as a cash transaction.
- Even though the trade might not settle for several days, certain market stock transactions are regarded as cash transactions.
- A futures contract is not regarded as a financial exchange.
- Comprehending a Financial Transaction

A monetary transaction might mean several things to various people. In essence, it is the receiving of an item in return for an instant cash payment. Market stock transactions fall under some criteria as cash transactions since they occur in the marketplace almost instantaneously at whatever the going rate is at that particular moment. Even if the deal might not settle for a few days, it is conducted, and the parties exchange money for shares.

A futures contract, on the other hand, is not regarded as a cash transaction. Even when the parties agree on the item's price and quantity when they sign the contract, the money is not exchanged

and the item is not delivered right away. Using a credit card to make a purchase is not seen as a cash transaction since the buyer does not pay for the item until they have paid their credit card bill, which might take a long time. Certain definitions of a cash transaction require that the deal be completed in its entirety on the trade date, including the delivery of payment.

When an asset is purchased, cash must be paid for it right away. This is known as a cash transaction. It is not the same as other kinds of transactions including forward contracts, futures contracts, credit transactions, and margin transactions that entail delayed delivery of the purchased goods or delayed payment for the item.

Cash transactions have the primary benefit of being instantaneous; both the seller and the buyer get money at the same moment and the customer obtains the products or services. Since cash transactions don't involve the use of a credit card or bank account, they are also quite handy. Cash transactions have one major drawback: they are dangerous; if the buyer does not have enough cash, the seller could not get paid.

Any exchange of money between parties is referred to as a "cash transaction". Cash transactions often occur in retail establishments when customers make in-store cash payments. Coins or paper money are two examples of cash.

Cash purchases: Cash purchases are made when you use actual money, such coins or banknotes, to pay for products or services.

Cash Sales: When you get paid in hard money for products or services that you have sold.

Cash withdrawals: Taking cash out of a bank account over the counter or via an ATM.

Cash deposits: Transferring funds into a bank account electronically, over the counter, or through an ATM.

Cash Payments: Using actual money to pay off obligations or expenses.

Cash advances: Using a credit card at an ATM or bank branch to obtain cash.

12.4 NON-CASH TRANSACTION

Non-cash transactions do not include the exchange of cash. Payments other than cash can be made with cheques, debit cards, or credit cards.

Non-cash transactions include, for example:

Contracts for forwarding: A contract to purchase or sell an item at a later time. Although the asset might be anything, it is often a financial asset like a stock, commodity, or money.

Contracts for options: A contract that grants the holder the option—but not the duty—to purchase or sell an item at a given price on or before a given date. Contracts for options are frequently employed as a hedge against the risk of changes in the underlying asset's price.

Contracts for futures: A contract that requires the seller to sell

and deliver an item at a certain price on a given future date, and the buyer to acquire it at that price. Contracts for futures are frequently used as a hedge against the risk of changes in the underlying asset's price.

Changes: A financial arrangement known as a credit default swap (CDS) shifts the credit risk associated with a financial asset from one party to another. A CDS can be used to speculate on the likelihood of default or to hedge against the risk of default on a financial obligation.

Electronic methods, including the following, can also be used to pay for products and services:

- Credit histories
- Debit cards
- ACH transactions
- Transfers via wire
- electronic bank transfers
- The cryptocurrency

The primary benefit of electronic payments is their security and safety. Because they may be done anywhere in the globe, electronic payments are also quite handy. The primary drawback of electronic payments is their potential for processing delays of many days.

12.5 KEEPING TRACK OF CASH TRANSACTIONS

When you manage a brick and mortar business, you have to keep track of your retail sales and earnings. For this reason, keeping a

record of every monetary transaction is crucial.

Cash sheets, POS data, sales receipts, and bank reconciliation are some of the methods available for doing this.

1. Receipts for sales

Using your sales receipts is one method of documenting monetary transactions. It is necessary to record each cash transaction chronologically and total sales receipts in a chronological manner.

Record all of your bills and receipts in a cash diary. A cash notebook keeps track of every credit sale a company makes. The sale date, the buyer's name, the goods' description, the selling price, and the sales tax should all be included in a journal entry.

Here's an illustration of a cash journal.

Cash Receipt Journal Entry

Date	Account Credited	Ref	Explanation	Cash Dr.	Sales Discount Dr.	Accounts Receivable Cr.	Sales Cr.	Other Accounts Cr.
1/5/2018	Sales			200	3	105	50	100
2/6/2018	B & Co.			150	2	100	50	100
5/6/2018	Sales			155	3	115	30	80
10/8/2018	B & Co.			150	2	100	20	100
Total				**655**	**10**	**420**	**150**	**380**

A spreadsheet with a date list of all transactions and totals from the cash drawer for each transaction.

The cash receipt journal can be used as follows:

- **Date:** Note the day on which you got the money.
- **Credited account:** Enter the name of the account that was credited with the cash transaction.
- **Ref:** Type any numbers that are internal references.

- **Justification** Jot down a brief justification for the monetary transaction.
- **Cash dr:** In the general ledger, note the amount of cash received.
- **Sales discount:** Make a note of any savings the customer receives.
- **Receivables Cr:** Note the sum that has been credited to a client's account.
- **Sales cr:** Enter the amount of the cash sale.
- **Additional accounts cr:** Keep track of money received from other sources, such as rent or interest.

2. **Reconciling banks**

You may also keep track of your funds by doing a bank account reconciliation. To make sure there are no inconsistencies, you compare your bank statements with your documentation. Not only cash, but a summary of all your transactions would be provided. Regardless of when the money was received or paid, reconciliation needs to be performed each month.

To reconcile your bank statements, do the following eight measures:

- Understanding your final bank balance is the first step in balancing your accounts.
- To check your ending balance, make sure you have your most current statement or have signed into your online banking account.
- Check your documentation against the final bank balance: Examine your own transaction records, which are often stored in the form of receipts, credit card statements, or checkbook

registers, and make sure they match the transactions on your bank account. Any disparities ought to be looked upon.

- Ensure that your records reflect any overdue checks: Make careful to subtract any checks you have written from your records if the bank has not yet cleared them.
- Modify your records to reflect deposits that are en route: Make careful to include any deposits you have made in your records if they haven't yet been withdrawn by the bank.
- Make sure your records reflect any interest or bank service fees. Any interest or service fees applied to your account can be added or subtracted.
- Reconcile discrepancies: Look into any discrepancies that exist between the bank statement and your records to ascertain the reason.
- Make the required changes to your documentation: Make the required modifications after you have looked into and identified the reason for any discrepancies.
- Update your ending bank balance: Make sure to make any necessary modifications to your bank balance in your records.

3. **Bank statements**

Businesses use cash sheets, which are records of cash transactions, to monitor their cash inflows and outflows. Petty cash, bank balances, and available cash can all be tracked on the cash sheet.

You can determine whether there is a shortage or excess by maintaining cash sheets. Many companies count cash at the register at the end of the day without maintaining a cash sheet, which leaves them unaware of any discrepancies.

Cash Count Sheet

Department: Month:

Description	Quantity	Amount
Total cash counted		
Cash book balance		
Difference		

Comments

Prepared by: Date:

The date, kind of transaction, amount, and funding source should all be listed on cash sheets. It will assist you in monitoring cash flow and identifying the source of the funds.

Some pointers for utilizing a cash sheet:

Ideally, you should update your cash sheet every day to find any possible inconsistencies.

Track your expenditure and find areas where expenses might be

cut by using the cash sheet.
To help you get ready for impending financial requirements, such payroll or inventory purchases, use the cash sheet.

4. **Point-of-sale (POS)** data By giving details on every sale, POS data can assist in recording cash transactions. The sales diary and the cash receipts notebook can then be filled in with this data.

With a point-of-sale (POS) cash register, sometimes called a store till, you may securely accept and monitor cash payments by combining point-of-sale software with a cash drawer. You can balance your drawer and cut down on inconsistencies by using the cash management capabilities that a point-of-sale system like Shopify provides.

For instance, a cash payments summary showing the total amount of cash paid for all sessions that took place at the chosen location within the specified period of time is visible to you.

12.6 CASH FLOW STATEMENT (CFS)

A cash flow statement monitors the influx and outflow of funds and offers details on the financial stability and operational effectiveness of a business.

The CFS evaluates a firm's ability to create enough cash flow to cover its operational costs and pay off its debt. In other words, it gauges how well a corporation manages its financial situation. The balance sheet and the income statement are enhanced by the CFS, one of the three primary financial statements. This post will explain the structure of the CFS and how to utilize it for company

analysis.

ESSENTIAL NOTES

- A cash flow statement provides an overview of the total amount of money coming into and going out of a business.
- A company's cash management, especially its ability to create cash, is highlighted by the CFS.
- The income statement and balance sheet are enhanced by this financial statement.
- Cash from three sources makes up the majority of the CFS: finance, investment, and operating operations.
- The direct approach and the indirect technique are the two ways to compute cash flow.

12.7 THE USE OF THE CASH FLOW STATEMENT

The cash flow statement provides insight into the sources of a company's funds, the manner in which it is being spent, and the status of its operations. Alternatively called the statement of cash flows, the cash flow statement (CFS) assists creditors in ascertaining the amount of cash on hand—also known as liquidity—that the business needs to cover its debts and pay for operational expenditures. Investors value the CFS equally since it provides information about a company's sound financial standing. As a result, individuals may utilize the statement to help them decide on their investments in a better, more knowledgeable way.

12.8 THE CASH FLOW STATEMENT'S ORGANIZATION

The cash flow statement's primary elements are:

1. Operating activity cash flow
2. Income from Investing Activities
3. The amount of money coming in for financing
4. Non-cash activity disclosure is occasionally included in financial statements produced in accordance with generally accepted accounting principles (GAAP).

Revenue from Day-to-Day Operations

Any sources and uses of funds from business operations are included in the CFS's operational activities. Stated differently, it represents the amount of money that a business makes from its goods or services.

These operational tasks might consist of:

- receipts for products and services sold
- Payment of interest
- Payment of income taxes
- payments given to vendors of supplies and labor that go into manufacturing

  Employee salary and wage payments

- Rent installments
- Any additional forms of operational costs
- Receipts from the sale of debt, equity, or loan instruments are also included in a trading portfolio or investment firm since they are related to business activities.

Cash from operations often reflects changes in cash, accounts receivable, depreciation, inventory, and accounts payable.

Money Received from Investing Activities

Any sources and purposes of funds from an organization's investments are considered investing activities. This category includes asset purchases and sales, vendor and customer loans, and any payments pertaining to mergers and acquisitions (M&A). To put it briefly, adjustments to machinery, assets, or investments have an impact on investment cash.

Since cash is often used to purchase new machinery, real estate, or short-term assets like marketable securities, changes in cash from investments are typically seen as cash-out items. However, for the purpose of determining cash from investing, a company's asset divestment is treated as a cash-in transaction.

Money Received from Financing Operations

The money received from banks and investors, as well as the money distributed to shareholders, is referred to as cash from financing operations. This covers all dividends, buyback payments for shares, and principal repayments for loans provided by the corporation.

Cash-in occurs when capital is raised, and cash-out occurs when

dividends are paid. These are changes in cash from finance. Therefore, a business that offers bonds to the general public gets funding in the form of cash. But the corporation is using less cash when bondholders receive their return. Recall that interest is recorded as an operational activity rather than a finance activity even though it is a cash-out item.

12.9 HOW TO CALCULATE CASH FLOW

Cash flow may be calculated using one of two methods:

1. Direct Method or

2. Indirect method.

12.9.1 Cash Flow Direct Method

Cash payments to suppliers, cash revenues from clients, and cash disbursed for wages are all totaled using the direct approach. For relatively small enterprises that employ the cash basis accounting system, this CFS approach is simpler.

These numbers may also be computed by looking at the net rise or reduction in the accounts using the beginning and ending balances of various asset and liabilities accounts. It is given in an easy-to-understand way.

12.9.2 Method of Indirect Cash Flow

When using the indirect technique, changes arising from non-cash transactions are added to or subtracted from net income to determine cash flow. Changes in a company's assets and liabilities from one period to the next are indicative of non-cash items. In order to determine an accurate cash influx or outflow, the

accountant will thus note any additions and decreases to the asset and liability accounts that must be added to or subtracted from the net income number.

Cash flow must show changes in accounts receivable (AR) on the balance sheet from one accounting period to the next:

If AR declines, it might be because consumers are paying off their credit accounts, which brings in more revenue for the business. This fall in AR is then added to net earnings.

Although the quantities reflected in AR are in revenue, they are not cash, thus a rise in AR must be subtracted from net earnings.

What about adjustments to a business's inventory? They are accounted for as follows on the CFS:

An rise in inventory indicates higher raw material costs for the business. When cash is used, net earnings are reduced by the rise in inventory value.

Net earnings would increase in response to a drop in inventory. On the balance sheet, credit purchases are represented by an increase in accounts payable; the amount of this increase from year to year is added to net earnings.

The same reasoning applies to salary, pre-paid insurance, and taxes due. The difference between the amount due from year to year and what has been paid off must be deducted from net income. Any discrepancies must be added to net earnings if there is a balance that is still due.

12.10 CASH FLOW STATEMENT'S LIMITATIONS

Without more investigation, negative cash flow shouldn't automatically raise alarms. Sometimes a company's decision to grow at a certain point in time—which might be beneficial for the future—results in poor cash flow.

By examining variations in cash flow over time, investors may gain a more comprehensive understanding of the company's performance and determine if it is headed toward bankruptcy or prosperity. It is advisable to evaluate the CFS in conjunction with the other two financial statements (see below).

The income statement and balance sheet are two additional financial statements that may be reconciled using the indirect cash flow approach.

12.11 INCOME STATEMENT VS BALANCE SHEET VERSUS CASH FLOW STATEMENT

A company's performance over time is gauged by the cash flow statement. However, the timing of non-cash transactions cannot influence it as readily. The income statement and the balance sheet may be used to calculate the CFS, as was previously mentioned. The amount derived from the income statement's net profits is what the CFS uses to determine its information. However, they are only taken into account when defining the CFS's operational operations portion. Therefore, the CFS's sections on investment

and financial activities have nothing to do with net earnings.

Depreciation expenditure is included in the income statement even when there isn't a corresponding cash outflow. It is only the distribution of an asset's cost throughout the course of its useful life. A business can pick its depreciation method with some degree of freedom, which affects how the depreciation expenditure appears on the income statement. Contrarily, the CFS is a measure of actual inflows and outflows that is more difficult to manipulate.

Regarding the balance sheet, the net change in the different line items shown on the balance sheet should match the net cash flow recorded on the CFS. This does not include non-cash items such cumulative amortization and depreciation, nor does it include cash and cash equivalents. For instance, make sure to include the 2018 and 2019 balance sheets when calculating cash flow for 2019.

12.12 LET US SUM UP

Cash transactions involve the physical exchange of currency, such as coins and banknotes, for goods, services, or financial activities like withdrawals and deposits. Non-cash transactions, on the other hand, occur electronically, utilizing methods such as credit/debit cards, online banking transfers, direct deposits, mobile wallets, wire transfers, and cryptocurrency transactions. Both types of transactions are essential for facilitating economic activities and managing finances, with cash transactions offering immediate liquidity and non-cash transactions providing convenience and efficiency through electronic means.

The cash flow statement provides a comprehensive summary of the movement of cash within a business over a specific period. It begins with the opening balance of cash and categorizes cash flows into operating, investing, and financing activities. Operating activities involve cash transactions related to the core business operations, such as sales, purchases, and expenses. Investing activities include cash flows related to the acquisition and disposal of long-term assets, like property, equipment, and investments. Financing activities involve cash transactions with owners and creditors, such as issuing stock, repaying loans, and paying dividends. Analyzing the cash flow statement helps stakeholders assess a company's liquidity, solvency, and financial health. Positive operating cash flows indicate the ability to generate cash from core operations, while negative investing cash flows may signify investment in growth opportunities. Conversely, negative financing cash flows might suggest reliance on external financing. By analyzing these trends, investors, creditors, and managers can make informed decisions regarding the company's financial performance and future prospects.

12.13 KEY WORDS

Cash Flow: The movement of cash into and out of a business over a specific period, reflecting its liquidity and financial health.

Cash Flow Statement: A financial statement that summarizes the cash inflows and outflows from operating, investing, and financing activities during a given period, providing insights into a company's cash position.

Physical currency: Tangible form of money, such as coins and banknotes, used for transactions.

Cash purchases: Buying goods or services using physical currency.

Cash sales: Selling goods or services and receiving payment in physical currency.

Cash withdrawals: Removing money from a bank account using methods like ATMs or over-the-counter transactions.

Cash deposits: Putting money into a bank account via methods like ATMs, bank branches, or electronic transfers.

Cash payments: Settling obligations or debts using physical currency.

Cash advances: Obtaining cash from a credit card account, often subject to fees and interest charges.

Electronic: Involving the transfer of data or funds through electronic means.

Credit card: Payment method where funds are borrowed from a financial institution to make purchases, to be repaid later.

Debit card: Payment card linked directly to a bank account, deducting funds immediately from the account upon transactions.

Online banking transfers: Moving money between bank accounts using internet-based banking services.

Direct deposits: Electronic transfer of funds directly into a recipient's bank account, often used for payroll or government benefits.

Electronic bill payments: Settling bills or invoices through online banking or third-party payment platforms.

Mobile wallets: Digital applications that store payment card information and allow for contactless payments via smartphones or other mobile devices.

Wire transfers: Electronic transfer of funds between banks or financial institutions, often used for large transactions or international payments.

ACH transactions: Automated Clearing House transactions involve electronic funds transfers between bank accounts within the United States.

EFT (Electronic Funds Transfer): General term for electronic transactions that move money between accounts, including wire transfers, ACH transactions, and online bill payments.

Cryptocurrency: Digital or virtual currencies that use cryptography for security and operate independently of central banks.

12.14 REVIEW QUESTIONS

Q1. What are the main differences between cash transactions and non-cash transactions?

Q2. Can you explain the difference between cash flow and net income?

Q3. How do you calculate operating cash flow from a company's financial statements?

Q4. What are some common sources of cash inflows and outflows in operating activities?

Q5. How does depreciation affect the cash flow statement?

Q6. Why are cash transactions still prevalent in certain industries despite the rise of non-cash payment methods?

Q7. How do non-cash transactions contribute to the efficiency of financial transactions in a digital age?

Q8. What security measures are in place to protect consumers during non-cash transactions, especially online?

Q9. How do businesses benefit from offering multiple payment options, including both cash and non-cash methods?

Q10. What are the potential risks associated with cash transactions, and how can they be mitigated?

Q11. How do government regulations impact cash and non-cash transactions, particularly concerning taxation and reporting requirements?

Q12. How can a company's cash flow statement be used to assess its liquidity and solvency?